

**China as a 'National Strategic Buyer': Towards a  
Multilateral Regime for Cross-Border M&A**

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Law Working Paper N° 407/2018

June 2018

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## Abstract

Unlike the case of cross-border trade, there is no explicit international governance regime for cross-border M&A; rather, there is a shared understanding that publicly traded companies are generally for purchase by any bidder – domestic or foreign – willing to offer a sufficiently large premium over a target's stock market price. The unspoken premise that undergirds the system is that the prospective buyer is motivated by private economic gain-seeking. The entry of China into the global M&A market threatens the fundamental assumptions of the current permissive international regime. China has become a significant player in the cross-border M&A market, particularly as an acquirer. The central claim of the article is that the cross-border M&A regime will require a new rules-of-the-game structure to take account of China's ascension. This is because cross-border M&A with China introduces a new dimension: what we call the "national strategic buyer" (NSB), whose objective is to further the interests of a nation state in the pursuit of industrial policy or out of national security concerns. Thus, China presents a problem of "asymmetric motives" in the global M&A market: sellers to Chinese firms have private motives for pursuing transactions, while at least some Chinese acquirers have non-economic motivations. Yet distinguishing commercial and financial motives from national strategic motives in Chinese firms is difficult. To date, the only mechanisms for addressing the NSB problem are national security review mechanisms such as the CFIUS process in the United States. Currently there are proposals pending in Congress to expand the CFIUS process. In Europe a proposal to create a basic screening framework at the EU level is pending. But this approach fails to take on the long-term concern of fully assimilating China as a normal actor in the global economic system. To address the NSB problem, we propose adoption of a multilateral regime under which firms subject to potential government influence in their corporate decision-making must demonstrate their "eligibility" to engage in outbound M&A. For covered firms, the regime would require a commitment to exclusively commercial/financial motives in cross-border acquisitions, made credible through a corporate governance set up featuring independent directors (selected by foreign investors) who publicly verify adherence and disclose the source of acquisition financing. Enforcement would consist of a secretariat that can evaluate eligibility and monitor post-acquisition conduct, and national legislation that would permit rejection of an acquisition of a local target by an acquirer that does not meet the eligibility criteria.

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Keywords: Mergers, Acquisitions, Foreign Investment, National Security

JEL Classifications: F02, F21, F52, G34, G53

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**This draft: June 27, 2018**

**ABSTRACT**

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The entry of China into the global M&A market threatens the fundamental assumptions of the current permissive international regime. China has become a significant player in the cross-border M&A market, particularly as an acquirer. The central claim of the article is that the cross-border M&A regime will require a new rules-of-the-game structure to take account of China’s ascension. This is because cross-border M&A with China introduces a new dimension: what we call the “national strategic buyer” (NSB), whose objective is to further the interests of a nation state in the pursuit of industrial policy or out of national security concerns. Thus, China presents a problem of “asymmetric motives” in the global M&A market: sellers to Chinese firms have private motives for pursuing transactions, while at least some Chinese acquirers have non-economic motivations. Yet distinguishing commercial and financial motives from national strategic motives in Chinese firms is difficult.

To date, the only mechanisms for addressing the NSB problem are national security review mechanisms such as the CFIUS process in the United States. Currently there are proposals pending in Congress to expand the CFIUS process. In Europe a proposal to create a basic screening framework at the EU level is pending. But this approach fails to take on the long-term concern of fully assimilating China as a normal actor in the global economic system.

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6/27/18

## **China as a “National Strategic Buyer”: Towards a Multilateral Regime for Cross-Border M&A**

**Jeffrey N. Gordon & Curtis J. Milhaupt\***

### **Introduction**

The current trade dispute with China, framed in terms of the US-China balance-of-trade deficit, causes us to reflect once again on the liberal global economic regime that has been the premise for the post-World War II global order. Economic theory makes it clear that the global welfare-maximizing trade regime would seek to lower trade barriers to permit the pursuit of national comparative advantage in both goods and services. National governments, however, face on-going political and economic pressure from local losers as well as the consequences of local adjustment costs from the global trade regime. Governments may thus incline toward protectionist measures that over time would undo initial commitments to an open trade regime. The on-going maintenance of this liberal global order therefore requires a structure that creates a binding rules-of-the-game framework to constrain national defection and a dispute resolution procedure for settling grievances. Enter the WTO.

The regime for the global movement of capital has been less well developed. The general framework has been permissive and facilitative. At times nations have imposed general capital controls, either outbound (to foster in-country investment; to reduce exchange rate deterioration) or in-bound (to avoid boom/bust economic cycles; to minimize inflation). A somewhat different question arises when global capital flows take the form of a cross-border acquisition, when an acquirer domiciled or headquartered in one country acquires a company domiciled or headquartered in another.

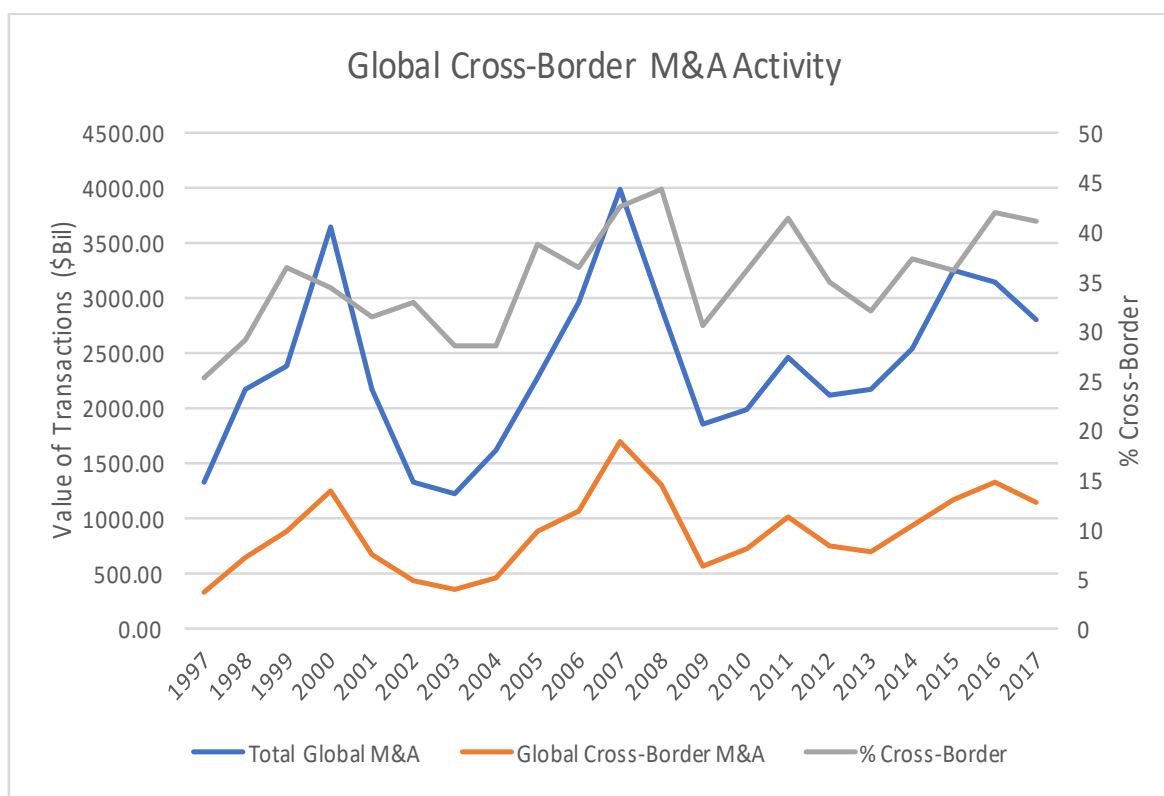
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\* Gordon is the Richard Paul Richman Professor of Law at Columbia Law School; ECGI; Milhaupt is Professor of Law at Stanford Law School; ECGI. We benefitted from an early conversation about this project with Karl Sauvant. We thank Scott Barshay, Ron Gilson, Joe Grundfest, Michael Klausner, Trevor Norwitz, Leo Strine, Alan Sykes, and participants at a Columbia Law School Blue Sky Workshop and a conference at Trinity College Dublin for helpful comments. Maddy Berg (Columbia Law School) and Andres Rovira (Columbia College) provided excellent research assistance. The usual disclaimers apply.



As Figure 1 indicates, cross-border mergers and acquisition activity is a consequential form of global economy activity. In the post-financial crisis recovery years (2014-2017), the annual level of cross-border M&A activity has exceeded \$1 trillion, and the cross-border share of global M&A activity has exceeded 40 percent.<sup>1</sup>

**Figure 1**



Source: Thomson-Reuters Database, author calculations.

Unlike the case of cross-border trade, there is no explicit international governance regime for cross-border M&A; rather, there is a shared understanding that publicly traded companies are generally available for purchase to any bidder – domestic or foreign – willing to offer a sufficiently large premium over a target’s stock market price. This expectation is of course limited by the shifting boundaries of host country protectionism and the prevailing patterns of corporate ownership in different countries. But the unspoken premise that undergirds the

<sup>1</sup> To scale this activity: Trade in merchandise exports and commercial services was approximately \$20 trillion in 2016. See WTO World Trade Statistical Review, at 100 (Table A-4), 107 (Table A-8). The measures are not directly comparable, of course. Among other things, M&A reflects irreversible (or at least long-term) commitments, whereas a significant portion of trade reflects spot market transactions or short-term contracts.

system is that the prospective buyer is motivated by private economic gain-seeking. Some buyers may be “strategic,” seeking economies of scale or scope; and others may be “financial,” looking to maximize immediate cash flows. These differences, which may elicit different target and host country responses, are nevertheless similar in their overarching *private* objectives: Firms and management teams are seeking to advance the economic interests of their private “owners.”

A particular aspect of the implicit assumptions supporting the cross-border M&A regime bears emphasis. It is assumed that the state enters the picture on the target-side only, the “sell side.” That is, the laissez-faire system is subject to state-level decisions that a particular target is not for sale, perhaps because (i) the follow-on business strategy is anticipated to cost jobs in the target’s home country, (ii) the target provides “strategic” infrastructure (like a port or public utility), or (iii) the target is important for “national security” reasons. By contrast, it is assumed that the state does not play a directive role in the acquirer’s decision-making, the “buy side.” Protectionism and other forms of mercantilism have entered as *constraints* on the pecuniary motives of target shareholders, not as *industrial policy imperatives* that outweigh the pecuniary motives of the acquirers. The relatively bounded nature of state action has meant that the permissive international cross-border M&A regime could survive and even thrive without the law-making and enforcement apparatus of a multilateral regime like the WTO.

The entry of China into the global M&A market threatens the fundamental assumptions of the current permissive international regime. The rise of China-related M&A reflects not only consolidation in its domestic economy but, most important, China’s increasing share of cross-border transactions. In 2016, for example, China accounted for \$92 billion of net purchases in cross-border acquisitions, 10 percent of the worldwide total and more than the United States, with \$78 billion.<sup>2</sup> A significant fraction of these transactions related to advanced physical and digital technology, domains of an articulated Chinese state objective to become a world leader.

The central claim of this article is that the cross-border M&A regime will require a new rules-of-the game structure to take account of China’s ascension. This is because cross-border

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<sup>2</sup> UNCTAD, World Investment Report (2017), Annex table 3. Some regard 2016 as an aberrational year, with China outbound M&A spurred by now-curbed activity of a handful of Chinese financial conglomerates. See Joy Dantong Ma, Reversion to the Mean: Why Chinese Investment in the US Did Not, In Fact, Collapse (June 4, 2018), available at <https://macropolo.org/author/joy-ma/> (\$34 billion in US deals by 4 private buyers). However, as Figure 4 below indicates, the focus of outbound Chinese M&A shifted from the US to Europe in 2017.

M&A with a Chinese acquirer adds a new dimension: what we will call the “national strategic buyer” (NSB), whose objective is to further the interests of a nation state in the pursuit of national industrial policy or perhaps national security concerns. Thus, China presents a problem of “asymmetric motives” in the global M&A market: sellers to Chinese firms have private motives for pursuing transactions, while at least some Chinese acquirers have non-economic motivations; they are NSBs. Yet distinguishing commercial and financial motives from national strategic motives with a given Chinese acquirer is difficult: high levels of state ownership, the murkiness of corporate ownership in many cases, and the Communist Party’s extensive levers of influence over all firms, whether “state-owned” (SOE) or “private” (POE), creates the potential for national strategic motives to be involved in many transactions. Moreover, the Chinese government’s recent clampdown on outbound M&A to stem capital flight<sup>3</sup> demonstrates that the government perceives outbound M&A as closely linked to its overall economic strategy, and the administrative procedures associated with outbound M&A as an important tool of government economic control.

A comparison with France may be useful in illustrating the dilemma raised by an NSB: While it may be difficult for a foreign acquirer to gain control of a French firm due to the relatively statist orientation of that country’s economy, the French government is not pursuing a national industrial strategy of targeting foreign firms in order to obtain advanced technologies<sup>4</sup> or regulating the volume of outbound deal flow in service of national economic policy.

While the existence of NSBs in the cross-border M&A market benefits target company shareholders, who are essentially overcompensated for sale of control to the foreign acquirer (because a portion of the premium paid for their shares reflects the perceived industrial policy benefit to the NSB’s home country government), it may cause distortions in the market itself and negative welfare consequences in the target company’s home country. We elaborate on these problems below,<sup>5</sup> but of particular concern is the potential loss of long-term innovative capacity and growth potential of the US economy, as transfer of control over leading-edge technologies to

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<sup>3</sup> See Don Weinland, Capital Crackdown Threatens Wave of Overseas Buyouts, Financial Times, <https://www.ft.com/content/091677dc-f8ec-11e6-bd4e-68d53499ed71>.

<sup>4</sup> Compare Made in China 2025. See *infra* text accompanying notes 36-42.

<sup>5</sup> See *infra* Part V.

NSBs may occur on a scale that diminishes “agglomeration economics”<sup>6</sup> in “industrial districts” like Silicon Valley and shifts the center of innovative gravity from the United States to China.

To date, the only mechanisms for addressing the NSB problem are national security review mechanisms for cross-border acquisitions of domestic targets at the level of separate nation states. In the United States, this mechanism is the so-called CFIUS process.<sup>7</sup> Although the precise mechanisms differ, Australia, Canada and a number of other countries have adopted similar screening regimes. Concern over Chinese acquisitions has prompted recent legislative proposals to reform the CFIUS process. These proposals focus particularly on the need to expand the range of transactions covered by the screening mechanism to include not simply foreign acquisitions of “control,” but joint ventures and other deal structures through which a foreign participant might potentially extract sensitive technology or otherwise exert influence in ways that could harm U.S. national interests. Similar concerns have led to a proposal to adopt a national security screening mechanism at the EU level, where none currently exists.<sup>8</sup>

In our view, this approach, legitimate in the moment, fails to take on the crucial long-term concern of assimilating China as a “normal” actor in the global economic system. A cross-border M&A regime featuring acquirers with asymmetric motives is not stable over the long term. As noted, amendments to the CFIUS regime and comparable initiatives at the EU and member-state level are a likely response. But the national approaches differ in their details, have gaps in coverage, and lack follow-up mechanisms to monitor the behavior of the acquirer once a deal has been cleared. Eventually, the presence of actors in the global M&A market with asymmetric motives will lead to a backlash that could disrupt global capital markets. Indeed, there are already signs of backlash against China building.<sup>9</sup> A multilateral regime to complement the national-level screening mechanisms would prevent country-shopping by NSBs and enhance the predictability and stability of the cross-border M&A market. The US has a particular interest

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<sup>6</sup> Agglomeration economics refers to “the benefits that come when firms and people locate near one another in cities and industrial clusters.” Edward L. Glaeser, ed., *Agglomeration Economics* 1 (2010).

<sup>7</sup> See *infra* text accompanying notes 46-69. For the origins of the Committee on Foreign Investments in the United States in 1975 and its activities for the first 30 years, see George S. Georgiev, *The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security*, 25 *Yale J. Reg.* 125 (2008).

<sup>8</sup> See *infra* text accompanying notes 70-82.

<sup>9</sup> See, e.g., Jonathan Sterns, *Amid China M&A Drive, EU Rushes for Investment-Screening Deal*, *Bloomberg*, March 5, 2018 (quoting a French member of the European Parliament who is leading the body’s deliberations over adoption of an EU-wide screening mechanism, prompted by concerns over China: “It’s the end of European naiveté. We have to have the courage to change things.”).

in fostering the development of a multilateral regime, since it is the major beneficiary of the industrial district effects referred to above. The international diffusion of technological prowess means that country-shopping by Chinese NSBs could permit assembly of a rival center even without acquisition of US targets.

The problem of asymmetric motives could be eliminated through a multilateral regime of mutual contestability – i.e., a requirement that every acquirer in a cross-border deal must itself be susceptible to takeover by a foreign buyer. In such a regime, value-reducing acquisitions to serve national strategic objectives could elicit a hostile bid; this would serve as a check on such state insistence. Such a regime is not politically feasible, however, as demonstrated by the collapse of an effort to agree to such a regime at the EU level almost two decades ago.

This article sets forth the framework for a second-best solution, in which the problem of asymmetric motives can be mitigated through adoption of a multilateral regime under which firms (whether SOE or POE) subject to the potential for direct government influence in their corporate decision-making must demonstrate “eligibility” to engage in outbound M&A. Our proposal contemplates that state-owned-enterprises, firms subject to a golden share held by a governmental body, or privately owned enterprises with governing-party-based internal governance organs would commit to an “eligibility regime” before undertaking acquisitions of foreign firms. This regime would require a *commitment* to own-firm commercial or financial motives in cross-border acquisitions made *credible* through a corporate governance set-up that could verify adherence. We offer an outline for such a regime below. The elements are foreign ownership of a significant block of shares of the acquirer; selection rights lodged with such foreign investors over a number of independent directors, who are in turn charged with responsibility to investigate and certify the absence of government influence in the transaction; disclosure of financing; and an enforcement apparatus. These specifics are offered by way of example – other possible solutions to the credible commitment problem are conceivable.

The regime could be developed through governmental agreement, for example, as an addition to the G20 Guiding Principles for Global Investment Policymaking, agreed to in 2016 during China’s presidency of the G20. Alternatively, the regime could be developed through a public-private consultative process led by the OECD. The regime could be implemented on an opt-in basis at the national level, for example as a new element added to an existing cross-border screening regime in lieu of an ever-expanding definition of “national security.” An eligibility regime would provide incentives for governments to reduce the number of firms subject to its

requirements (by eliminating government/political party involvement in corporate governance) and provide meaningful discipline against a state's efforts to advance national-strategic motives in cross-border M&A for firms subject to its requirements.

Part I surveys evidence of China's rise as a serious player in the global M&A market. Part II explains the role of China's firms as "national strategic buyers" and illustrates the way this undermines the basic assumption of *symmetric private motivations* on which the global M&A market is based. Part III examines the existing regimes at the national level for dealing with national security concerns and the proposals for reforming them. It explains why these regimes do not fully address the problem of the NSB.

Part IV contains our proposal for a coordinated regime for cross-border M&A based on the concept of "eligibility," which would be applied to all firms, regardless of domicile, that are subject to potential government influence in their cross-border acquisitions. As we outline in detail in Part IV, the "eligibility" criteria are designed to make it possible for an acquirer to make a credible commitment that its cross-border acquisition proposal is motivated by private commercial objectives rather than "national strategic" objectives.<sup>10</sup> Credibility for the

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<sup>10</sup> A firm subject to the eligibility regime would be eligible to engage in cross-border M&A if it met the following requirements:

- (i) the company commits in its charter or other constitutive documents to undertake foreign acquisitions solely for own-firm financial or commercial objectives and not at the behest of any government;
- (ii) a significant portion, 25 percent, of the company's cash flow rights are available for purchase by foreign shareholders;
- (iii) the company's governance structure provides for independent directors, at least 25 percent of the board (but no less than two), who will be nominated by foreign shareholders;
- (iv) in advance of a public acquisition proposal, the independent directors are required under the acquirer's governance documents to prepare a report for subsequent public release that attests to the own-firm financial or commercial motivation and absence of government involvement in the acquisition decision; and
- (v) the company provides full disclosure of the sources of funding for the transaction before the transaction is final.

commitment to commercial objectives would be provided by a corporate governance mechanism featuring public certification of the commercial objectives by independent directors nominated by the acquirer's foreign shareholders. We also outline an enforcement structure for the eligibility regime featuring a secretariat (for example under the auspices of the OECD) and opt-in legislation at the level of the nation states.<sup>11</sup>

In Part V, we anticipate some likely objections to our proposal. First, target shareholders are likely to benefit from aggressive NSB activity through higher premiums. Second, NSB activity may simply fuel more investment in the areas of great interest to NSB acquirers. Third, restrictions on cross-border M&A are inherently protectionist; countries have the right to choose distinctive economic systems. Fourth, China will never go for this, so what's the point?<sup>12</sup>

One general response is framed in terms of the interest of long-term participants in global capital markets, who will regard the explicit or implicit state support behind NSB acquisitions as distortionary of the cross-border M&A market. Another general response looks to the emerging backlash of target-home governments that are becoming alarmed at the use of the cross-border M&A market to pursue national industrial policy. Indeed, this appears to be happening currently in the developed world in regard to Chinese investment.<sup>13</sup> It is a concern that extends beyond a particular acquisition but rather identifies a systemic threat, including the loss of leading-edge

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Enforcement of the regime would consist of two elements: first, a secretariat that can evaluate whether a would-be acquirer satisfies the eligibility criteria both as a general matter (the company's governance set-up) and as to the specific transaction; second, national legislation that would permit rejection of the acquisition of a local target by an acquirer that does not meet the eligibility criteria.

<sup>11</sup> Our scheme is novel in its effort to use a particular mechanism of private ordering – corporate governance – to serve global “law making” objectives, but not unprecedented in this regard. The Basel Committee on Banking Supervision has recently promulgated corporate governance guidelines the point of which is to use board and other corporate governance mechanisms to constrain risk-taking by large banks in the name of the global objective of the maintenance of financial stability. Basel Committee on Banking Supervision, Guidelines; Corporate Governance Principles for Banks (July 2015).

<sup>12</sup> An objection from a different direction is that our proposal is too limited in scope, since it addresses only M&A and not foreign direct investment that may have a similar national strategic stimulus. We think the problems of a “national strategic investor” are ultimately less serious than those posed by a “national strategic buyer” because of the control rights that are shifted in M&A; the influence of a national strategic investor is subject to limitations imposed by the target company board and its conduct is more susceptible to government monitoring through such measures as the export control regime. However, the eligibility regime contemplated by our proposal could be expanded to include strategic investments (as defined under the regime) that fall short of a change of control.

<sup>13</sup> See Thilo Hanemann & Daniel H. Rosen, Rhodium Group, Chinese FDI in the US in 2017: A Double Policy Punch, Jan. 17, 2018, at 38 (“Chinese FDI in the US is being curtailed by ...an uptick in US investment screening intensity. Policy bellicosity especially from Washington is casting a generally dark shadow over the broader bilateral relationship”).

technologies to the NSB and the NSB-home country, with potentially serious ramifications for the target-home country's long-term economic capacity and military capability. In the words of a U.S. Department of Defense report:

While it is likely that China's investment in technology is driven in part by commercial interests, it is unlikely this is the sole reason given China's explicit technology goals. ... The principal vehicles [to enable transfer of technology] are investments in early-stage technologies as well as acquisitions. When viewed individually, some of these practices may seem commonplace and not unlike those employed by other countries. However, when viewed in combination, and with the resources China is applying, *the composite picture illustrates the intent, design and dedication of a regime focused on technology transfer at a massive scale.*<sup>14</sup>

We see the "eligibility regime" as sustaining the relatively open cross-border M&A regime that helps knit together a global economic system, not to advance the interests of any particular nation(s). Global M&A is a complement to a global trade regime, and together these global regimes serve the long-term project of peaceful national economic competition and the spread of economic well-being. These values cannot be forgotten as nations struggle with the dislocations and the consequence of the global economic system. We also make no apology for using tools from the corporate governance toolbox in the service of internationalist objectives rather than grander international law schema.

Why would China, or any other regime that imposes on its firms an NSB obligation, ever subject itself to such discipline? We have no illusions that China's political leadership would find the loss of this lever of influence over the economy attractive. But as the national security screening mechanisms in advanced western economies proliferate and tighten, it will be in China's national interest to accede to a harmonized M&A regime that minimizes the "suspicion tax" under which many Chinese firms currently operate in global markets. Moreover, at least a rhetorical level, China's leadership has expressed support for the type of agreed upon rules-of-the-game approach in support of global markets that we advocate in this article. At the 2017 World Economic Forum in Davos, President Xi Jinping called for an open global economy and projected himself as a chief statesman on behalf of global governance. He explained China's decision to join the WTO as reflecting

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<sup>14</sup> Defense Innovation Unit Experimental, China's Technology Transfer Strategy: How Chinese Investments in Emerging Technologies Enable a Strategic Competitor to Access the Crown Jewels of U.S. Innovation 5, 14 (Feb. 2017) (emphasis in the original).



“the conclusion that integration into the global economy is a historical trend. To grow its economy, China must have the courage to swim in the vast ocean of the global market.”<sup>15</sup>

Support for a multilateral regime that constrains mercantilist, national-strategic motivations for deals would demonstrate China’s commitment to sound governance of the global market for cross-border M&A.

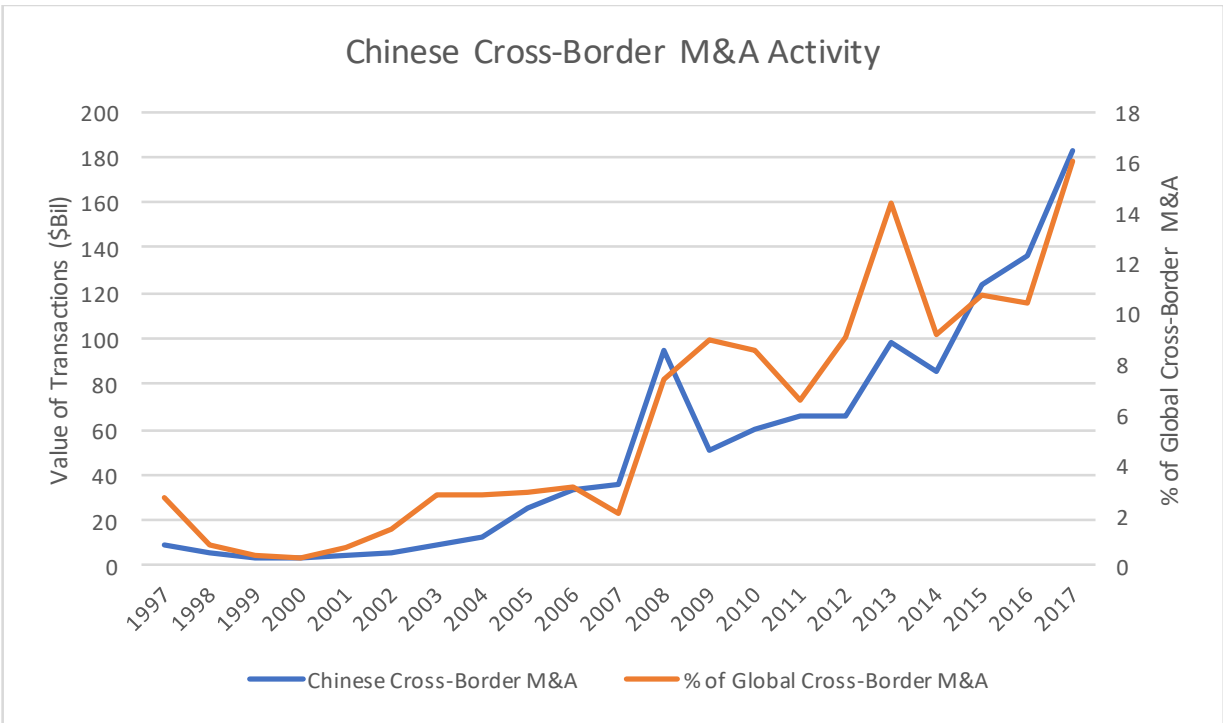
### **I. China’s Rise as a Player in Global M&A**

As Figure 2 demonstrates, China has become an increasingly important player in cross-border M&A. Over a twenty-year period there has been a steady increase in both the annual value of the cross-border transactions entered into by Chinese firms and the fraction of world-wide cross-border M&A activity. This increase has been particularly pronounced in the post-global financial crisis period, especially over 2015-2017. Perhaps more remarkable has been the shift in the composition of China-related cross-border M&A from predominantly *inbound* earlier in the period to predominantly *outbound*. Measured by value, by the time of the financial crisis the outbound/inbound ratio reached 60/40; in recent years it has been more like 80/20. Measured by number of deals, the outbound/inbound ratio is 60/40, reflecting that outbound deals have been larger. See Figure 3.

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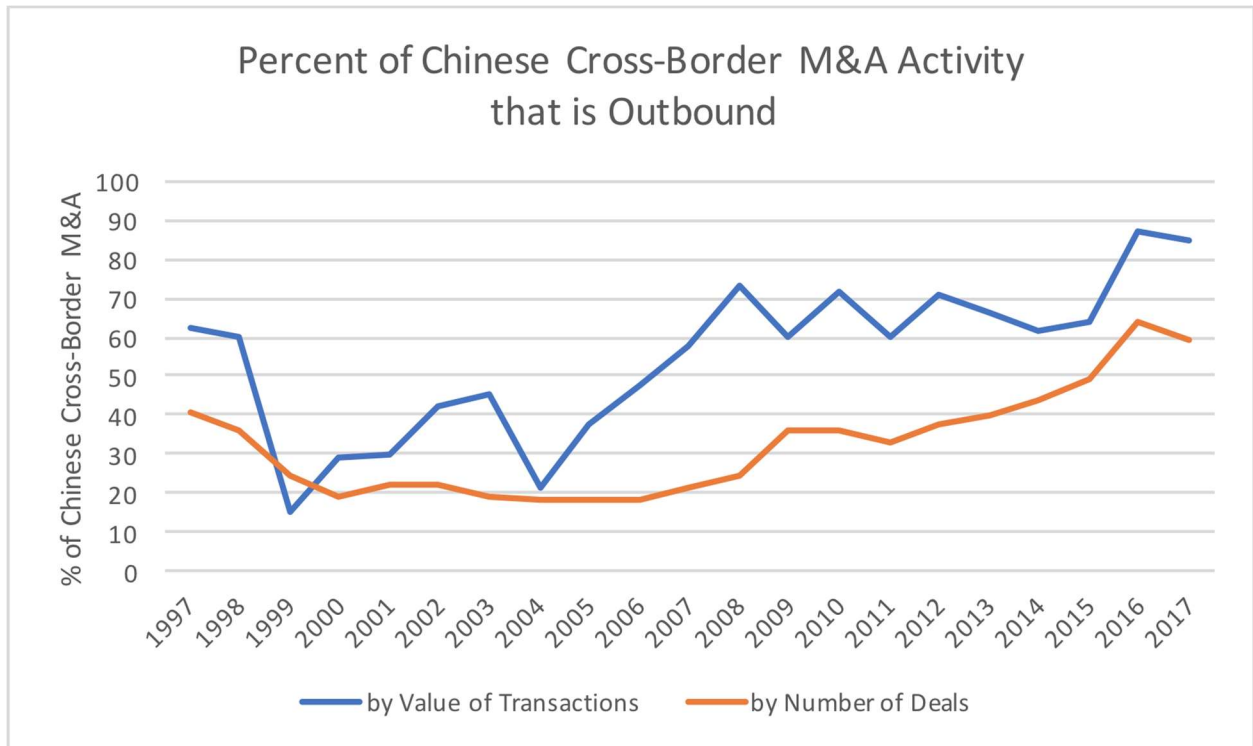
<sup>15</sup> See World Economic Forum, <https://www.weforum.org/agenda/2017/01/full-text-of-xi-jinpin-keynote-at-the-world-economic-form>.

**Figure 2**



Source: Thomson-Reuters Database, author calculations

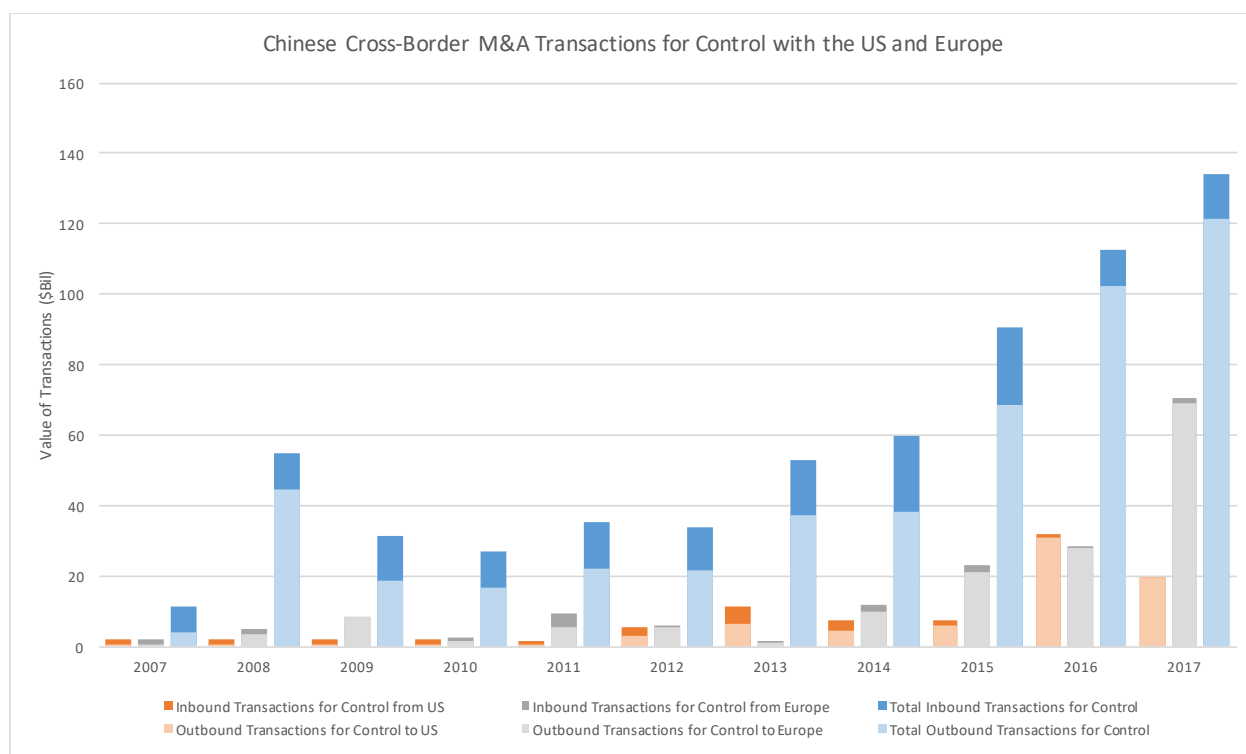
**Figure 3**



Source: Thomson-Reuters Database; author calculations

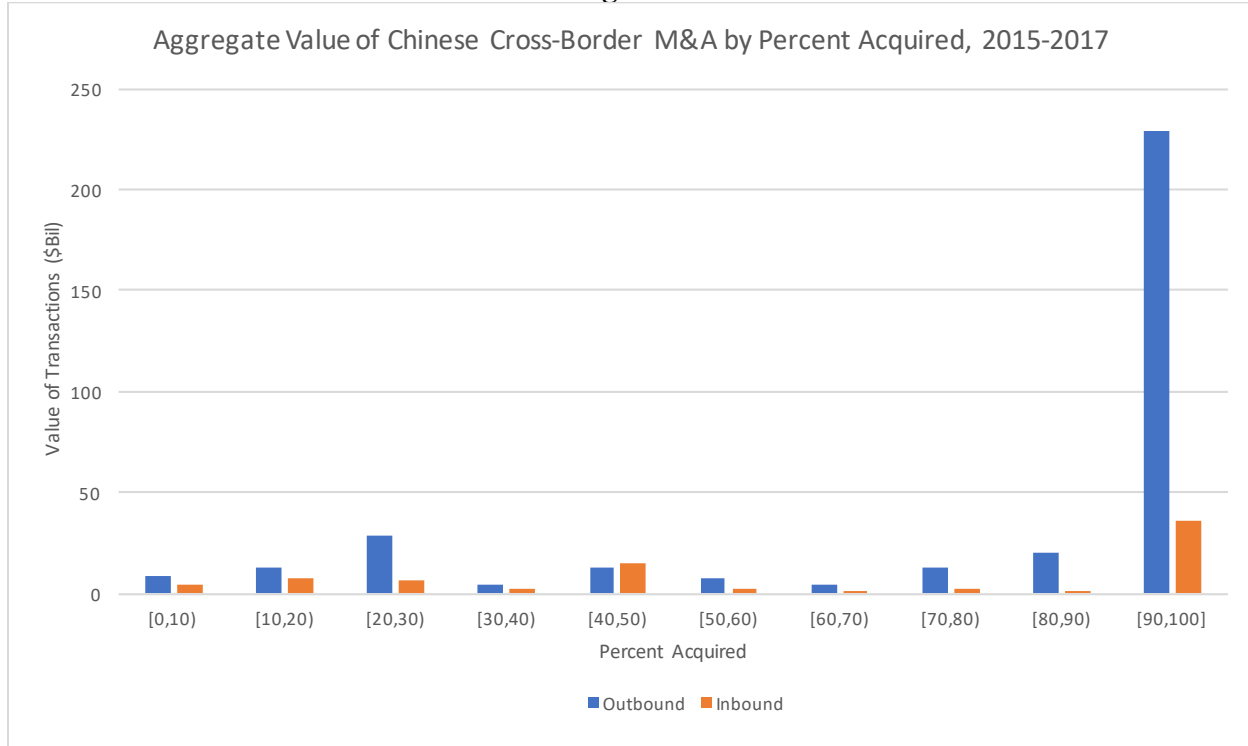
The starkest comparisons show up when the definition of “M&A” is limited to transactions for control, meaning acquisitions that result in obtaining an ownership position of more than 50% of the target’s stock. When control is at issue, the data show a pronounced skew towards outbound transactions throughout a decade-long period (measured by value). See Figure 4, right hand column for each year. Inbound acquisitions for control tend to come from Hong Kong companies (which may be under the control of Chinese owners; the data do not indicate). In the case of China-related M&A activity involving the U.S. and Europe, Figure 4 shows that inbound transactions for control appear to be rare; the direction of deal flow for control transactions is overwhelmingly outbound. Chinese firms are acquirers in control transactions in the US and Europe, not targets. Moreover, Figure 5 shows that over the 2015-2017 period, most of the outbound acquisition value is reflected in transactions in which Chinese acquirers obtained more than 90%.

**Figure 4**



Source: Thomson-Reuters Database, author calculations

**Figure 5**



Source: Thomson-Reuters Database, author calculations

## II. China as a National Strategic Buyer

As amply demonstrated in the preceding section, China’s economic rise and growing participation in the global economy have introduced a new player in cross-border M&A – the Chinese acquirer, which overwhelmingly seeks a dominant ownership position if not 100%. Outwardly familiar, cloaked in corporate form, the Chinese acquirer has qualities that defy conventional categories and make assessment of its motives difficult. This is so for several reasons rooted in the Chinese political economy. First, SOEs, which led the surge in Chinese outbound acquisitions, have distinctive ownership structures and institutionalized linkages to the Communist Party that influence their governance in unprecedented ways. Second, because their corporate governance is channeled through Chinese institutions of political governance, the SOEs facilitate “policy channeling” – the use of state-controlled companies (and non-controlling

private shareholders' investments) as a means of implementing public policy.<sup>16</sup> If SOEs were the only Chinese firms engaged in cross-border acquisitions, the problem of asymmetric motives might find relatively straightforward policy solutions.<sup>17</sup> But large Chinese private firms are increasingly active in cross-border M&A, and they present a third conundrum for assessing a Chinese buyer's motives: the conventional dichotomy between "state owned" and "privately owned" enterprises is blurred in China.<sup>18</sup> Due to heavy state intervention in the economy, party penetration of all significant organizations in society, and weak institutions to check state power, all large firms – whether SOEs, POEs, or mixed ownership enterprises – survive and prosper by remaining in the good graces of the party-state. Proximity to the party-state provides a roadmap of industrial policy goals, the pursuit of which generates rents such as subsidies, state-backed finance, and market protections. As a result, large firms in China exhibit substantial similarities in their relationship with the state in ways that do not depend on equity ownership. We discuss these distinctive Chinese corporate traits in turn.

*SOE Ownership Structure and Governance:*<sup>19</sup> Approximately two-thirds of Chinese Global Fortune 500 companies are national-level SOEs. These SOEs are structured as massive business groups whose formation in the 1990s was inspired by the apparent success of the Japanese *keiretsu* and South Korean *chaebol* in propelling economic development in those countries. The parent (holding) company of an SOE business group has only one shareholder: an agency formed under the State Council (China's cabinet) known as the State-owned Assets Supervision and Administration Commission (SASAC), which acts as both an investor on behalf of the Chinese people and as a regulatory agency. The holding company serves as an intermediary between SASAC and the other group member firms. It coordinates strategy and resource allocation within the group, transmits policy downward from Chinese regulators to

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<sup>16</sup> See Curtis J. Milhaupt & Mariana Pargendler, RPTs in SOEs: Tunneling, Propping and Policy Channeling, in Luca Enriques & Tobias Troeger eds., *The Law and Finance of Related Party Transactions* (Cambridge, forthcoming).

<sup>17</sup> For example, the US-China Economic and Security Review Commission has recommended a ban on acquisitions of U.S. corporations by Chinese SOEs. US-China Economic and Security Review Commission, Annual Report 507 (2016).

<sup>18</sup> Curtis J. Milhaupt & Wentong Zheng, Beyond Ownership: State Capitalism and the Chinese Firm, 103 *Geo. L.J.* 665 (2015).

<sup>19</sup> What follows is drawn from Li-Wen Lin & Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, 65 *Stan. L. Rev.* 697 (2013).

group members, and provides information upward from the group to state strategists and regulators. The global face of a Chinese SOE however, is not the holding company, but one or more of its publicly traded subsidiaries. While the publicly traded subsidiaries have private (non-state) shareholders, ultimate control resides with the party-state through SASAC's indirect ownership of a substantial percentage of the publicly traded company's equity,<sup>20</sup> along with other unusual governance rights discussed below.

Atop the national SOE business groups is SASAC, which has been described as “the world's largest controlling shareholder.”<sup>21</sup> SASAC has a long list of formal functions and responsibilities, including preserving and enhancing the value of state-owned assets, appointing and removing top SOE executives, setting remuneration for SOE personnel and regulating income distribution among senior SOE managers, dispatching supervisory panels to the SOEs, and drafting regulations on the management of state-owned assets.<sup>22</sup>

The legal foundation for SASAC's role in the SOE system is the Law of the People's Republic of China on State-Owned Assets of Enterprises (“SOE Asset Law”).<sup>23</sup> In essence, the law formally recognizes SASAC as an *investor* – a shareholder in the national SOEs, with the rights and duties of a shareholder.<sup>24</sup> But the law contains some provisions that alter the ordinary rights of a shareholder under standard corporate law principles. For example, Article 34 requires that SASAC obtain government approval before exercising its rights as a shareholder with respect to the “merger, splitting, dissolution or petition for bankruptcy of an important” SOE under its supervision. Article 22 gives SASAC the power to appoint and remove senior managers in the SOEs under its supervision.

The corporate ownership structure just outlined, however, conveys an incomplete picture of the governance mechanics in Chinese SOEs. Equally or more important are the mechanisms

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<sup>20</sup> SASAC is the sole shareholder of 97 parent holding companies that in turn control 340 publicly traded subsidiaries. Author calculations based on publicly available information.

<sup>21</sup> Marcos Aguiar et al., *SASAC: China's Megashareholder*, BCG Perspectives (Dec. 1, 2007), [http://www.bcgperspectives.com/content/articles/globalization\\_strategy\\_sasac\\_chinas\\_megashareholder](http://www.bcgperspectives.com/content/articles/globalization_strategy_sasac_chinas_megashareholder).

<sup>22</sup> See SASAC, Main Functions, available at <http://en.sasac.gov.cn/n1408028/n1408521/index.html>.

<sup>23</sup> Zhonghua Renmin Gonghe Guo Quiye Gouyou Zichan Fa (promulgated by the Standing Com. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009). The SOE Asset Law was enacted for the purpose of “consolidating and developing the state-owned economy, strengthening the protection of state-owned assets, giving play to the leading role of the state-owned economy in the national economy, and promoting the development of the socialist market economy. Id., art 1.

<sup>24</sup> See id. arts. 11-14.

by which the SOE business groups are linked with institutions of the central government and the Chinese Communist Party. For example, a number of positions in government and party bodies, such as the National People's Congress and the National People's Political Consultative Conference, are reserved for leaders of the national SOEs, and senior managers of national SOEs sometimes simultaneously hold important positions in the party, the government, or industrial associations that perform governmental functions.<sup>25</sup>

Institutionalized party penetration of the corporate form mirrors the party's parallel governance structures vis-à-vis the organs of government. There are two personnel systems in all national Chinese SOEs: the regular corporate management system and the party system. In the corporate management system, positions are similar to those found in firms elsewhere in the world, including CEO, Vice-CEO, chief accountant and independent board members. Senior management appointments are made in a highly institutionalized arrangement between SASAC and the party. While appointments power formally resides with SASAC, senior appointments are made with input from various party organs and ministries regulating relevant business operations and are subject to approval by the State Council. The leadership team in the parallel party system includes the secretary of the party committee, several deputy secretaries, and a secretary of an anti-corruption office called the Discipline Inspection Commission. Overlaps between the two systems are rather uniform, such that a corporate manager of a given rank typically holds a position of equivalent rank in the party system. The Articles of Association of the SOEs, for example, require the chairman of the board to concurrently serve as the secretary of the company's party committee.

The presence of the party throughout the SOE system is concretely manifest in party committees, established within SASAC and, pursuant to Chinese Company Law, within each SOE group member corporation. These committees play some corporate roles, such as performing supervisory and personnel functions. But they also have political functions, such as building allegiance to party principles and disseminating campaigns announced by senior government leaders. In recent years, high level government and party organs have issued policies seeking to reinforce the party's leadership in SOEs, and the principle of party leadership in SOEs

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<sup>25</sup> See Lin & Milhaupt, *supra* note 19.

has recently been enshrined in the Constitution of the Chinese Communist Party.<sup>26</sup> Guidelines issued by SASAC and the Ministry of Finance provide a template for SOEs to amend their Articles of Association so as to weave the principle of party leadership into their constitutive documents. The party committee is now effectively superior to the board of directors with respect to material business decisions and senior management appointments.<sup>27</sup>

Thus, the party, working through SASAC and the company-level party committees, is able to bypass or influence boards of directors in the appointment, removal, remuneration and supervision of senior managers, and with respect to major business decisions. Although given that senior corporate managers simultaneously hold senior party positions within the firm, direct conflict between decisions of the party and the board are unlikely. Rather, as a consequence of the Party's shadow corporate governance rights, the board's decisions are likely to anticipate and dovetail with the interests of the party.

*Policy Channeling:* In firms with dispersed, diversified shareholders, shareholder wealth is affected by corporate decisions only through their impact on stock price. As a result, shareholders will agree about the corporation's objective function: it should act to increase the value of the corporation's stock. But this "separation theorem" does not hold in a variety of contexts, including where the government acts as the controlling shareholder of an SOE with public (non-state) minority shareholders. In this case, while shareholder value maximization is the goal of the non-state shareholders, the state may use the corporation (effectively or otherwise) to serve public policy objectives – a strategy one of us in previous work has called "policy channeling."<sup>28</sup> These objectives might include maintaining employment, pursuing industrial policy goals, or securing state control over the "commanding heights" of the economy. States may engage in policy channeling because it is perceived as a lower-cost substitute for

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<sup>26</sup> See, e.g., Guiding Opinions of the Central Committee of the Communist Party of China and the State Council on Deepening State-Owned Enterprise Reform, item I.2. ("Insist on the leadership of the State-owned enterprises by the party"); Constitution of the Communist Party of China, revised and adopted on Oct. 24, 2017, art. 33 ("The leading ... Party committees of state-owned enterprises shall play a leadership role, set the right direction...and discuss and *decide* on major issues of their enterprise in accordance with regulations.") (emphasis added).

<sup>27</sup> See Houze Song, State-Owned Enterprise Reforms: Untangling Ownership, Control, and Corporate Governance, Macro Polo.org, available at <https://macropolo.org/anaysis/state-owned-enterprise-reforms-untangling-ownership-control-corporate-governance/> ("decision-makers now favor putting the Party committee atop the board as the ultimate authority in an SOE").

<sup>28</sup> Milhaupt & Pargendler, *supra* note 16.



regulation in weak institutional environments,<sup>29</sup> for ideological reasons, or because the SOE insulates government action and distributive decisions from public scrutiny and participation.

Policy channeling can of course be found outside China – it is the principal theoretical explanation for state ownership of business enterprise everywhere. But the governance characteristics of Chinese SOEs described above make them unusually powerful instruments of policy channeling. Thoroughgoing party penetration of the SOEs' corporate governance structures suggests that the goal of this massive network of firms is to maximize social rather than shareholder welfare. Or to put it differently, China's leaders view the SOEs as a means of maximizing at the *country*, rather than the corporate, level.

*Blurred SOE-POE Dichotomy:* The impact of China's political economy on corporate governance and objectives extends well beyond SOEs, rendering distinctions among firms based on ownership misleading.<sup>30</sup> The boundary between public and private enterprise has long been blurred in China, a country with a tradition of state intervention in the economy, inchoate notions of property rights, and a history of economic reform strategies relying heavily on mixed (state and private) ownership of the means of production. State-generated rents are distributed not only to SOEs, but also to POEs perceived to be furthering state objectives. The human agents managing SOEs and POEs in China respond in similar fashion to the institutional environment: fostering close personal ties to government and party organs, seeking state largesse, and remaining in the good graces of political leaders are important to the success of all firms in China. One indication of the gravitational pull of the party-state in the corporate realm is widespread membership by the founders of large private firms in government and party organs, in the same way that high-level SOE executives are affiliated with these organs.<sup>31</sup> Thus functionally, SOEs and large POEs share many similarities in the areas commonly thought to

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<sup>29</sup> For an analysis of Chinese SOEs as an efficient response to high regulatory costs in a weak institutional environment, see Si Zeng, *State Ownership as a Substitute for Costly Regulation, The Law and Economics of State-Owned Enterprises in China*, Working Paper, (2017).

<sup>30</sup> Milhaupt & Zheng, *supra* note 18.

<sup>31</sup> *Id.* (finding that 95/100 founders or chief executives of the largest POEs in China are members of party and government organs; same for 8/10 of China's largest internet-based firms). Access to the finance necessary to accomplish cross-border M&A is strongly influenced by political connections of the POE principals. See Denis Schweitzer, Thomas Walker, and Aaron Zhang, *Cross-Border Acquisitions by Chinese Enterprises: The Benefits and Disadvantages of Political Connections* (forthcoming, *Journal of Corporate Finance* 2018), available at <https://ssrn.com/abstract=3049696>.

distinguish state-owned firms from privately owned firms: market access, receipt of state subsidies, proximity to state power, and execution of the government's policy objectives. The identity of a Chinese firm's equity owners thus provides relatively little information about the degree of autonomy the firm enjoys from the state.

Nevertheless, as Chinese cross-border M&A activity has ratcheted up, the composition of Chinese acquirers has shifted from SOEs to POEs.<sup>32</sup> SOE acquisitions attract heightened scrutiny under existing regulatory regimes. For POEs, the government connections and support are not as obvious and thus POE transactions are less likely to be challenged. Schweitzer et al. report a pronouncement to this effect by a member of the Chinese People's Political Consultative Conference:

Given the fact that SOEs often experience setbacks when acquiring foreign companies in advanced economies, POEs are encouraged to acquire the high technology for the growth of China's economy. Because POEs rarely have Chinese government background, they can avoid the scrutiny from foreign governments targeting Chinese SOEs. The government should provide financing to POEs for their cross-border deals and even state-owned companies could provide funding in the background to POEs.<sup>33</sup>

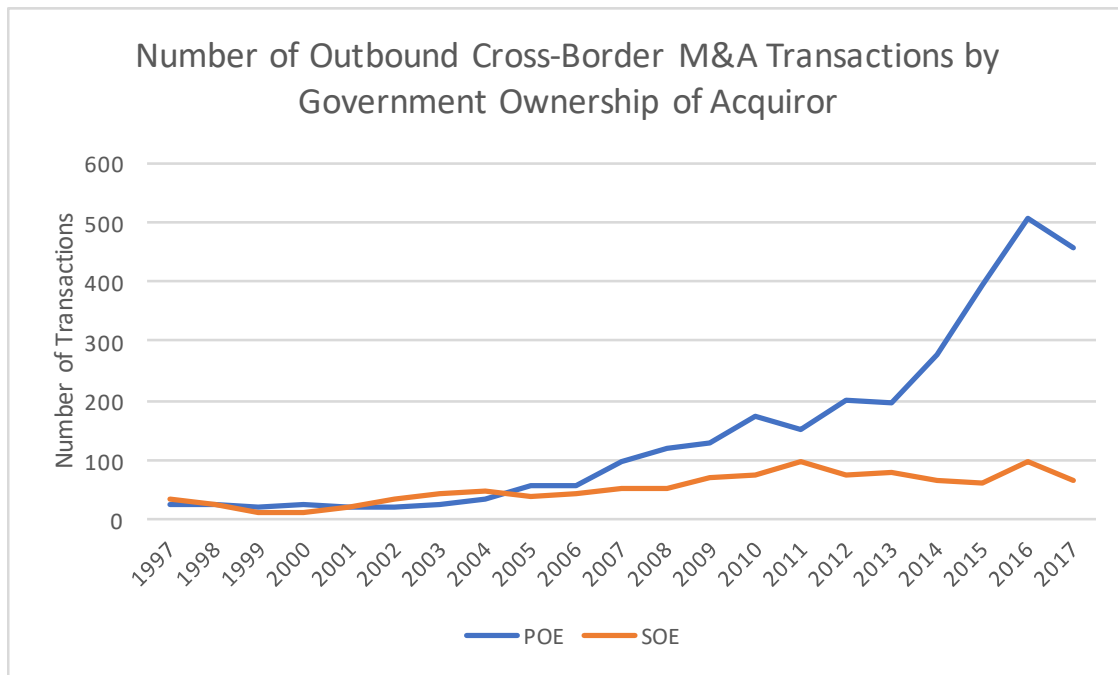
The shift from SOEs to POEs is reflected in the data. Figure 6 shows that the *number* of POE cross-border acquisitions now far outstrips SOE acquisitions. Figure 7 shows that, by *value*, POE acquisitions have become increasingly important but that SOEs undertake significant acquisitions as well.

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<sup>32</sup> Id., citing Sina Finance, *65 listed firms have completed cross-border mergers and acquisitions this year: privately owned enterprises account for nearly 70%*, Dec. 26, 2016, available at: <http://finance.sina.com.cn/roll/2016-12-26/doc-ifyxvcr7574949.shtml> (in Chinese).

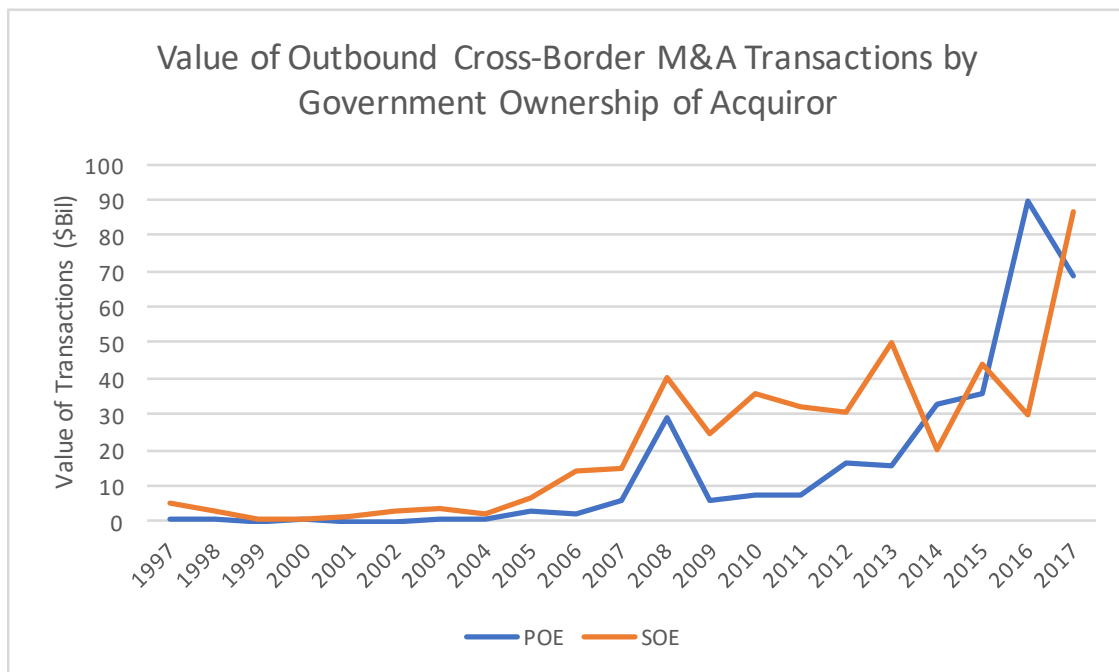
<sup>33</sup> Id., citing Sina Finance, *Hongwei Zhang (CPPCC) suggests diversifying the method of overseas investment on energy*, March 8, 2010, available at: <http://news.sina.com.cn/c/2010-03-08/120919815889.shtml> (in Chinese).

**Figure 6**



Source: Thomson-Reuters Database, author calculations

**Figure 7**



Source: Thomson-Reuters Database, author calculations

*Summary:* Large Chinese corporations have a number of highly distinctive traits resulting from that country's political and economic systems. We highlight these traits not to pass judgment on Chinese economic governance structures, but to underscore that the multilateral trade and investment regimes that took shape in the post-war period simply do not contemplate this type of actor.<sup>34</sup> It is thus not surprising that the emergence of Chinese firms as major participants in the global economy has generated anxiety in the countries where these firms are active. To quote from a prior work:

Suspensions about foreign investments by Chinese firms, regardless of ownership, are likely to remain as long as the state retains equity interests in ostensibly private enterprises; the government routinely provides subsidies and privileged market access to state-linked firms; and it is common practice for senior executives at major firms, SOE or POE, to be affiliated with the party-state in various capacities. In short, suspicions about foreign investments by Chinese firms will linger as long as the institutional foundations of Chinese state capitalism remain intact.<sup>35</sup>

***Illustration: Made in China 2025***

Made in China 2025 (MIC2025), issued by the State Council in May 2015, is the Chinese government's policy response to challenges facing the country's domestic manufacturing industry. While China's manufacturing industry is huge, it has not produced a large number of indigenously developed, globally competitive products and still depends heavily on core technologies developed by foreign companies. MIC2025 identifies ten priority sectors accounting for 40% of China's value-added manufacturing, including next generation information technology, aviation, new materials and biosciences. It sets domestic market share targets for various products, such as new energy vehicles, mobile phone chips and wide-body aircraft, as well as targets for innovation, quality, digitization and green development.<sup>36</sup> Among the policy tools actually or allegedly being used by the Chinese central and local governments to

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<sup>34</sup> Mark Wu, The WTO and China's Unique Economic Structure, in Benjamin Liebman & Curtis J. Milhaupt, eds., *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism* 313 (2016).

<sup>35</sup> Milhaupt & Zheng, *supra* note 18, at 707.

<sup>36</sup> MIC2025 "appears to provide preferential access to capital to domestic companies in order to promote their indigenous research and development capabilities, support their ability to acquire technology from abroad, and enhance their overall competitiveness...MIC2025 constitutes a broader strategy to use state resources to alter and create comparative advantage in these sectors on a global scale." U.S. Chamber of Commerce, *Made in China 2025: Global Ambitions Built on Local Protections* 6 (2017).

implement MIC2025 are forced technology transfers in exchange for market access, government-backed investment funds, and acquisition of foreign technology through outbound investment.<sup>37</sup>

Evidence of state-led investment tied to MIC2025 priorities is most evident in the information technology industry, where outbound Chinese investments in the semiconductor industry skyrocketed in 2015 and 2016 after the Chinese central government promulgated guidelines on promotion of the national integrated circuit industry. The Rhodium Group, a private firm that gathers data on Chinese investment in the United States, concluded that semiconductors are “the clearest example of the nexus between strategic high-tech policy and outbound investment in today’s China.”<sup>38</sup>

As the semi-conductor example suggests, given the political economy context in which Chinese firms operate, MIC2025 is more than a simple statement of government policy. It is a roadmap for Chinese firms in their pursuit of profitable investments. In the words of a European Union Chamber of Commerce report, “the priorities and targets that the [MIC2025] outlines will have sent a strong message to provincial and local governments, SOEs and private Chinese companies regarding the central government’s priorities. This will give them a clear idea of where subsidies, other forms of support, and therefore near-term opportunities for profit, can be expected to flow.”<sup>39</sup> The report notes a surge in Chinese investment into European firms in the wake of MIC2025’s publication, quoting a State Council directive that “SOEs should be encouraged to carry out acquisitions and mergers with a focus on developing strategies and a goal for attaining key technologies and core resources.”<sup>40</sup> The report asks whether MIC2025 “amount[s] to a shopping list of technologies that the country has not been able to develop at home?” and concludes, “While it is perfectly standard for private business to make strategic acquisitions, their decisions should ultimately be informed by the profit motive. Investments made by firms in response to their government’s industrial policies or strategic interests may be completely at odds with the interests of the country into which the investment is made.”<sup>41</sup> Similar

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<sup>37</sup> European Union Chamber of Commerce in China, *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces* 15-16 (2017).

<sup>38</sup> Thilo Hanemann & Daniel H. Rosen, *Chinese Investment in the United States: Recent Trends and the Policy Agenda*, Rhodium Group, December 2016.

<sup>39</sup> EU Chamber report, *supra* note 37, at 13.

<sup>40</sup> *Id.* at 18-19.

<sup>41</sup> *Id.*

sentiments are expressed in a US Chamber of Commerce report, citing global concerns that outbound Chinese investments tied to industrial policy result in the acquisition of foreign technology.<sup>42</sup>

The EU and US Chamber of Commerce reports might be discounted as scaremongering by China's global competitors. Some of their language is reminiscent of fears expressed about Japanese industrial policy in the 1980s, which turned out to be unfounded. But several considerations suggest that the concerns raised by these bodies should be taken seriously. First, at a conceptual level, it not unreasonable to think that cross-border M&A could be a vehicle for advancing the power of a state actor, particularly an authoritarian regime with lofty global ambitions. Second, government policy does in fact influence outbound deal flow and acquisition targets. A steep decline in Chinese FDI into the US in 2017 was caused by Beijing's clampdown on capital outflows to stem a decline in foreign exchange reserves and limits on overseas dealmaking by large private firms in an effort to reduce leverage in the financial sector.<sup>43</sup> Third, Chinese press reports indicate that most of the cross-border deals are not profitable for the companies that enter into them,<sup>44</sup> suggesting that the impetus comes from government direction with the implicit promise of government financial support. Fourth, the concerns voiced in these EU/US Chamber reports are echoed by independent analysts.<sup>45</sup> Fifth, the reaction of governments around the world to Chinese outbound investment indicates that the concerns expressed in these reports are widely shared by lawmakers and policymakers, and that a backlash is building due to the perception that China is using a liberal regime for national gain. It is to the policy reactions around the world that we now turn.

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<sup>42</sup> US Chamber report, *supra* note 36, at 23-24 & n. 68-71.

<sup>43</sup> See Thilo Hanemann & Daniel H. Rosen, Rhodium Group, Chinese FDI in the US in 2017: A Double Policy Punch, Jan. 17, 2018.

<sup>44</sup> Schweitzer et al. *supra* note 31, citing Sina Finance, *The cross-border M&A of Chinese companies have been experiencing exponential growth, but only 13% of the deals are profitable*, Oct. 8, 2016, available at: <http://finance.sina.com.cn/roll/2016-10-08/doc-ixfwrhpm2611573.shtml> (in Chinese).

<sup>45</sup> See, e.g., Scott Kennedy, Center for Strategic and International Studies, Statement before the House Committee on Financial Services, Subcommittee on Monetary Policy and Trade, Hearing on "Evaluating CFIUS: Challenges Posed by a Changing Global Economy," Jan. 9, 2018; Derek Scissors, Resident Scholar, American Enterprise Institute, Statement before the House Committee on Financial Services Subcommittee on Monetary Policy and Trade, Hearing on "Evaluating CFIUS: Challenges Posed by a Global Economy," Jan. 9, 2018.

### III. Existing Regimes and Proposals for Reform

#### *The United States*

Concerns that foreign investors may pose a threat to host countries are of course not new. The United States has had a regime to examine the national security implications of foreign direct investment since 1975. This regime, the Committee on Foreign Investment in the United States (CFIUS), was created by executive order providing that CFIUS would have “the primary continuing responsibility within the executive branch for monitoring the impact of foreign investment in the United States, both direct and portfolio, and for coordinating the implementation of United States policy on such investment.”<sup>46</sup> CFIUS is an interagency committee chaired by the Secretary of the Treasury and comprised of the heads of numerous executive branch agencies, including the Departments of State, Commerce, Justice, Defense and Homeland Security.<sup>47</sup>

In 1988, amidst concerns over Japanese acquisitions of US firms, Congress approved the Exon-Florio amendment to the Defense Production Act, granting the President authority to block mergers and acquisitions that threaten national security.<sup>48</sup> The Exon-Florio amendment provided a statutory basis for the national security screening process undertaken by CFIUS. By executive order, President Reagan delegated his authority to administer the Exon-Florio provision to CFIUS. As a result, “CFIUS was transformed from an administrative body with limited authority to review and analyze data on foreign investment to an important component of U.S. foreign investment policy with a broad mandate and significant authority to advise the President on foreign investment transactions and to recommend that some transactions be suspended or blocked.”<sup>49</sup>

The current CFIUS regime is governed by the Foreign Investment and National Security Act of 2007 (FINSAs), implemented by executive order in 2008.<sup>50</sup> FINSAs codified CFIUS

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<sup>46</sup> Executive Order No. 11858 § 1(b), May 7, 1975, 40 C.F.R. 20263 (1975).

<sup>47</sup> U.S. Department of the Treasury, Composition of CFIUS, <https://www.treasury.gov/resource-center/international/foreign-investment/Pages/cfius-members.aspx>.

<sup>48</sup> Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, tit. V, subtitle A, pt. II § 5021 (1988).

<sup>49</sup> James K. Jackson, Congressional Research Service, The Committee on Foreign Investment in the United States (CFIUS), Oct. 11, 2017 at 6.

<sup>50</sup> 50 U.S.C.A. § 4565; Executive Order No. 13456, 73 C.F.R. 4677 (2008).

itself,<sup>51</sup> along with various elements of the CFIUS process that had emerged since the Exon-Florio amendment, and strengthened CFIUS in various ways, including by broadening the definition of national security to include threats to homeland security and “critical infrastructure.”<sup>52</sup> By law, CFIUS is required to review all “covered” foreign investment transactions.<sup>53</sup> A covered transaction is defined as a “merger, acquisition or takeover ... by or with a foreign person which could result in foreign control of any person engaged in interstate commerce in the United States.”<sup>54</sup> CFIUS must review any transaction that could result in control by a “foreign-government controlled” entity.<sup>55</sup>

Under FINSA, the CFIUS review process is comprised of three stages. The first stage is a 30-day national security review to determine whether the investment threatens to impair national security, critical infrastructure, homeland security, or is state-owned or controlled.<sup>56</sup> If no risks are found or such risks are resolved, no further action is taken and the transaction is granted a safe harbor. If risks are not resolved or if the acquirer is controlled by a foreign state, review moves to the second stage, a national security investigation of up to 45 days.<sup>57</sup> During this period, CFIUS can impose conditions, develop interim protections or negotiate mitigation agreements.<sup>58</sup> If outstanding concerns are not resolved, CFIUS can send a negative recommendation to the President. The President has 15 days to make a determination.<sup>59</sup> At any time during this process, parties can withdraw and, if desired, re-file their notice. Prior to these formal stages, CFIUS often engages in informal pre-filing review of proposed transactions to identify potential issues. Informal review can benefit foreign acquirers, for example by allowing them to avoid negative publicity from having a proposed transaction blocked.<sup>60</sup>

Historically, very few transactions have been blocked under the CFIUS process, but the pace of blocked or abandoned deals appears to be quickening. Only two transactions were

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<sup>51</sup> 50 U.S.C.A. § 4565(k).

<sup>52</sup> Id. § 4565(a)(5).

<sup>53</sup> Id. § 4565(b)(1).

<sup>54</sup> Id. § 4565(a)(3). Purchases of 10% or less of the voting securities of a U.S. person solely for purposes of investment are not “covered” transactions. Treas. Reg. §800.302(d).

<sup>55</sup> 50 U.S.C.A. § 4565(b)(1)(B).

<sup>56</sup> Id. § 4565(b)(1).

<sup>57</sup> Id. § 4565(b)(2).

<sup>58</sup> Jackson, *supra* note 49, at 13.

<sup>59</sup> 50 U.S.C.A. § 4565(d).

<sup>60</sup> Jackson, *supra* note 49, at 11-12.



blocked from the inception of CFIUS through 2012. One reason for the low number of negative Presidential determinations is that foreign acquirers may withdraw their filings – particularly if the process moves from the first, review stage to the second, investigatory stage – in order to avoid potential negative consequences from having a transaction blocked.<sup>61</sup> However, three transactions involving Chinese acquirers have been blocked in the past two years, and one was abandoned.<sup>62</sup> The proposed acquisition of Qualcomm, a leading U.S. developer of 5G technology, by Broadcom, a company in the process of transitioning from Singapore domicile to Delaware, was blocked in 2018 on the grounds that “a weakening of Qualcomm’s position” [as a result of its acquisition by a foreign buyer taking a “private equity-style” approach to reducing R&D in favor of short-term profitability] “would leave an opening for China to expand its influence on the 5G standard setting process.”<sup>63</sup> Given the level of concern about Chinese direct investment in Washington and given that China was the home country of the acquirer in more CFIUS covered transactions than any other in the period 2013-15 (the most recent years for which data are available),<sup>64</sup> the rarity of negative Presidential determinations may be a thing of the past.

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<sup>61</sup> Id. at 21-22 (reporting that in the 2008-2015 period, 4% of transactions notified to CFIUS were withdrawn during the initial 30-day review period and 6% were withdrawn during an investigation.) Practitioners also describe a process of negotiation with CFIUS staff and divestitures and control arrangements to accommodate, or “mitigate,” the national security concerns, much like the maneuvering in an antitrust review process.

It may well be that CFIUS’ decisions are subject to judicial review under the APA. Although a Presidential decision to block a transaction is non-reviewable under the statute, a completed transaction may well give rise to property interests and due process rights. See *Ralls Corp v. CFIUS*, 758 F. 3d 296 (D.C. Cir. 2014) (subsequently settled without further opinion); Judy Wang, *Ralls Corp. v. CFIUS: A New Look at Foreign Direct Investments to the US*, 54 Colum. J. Transnat’l L. Bulletin 30 (2016) (note); Jonathan Wakely and Lindsay Windsor, *Ralls on Remand: U.S. Investment Policy and the Scope of CFIUS’ Authority*, 48 Int’l Lawyer 105 (2014).

<sup>62</sup> The blocked transactions are Fujian Grand Chip Investment Fund’s proposed acquisition of Axtron, a German semiconductor firm with assets in the U.S.; Lattice Semiconductor’s acquisition by Canyon Bridge Capital Partners, a Silicon Valley-based VC with funding from the Chinese government, and Ant Financial’s proposed acquisition of MoneyGram. Huawei abandoned plans to partner with AT&T to sell smartphones in the U.S.

<sup>63</sup> Letter from Aimen N. Mir, Deputy Assistant Secretary of the Treasury for Investment Security to Mark Plotkin and Theodore Kassinger, March 5, 2018, available at <https://www.qcomvalue.com/wp-content/uploads/2018/03/Letter-from-Treasury-Department-to-Broadcom-and-Qualcomm-regarding-CFIUS.pdf>

<sup>64</sup> Committee on Foreign Investment in the United States, Annual Report to Congress CY 2015 (unclassified version) 16-17 (2017). The unclassified version of the annual report is released with a two-year lag.

Today, there is a consensus in the U.S. government and policy communities that the CFIUS process is outdated and inadequate in its current form.<sup>65</sup> Chinese investments have been the catalyst for these concerns, both because of the rapid increase in such investments into the U.S. and due to suspicions that some Chinese investments have been structured to circumvent CFIUS review. This not only poses potential threats to national security, but it introduces a new level of regulatory uncertainty for deal planners. A recent law firm memo to clients sums up these sentiments as follows:

The CFIUS process is under significant pressure. The Committee's caseload is larger than it can reasonably handle with existing resources; the government doubts its own ability to monitor rapid technological changes that could present threats to national security; and the fastest growing source of technology investment – China – is becoming the United States' strongest technology competitor but lacks the shared security alliances enjoyed by other countries. In that setting, business's ability to assess, accommodate and respond to CFIUS risk has become even more tenuous than in the past.<sup>66</sup>

Several CFIUS reforms are under active consideration. The leading reform proposal is the Foreign Investment Risk Review Modernization Act (FIRRMA), introduced into both houses of Congress in the fall of 2017.<sup>67</sup> The bill would increase the types of transactions CFIUS may consider, enhance the existing CFIUS review process, and encourage greater resort to the CFIUS process by introducing a dual filing system. Other proposed legislation would allow CFIUS to consider the broader economic effects of the proposed investment as part of its review process,<sup>68</sup> a feature of the foreign investment screening regime in Canada. Another bill would require CFIUS to consider whether the home country of the acquirer offers reciprocity to foreign investors.<sup>69</sup>

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<sup>65</sup> One analysis by a prominent think tank concludes that “CFIUS is working” but warns that “emerging trends bear close monitoring as they could – over time – reduce the effectiveness of the [current CFIUS] system. Specifically, these include the increasing complexity of transactions, the growing role of foreign government-owned or controlled entities in mergers and acquisitions, [and] the growing number of cases filed with CFIUS...” Andrew Hunter & John Schaus, Center for Strategic and International Studies, CSIS Review of the Committee on Foreign Investment in the United States 11-12 (Dec. 2016).

<sup>66</sup> Davis Polk, Trends and Updates in the CFIUS Space, Jan. 16, 2018, at 5.

<sup>67</sup> S. 2098, 115<sup>th</sup> Cong. (2017); H.R. 4311, 115<sup>th</sup> Cong. (2017).

<sup>68</sup> S. 1983, 115<sup>th</sup> Cong. (2017).

<sup>69</sup> S. 1722, 115<sup>th</sup> Cong. (2017).

### *The EU and Member States*

Currently, the European Union has no region-wide process to review foreign investments for national security concerns. The Treaty on the Functioning of the European Union (TFEU) prohibits restrictions on the movement of capital between member states and between member state and third countries, except where necessary to achieve certain defined objectives, including public security.<sup>70</sup> Further, the European Commission has curtailed investment in certain instances, such as through its authority to review and block transactions where it finds antitrust concerns under EU merger regulation.

There are growing calls for creation of a CFIUS-like process at the EU level. Similar to the motivation for CFIUS reform in the United States, impetus for implementing a national security screening regime at the EU level has stemmed from concerns about Chinese investment – specifically, that China has gained access to key technologies in Europe, while shielding its own companies from foreign takeovers through its own regulatory regime.<sup>71</sup> On September 13, 2017, the EU set out a draft regulation proposing a framework for screening foreign investments on the grounds of “security or public order.”<sup>72</sup> Unlike FINSA’s tying of “covered” transactions to acquisition of “control,” the proposal has a more encompassing definition of foreign direct investment involving a “foreign investor aiming to establish or to maintain lasting and direct links between the foreign investor and the entrepreneur...including investments which enable effective participation in the management or control.”<sup>73</sup> In order for the proposal to become effective, 55% of the member states representing at least 65% of the total EU population must vote in favor.

If adopted in current form, the regulation would empower the Commission to undertake review of any foreign investment in an economic enterprise in a member state where it

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<sup>70</sup> Consolidated Version of the Treaty on the Functioning of the European Union, art. 63, Oct. 26, 2012, 2012 O.J. (C 326) (free movement of capital) and art. 65 (public policy and public security justification for restrictions on capital movements).

<sup>71</sup> David K. Lakhdir & Anna L. Christie, Paul Weiss Discusses Screening of Foreign Investments in EU, Columbia Law School Blue Sky Blog, <http://clsbluesky.law.columbia.edu/2017/10/06/paul-weiss-discusses-screening-of-foreign-investments-in-eu/>.

<sup>72</sup> Proposal for a Regulation of the European Parliament and of the Council Establishing a Framework for Screening of Foreign Direct Investment into the European Union (EC) No. 2017/0224 (COD) of 13 September 2017, art. 1.

<sup>73</sup> *Id.*, art. 2.

“considers that a foreign direct investment is likely to affect projects or programmes of Union interest on grounds of security or public order.”<sup>74</sup> However, the proposed regulation provides that while a member state is required to take “utmost account” of the Commission’s opinion, it need only “provide an explanation to the Commission in case its opinion is not followed.”<sup>75</sup> The proposal would not require member states to adopt a screening mechanism for foreign investments; rather, it would create an enabling framework and a set of basic principles for member states that seek to establish such a mechanism. In addition, the proposal would create a cooperation mechanism whereby member states undertaking a review of a transaction would be required to notify the Commission and the other member states of such a review within five days of its initiation.<sup>76</sup>

Some individual EU member states already have implemented their own national security screening mechanisms, among them German, France, Italy, and the United Kingdom. These regimes vary in form and stringency.<sup>77</sup> The French regime allows the government to block foreign takeovers of French companies in strategic industries. A 2014 decree expanded the list of sectors in which foreign investors must seek prior government authorization to include energy, transportation, and telecom, among others, and extended the list of circumstances in which a transaction may be blocked.<sup>78</sup> Germany, which already permitted review of foreign takeovers for public order and security concerns, enhanced its regime in 2017. Through the reform, Germany became the first EU member state to specifically screen transactions that threaten critical infrastructure. The reform also increased notification requirements and extended review periods.<sup>79</sup> The United Kingdom’s review process to date has been more limited, although national security has been invoked seven times to permit the government to intervene in a foreign investment.<sup>80</sup> In March 2018 the government lowered the threshold for its review of mergers that raised national security concerns, broadened to include “dual use” military items,

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<sup>74</sup> Id., art 9.

<sup>75</sup> Id.

<sup>76</sup> Id., art. 8.

<sup>77</sup> China also has a screening regime for foreign investment, featuring a “negative list” of off-limits sectors and provisions defining national security in extremely broad terms.

<sup>78</sup> Lakhdir & Christie, *supra* note 71.

<sup>79</sup> Id.

<sup>80</sup> Id.

computer hardware, or quantum technology.<sup>81</sup> This action is the first step to emerge from a consultative process launched in October 2017, which had raised the possibility of a mandatory notification regime, under which any foreign investor in any one of several specified sectors would need to obtain UK government approval before a transaction would receive legal effect.<sup>82</sup>

### *Evaluation*

Enhancing the existing national regimes in the ways being contemplated in the United States and elsewhere may be sound policy. On balance and subject to a variety of concerns ranging from lack of transparency to under-inclusiveness, the CFIUS process appears to have worked reasonably well in striking a balance between maintaining openness to foreign investment while screening out transactions that pose a risk to national security. Broadening the scope of CFIUS review and boosting its resources appear to be sensible ways to enhance the regime's functional efficacy.

But these reforms do not adequately address the threats posed to the global cross-border M&A regime posed by a NSB. As the brief review in this section demonstrates, the global response to concerns about the NSB have to date been national in scope, and the intensity and contours of the review processes vary significantly by country. The fact that many of the existing national regimes are currently being re-examined for possible enhancement suggests the weakness of the current approaches in the face of China's emergence as distinctive type of acquisitive actor in global M&A. The pending EU proposal, if adopted, would constitute the first multi-country, coordinated approach to national security screening. But as noted, it would not require the creation of a uniform screening process at the member state level, and the Commission's opinions as to specific transactions would not be binding on the member states.

Moreover, recent developments suggest inherent limitations in the use of national security screening mechanisms in response to concerns about the motives of Chinese acquirers. For example, the US Securities and Exchange Commission voted in February of 2018 to block a

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<sup>81</sup> Department of Business, Energy and Industrial Strategy, Draft Guidance, Enterprise Act 2002: Changes to the Turnover and Share of Supply Tests for Mergers (March 15, 2018). The Enterprise Act formally was amended in May 2018 to reach targets with revenue as low as GBP 1 million if the company is involved in military or dual-use goods which are subject to export control, computer processing units and quantum technology. The Enterprise Act 2002 (Turnover Test) (Amendment) Order 2018, No. 593 (May 14, 2018).

<sup>82</sup> Department of Business, Energy and Industrial Strategy, United Kingdom Green Paper on National Security and Infrastructure Investment Review (Oct. 2017).

proposed acquisition of the Chicago Stock Exchange by a Chinese acquirer, despite the fact that the deal had been cleared by CFIUS in 2016. According to media reports, the SEC rejected the deal because it “left too many unanswered questions about who would ultimately have control over big decisions at the exchange.”<sup>83</sup> The SEC indicated that it did not consider the national security implications of the deal or possible links between the buyer and the Chinese government, because the proposed structure itself was problematic.<sup>84</sup> A second recent illustration of the limitations of the CFIUS process is the Chinese government’s takeover of Anbang Insurance Group. Anbang, is a private company that engaged in a debt-fueled spate of overseas acquisitions in recent years, including the purchase of the Waldorf Astoria Hotel in New York. The Chinese government, increasingly concerned about the amount of debt being amassed in the corporate sector, took over Anbang in February 2018.<sup>85</sup> The case raises an additional risk associated with overseas Chinese acquisitions: that a domestic target acquired by a private Chinese buyer in a transaction cleared by CFIUS or another country’s national security screening regime may ultimately wind up under the control of the Chinese government.<sup>86</sup>

Similarly, the rejection of the Broadcom-Qualcomm transaction, discussed previously, shows the distortion that will emerge in the effort to package all concerns about the strategic objectives of state-guided foreign actors in a “national security” box. In stating CFIUS’s national security reasons for rejecting the proposed acquisition (which had no direct link to China), the U.S. Treasury was essentially forced to declare a national industrial policy of the development of a 5G telecommunications network and a national corporate governance policy to disfavor a debt-financed acquisition relative to a stock-for-stock deal because of the possible effect on long-term investment. In other words, China’s shadow as an NSB loomed over a deal that involved no Chinese participants, causing a contortion of the CFIUS process. In most cases the governmental concern will be that an acquisition by a NSB will be in service of a foreign state’s objectives, which may be hard to decipher: Is the state pursuing mercantilist goals, for

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<sup>83</sup> Emily Flitter, S.E.C. Blocks Chinese Takeover of Chicago Stock Exchange, New York Times, Feb. 15, 2018, available at <https://www.nytimes.com/2018/02/15/business/china-deal-chicago-exchange-blocked.html>.

<sup>84</sup> Id.

<sup>85</sup> Alexandra Stevenson, After Anbang Takeover, China’s Deal Money, Already Ebbing, Could Slow Further, New York Times, Feb. 26, 2018, available at <https://www.nytimes.com/2018/02/26/business/china-deals-anbang-takeover.html>.

<sup>86</sup> Id.

competitive advancement of NSB-home country firms? Or is there a geo-strategic motive in play? These types of concerns are a source of instability in a cross-border regime that features NSBs.

Finally, only a multilateral regime can constrain strategic use of M&A as instrument in a government's pursuit of sustainable national competitive advantage in the high-tech area. This is because technology has diffused world-wide. China, for example, might well be able to assemble a critical mass of innovation capacity by a diverse-country series of acquisitions that included few if any US targets. As a general technological leader the US may be affected more, but a shift in technological leadership to a *dirigiste* regime pursuing national strategic goals is likely to make many countries and their citizens worse off. Among other factors, the private international capital markets that fund most technology investments in open economies mean that enterprise profits can be shared globally. The profits of a national strategic buyer will be directed by the state.

Recall the contrast we noted in the Introduction between international trade and cross-border M&A. International trade is governed, imperfectly to be sure, by a multilateral regime of standard setting and dispute resolution. By contrast, cross-border M&A – another important source of global economic activity equally if not more sensitive to national interests than international trade – is regulated almost exclusively at the national level.<sup>87</sup> A global economic regime facing a problem of global dimensions calls for a global solution. We are not naïve about the prospects for a global regime of reciprocity in cross-border M&A. As we describe below, the failure of the Thirteenth Directive on Takeovers in the EU demonstrates the difficulty of crafting a truly comprehensive approach. Rather, in the section that follows, we propose an alternative solution to the problem of the NSB. Building on an existing set of principles on investment policy agreed to by the G20 in 2016, we outline a limited, but coordinated approach to cross-border M&A that would mitigate concerns over asymmetric motives.

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<sup>87</sup> Almost, but not entirely, exclusively because the EU Takeover Directive does attempt to coordinate basic principles for the regulation of M&A among member states. But the Takeover Directive is a pale reflection of a truly coordinated multilateral approach to cross-border M&A.

#### IV. Towards a Multilateral Regime for Cross-Border M&A

We begin by acknowledging the challenges in constructing any multilateral regime that would constrain states' efforts to use cross-border M&A for strategic purposes. A first-best solution would be a regime that was self-enforcing, in which the actors' internalized motives would constrain efforts by states to push for state-focused strategic objectives. One straightforward approach is an eligibility regime of "mutual contestability" under which a firm would be eligible to undertake an acquisition of a foreign target only if the would-be acquirer were itself susceptible to takeover by a bidder domiciled outside its home country. Over time, a regime of mutual contestability could be expected to eliminate the problem of the NSB. Assuming relatively efficient capital markets, if an SOE (with a public float) or government-influenced POE were to adopt a "national" strategy that does not maximize shareholder value, the firm would be susceptible to takeover by acquirers with purely financial motives, because the stock price would reflect the cost to shareholders of pursuing the national-welfare maximizing strategy. A financially motivated buyer could purchase the SOE or government-influenced POE at a discount, eliminate the costs incurred due to policy channeling, and benefit from the increase in stock price. Over time, the capital and control markets would eliminate NSBs. A regime of mutual contestability would also eliminate complaints about the lack of reciprocity that exacerbate frictions over Chinese foreign investment.

The EU's experience with its Company Law Directive on Takeovers<sup>88</sup> demonstrates the challenges that a mutual contestability proposal would face on a global level. In 2001, in the effort to resolve a longstanding deadlock over adoption of the Takeover Directive, the European Commission convened a High Level Group of Company Law Experts.<sup>89</sup> Seeking to overcome national barriers to cross-border acquisitions to facilitate growth of a "single market" while assuring a "level playing field," the expert group proposed a mandatory "board neutrality rule"

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<sup>88</sup> Directive 2004/25/EC on takeover bids (OJ L142/12, 30.4.2004).

<sup>89</sup> What follows is drawn from Jeffrey N. Gordon, *The International Relations Wedge in the Corporate Convergence Debate*, in Jeffrey N. Gordon & Mark J. Roe, eds., *Convergence and Persistence in Corporate Governance* (2004) and Paul Davies, Edmund Philipp-Schuster, and Emilie van de Walle de Ghelcke, *The Takeover Directive as Protectionist Tool?* In Ulf Bernitz & Wolf-Georg Ringe, eds., *Company Law and Economic Protectionism* (2010) available at <https://ssrn.com/abstract=1554616>.



and a “break-through rule.”<sup>90</sup> The break-through rule would permit the holder of 75 percent of a company’s cash flow rights to “break-through” takeover impediments such as dual class common stock or super-majority voting requirements. The member states resisted these mutual contestability provisions on local efficiency grounds – the value of dual class common structures, common in Scandinavia, for example – as well as arguments that were more directly protectionist.<sup>91</sup> The further objection was that the Directive’s provisions were under-inclusive: that they did not attack impediments such as pyramidal structures and left limitations on member states’ “golden shares” to resolution by the European Court of Justice. The final Directive permitted states to choose whether to opt-in to this (partial) mutual contestability regime and further permitted states and firms to resist bids from companies/jurisdictions that had opted against mutual contestability. It is commonly regarded as not having advanced the cause of greater economic integration in the “single market” through cross-border M&A.<sup>92</sup>

A mutual contestability regime is a heavy lift because it entails a general challenge to ownership and control structures that may have deep roots and even efficiency justifications. “Break-through” rules are particularly ineffective where the controller has a majority stock ownership position or exercises control through a complicated “group” structure, both of which are common features of state and private ownership of business enterprises in China. Thus, our proposal looks to a governance structure within the firm and an administrative agent to examine and certify the private/non-state economic motives behind a proposed cross-border M&A. It builds an enforcement mechanism using internal governance features rather than relying on self-enforcing capital market pressures.

The starting point for our proposal is a global commitment to *commercial/financial* motivations for outbound investments by firms subject to government ownership or influence as a means of contributing to the stability of the global M&A market. There is precedent for building a coordinated investment regime from this starting point. The Santiago Principles for

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<sup>90</sup> Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, Jan 10, 2002, available at [www.ecgi.org/publications/winter.htm](http://www.ecgi.org/publications/winter.htm).

<sup>91</sup> For a subtle critique from Scandinavia, see Erik Berglof and Mike Burkart, European Takeover Regulation, 188(36) Economic Policy 171 (2003).

<sup>92</sup> Wolfgang Drobetz & Paul P. Momtaz, Corporate Governance Convergence in the European M&A Market (2016), available at <https://ssrn.com/abstract=2642487> (finding no increase in EU cross-border M&A after adoption of the Directive; finding a decline in hostile bids).

Sovereign Wealth Funds were adopted in 2008 in response to concerns -- not unlike those relating to Chinese outbound investments currently -- about the possibility that SWF investments are motivated by non-commercial objectives.

The Santiago Principles are a nonbinding statement of generally accepted principles and practices that members of an “international working group” of SWFs have implemented or aspire to implement.<sup>93</sup> They emphasize the “core principle” that “investment decisions should aim to maximize risk-adjusted financial returns ... based on economic and financial grounds.”<sup>94</sup> They call for transparency in the source of funding and operational independence of the SWF from the government owner. These principles – financially oriented investment decisions, funding transparency, and independence from the government in its role as investor – should also comprise the “core principles” of acquisitions in a cross-border M&A regime.

However, addressing concerns about national strategic motives in the SWF realm are considerably less complex than in the case of cross-border M&A. This is because SWF investments are *portfolio* investments that do not implicate changes in control of the target or the composition of its core governance organs. A parsimonious solution to the problem of asymmetric motives in SWF investments is readily available: the voting rights of equity acquired by a foreign-government-controlled portfolio investor could be suspended (or voted in proportion to the votes of non-SWF shareholders) until the shares are sold to a non-government affiliated investor.<sup>95</sup> The Santiago Principles do not adopt this approach – instead emphasizing the importance of *ex ante* disclosure of whether and how SWF’s plan to vote in order to “dispel concerns about potential noneconomic or nonfinancial objectives.”<sup>96</sup> Voting suspension is obviously an untenable proposition in an acquisition of control or any significant stake by a buyer seeking to influence the target. *Ex ante* disclosure of financial motives is useful, but it is not credible as a signaling device because governments can (and often do) say one thing but do another. Thus, a commitment to financial investment motives is only a starting point, but one that could readily be added to the G20 Guiding Principles for Global Investment Policymaking,

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<sup>93</sup> International Working Group of Sovereign Wealth Funds, Sovereign Wealth Funds Generally Accepted Principles and Practices 5 (2008) (“Santiago Principles”).

<sup>94</sup> Id. at 22 (GAAP 19 Principle; Explanation and Commentary).

<sup>95</sup> See Ronald J. Gilson & Curtis J. Milhaupt, Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism, 60 Stan. L. Rev. 1345 (2008).

<sup>96</sup> Santiago Principles, *supra* note 93, at 23 (GAAP Principle 21; Explanation and Commentary).

adopted in 2016 when China held the presidency of the G20.<sup>97</sup> Borrowing from the Santiago Principles, the multilateral regime should contemplate the creation of a standing group of peer monitoring and information sharing to evaluate on-going compliance.

As an alternative to a G20 engagement, the cross-border eligibility regime could be fashioned under the auspices of the Organization for Economic Co-operation and Development (OECD), an organization of 35 developed countries that also works with emerging economies like China. The OECD could organize a consultative process, the end point of which should be: first, articulation of a commitment to own-firm financial/commercial objectives in outbound M&A, not at the behest of a government; second, the crafting of a compliance regime to monitor adherence to this commitment for firms where government involvement raises difficult verification questions – an “eligibility regime”; and third, establishment of a secretariat that would evaluate initial and continuing compliance with the eligibility regime. This set up would not require government agreement to forgo state ownership or “policy channeling,” but rather government acquiescence to firms that engage in cross-border M&A opting into a regime designed to assure that outbound acquisitions adhere to own-firm financial/commercial objectives exclusively.

The eligibility regime would be triggered for any firm whose governance is subject to intervention by a political party or government, through (a) state ownership of the firm’s equity, (b) mandatory representation by members of a political party or government in the corporation’s governance organs such as the board of directors or other committees, or (c) a golden share (or equivalent veto rights over major corporate decisions) held by a government.<sup>98</sup> The “eligibility” criteria are designed to make it possible for an acquirer to make a credible commitment that its cross-

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<sup>97</sup>The G20 Principles are available at <http://www.oecd.org/daf/inv/investment-policy/G20-Guiding-Principles-for-Global-Investment-Policymaking.pdf>. They are non-binding principles whose objectives are fostering an open and transparent environment for investment, promoting coherence in national and international investment policymaking, and promoting sustainable development. As such, a commitment to financially oriented investment, funding transparency and independence from the government is highly consistent with the G20 Principles.

<sup>98</sup> The secretariat would also have to be vested with a certain amount of discretion to trigger the eligibility regime where a firm does not meet any of the formal triggers but nonetheless appears susceptible to government influence in its cross-border M&A activity. The type of factors that might be considered in the exercise of this discretion could include such things as the amount of government contracts and government-linked financing the firm receives and the backgrounds of its principal investors and top managers.

border acquisition proposal is motivated by private commercial objectives rather than “national strategic” objectives.

A firm subject to the eligibility regime would be eligible to engage in cross-border M&A if it met the following requirements:

- (i) the company commits in its charter or other constitutive documents to undertake foreign acquisitions solely for own-firm financial or commercial objectives and not at the behest of any government;
- (ii) a significant portion, 25 percent, of the company’s cash flow rights are available for purchase by foreign shareholders;
- (iii) the company’s governance structure provides for independent directors, at least 25 percent of the board (but no less than two), who will be nominated by foreign shareholders;
- (iv) in advance of a public acquisition proposal, the independent directors are required under the acquirer’s governance documents to prepare a report for subsequent public release that attests to the own-firm financial or commercial motivation and absence of government involvement in the acquisition decision; and
- (v) the company provides full disclosure of the sources of funding for the transaction before the transaction is final.

Enforcement of the regime would consist of two elements: first, a secretariat that can evaluate whether a would-be acquirer satisfies the eligibility criteria both as a general matter (the company’s governance set-up) and as to the specific transaction; second, national legislation that would permit rejection of the acquisition of a local target by an acquirer that does not meet the eligibility criteria.

These eligibility criteria are chosen to reinforce one another. The availability of a 25 percent foreign float provides an opening for institutional investors, who have a major stake in preserving a flexible cross-border M&A regime because of the value thereby created. These minority shareholders are empowered to nominate – effectively to select – at least two independent directors. The independent directors have special fiduciary duties to assess the firm’s acquisition objectives and to verify both the commercial/financial motivation and the absence of government involvement in the particular acquisition decision. The acquirer is also separately obligated to disclose its funding sources for the acquisition, which should provide another occasion for critical scrutiny of a possible hidden governmental hand.

Compliance with the eligibility regime could be woven into national cross-border merger review schemes via local law. In addition to specific national security concerns, a country could: (i) debar an acquirer that fails the eligibility criteria, (ii) reject specific transactions that fail the verification scheme, (iii) debar an acquirer that initially satisfied (or appeared to satisfy) the eligibility regime with respect to a transaction where facts emerge that indicate otherwise. The eligibility regime gains its force from its consequences in the national review process.

## **V. Potential Objections**

We conclude by responding to several possible objections to our proposal. The first is a general welfarist objection: what is the actual concern raised by a “national strategic buyer”? Target shareholders get higher prices, and more investment flows into favored sectors, which should spur more innovation and risk-taking (much like the flood of venture capital finance). There is both a private and public answer. NSBs have a competitive advantage over conventional acquirers because of their access to lower-cost state finance and the implicit promise of state support if the acquisition is not successful in income statement terms. In other words, NSBs face soft budget constraints rather than hard budget constraints on acquisitive activity and deal pricing. NSB activity in the US and the EU could thus lead to distorted prices that adversely affect resource allocation in important sectors. Moreover, conventional acquirers could be deprived of access to competitively valuable technology or other resources, which would hamper their growth.

The more serious concerns are public. In critical sectors like technology the goal of national policy is to create “agglomeration economies,” that is, concentrations of expertise that build on one another for durable growth and innovation.<sup>99</sup> There is a geographical component, reflected in an “industrial district” like Silicon Valley,<sup>100</sup> but also a harder-to-specify human network that supplies energy and cross-fertilizing ingenuity. A critical feature of US “industrial policy” is to foster such developments through private finance and open capital markets. The concern is that the NSB, applying a more directive industrial policy, could capture key inputs

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<sup>99</sup> See generally Glaeser, ed., *supra* note 6.

<sup>100</sup> Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 NYU L. Rev. 575 (1999); AnnaLee Saxenian, *Regional Advantage: Culture and Competition in Silicon Valley and Route 128* (1994).

and channel them to NSB-home country advantage. More specifically, the concern is that Chinese NSBs could pursue such acquisitions on a scale that would shift the location of innovation, and thus durable economic growth, from the US to China.<sup>101</sup>

Whether these concerns are well-taken or merely scare-mongering, large-scale NSB acquisitions are perceived by other governments as threatening and violating the existing order in cross-border M&A. Target-home-country protectionism is grudgingly accepted as part of the M&A game, as the EU experience demonstrates, but acquirer-home state aid/state direction is a violation; it's the difference between offense and defense in state action. Our view is that NSB activity has injected instability into the cross-border M&A regime. As the developing pattern of US, UK, and EU responses demonstrates, Chinese NSB acquisitions could trigger a reaction that could radically transform the cross-border M&A regime.

The vetoed Broadcom-Qualcomm matter demonstrates this possibility. There was no threat to US national security interests as conventionally understood. Indeed, except for its (temporary) Singaporean domicile, Broadcom was a thoroughly “American” firm, if we look to ownership by US institutions and asset managers or the nationality of directors and senior managers. The Trump Administration decided that Broadcom’s acquisition of Qualcomm would undercut R&D investment in a telecommunications innovation, 5G, also pursued by Chinese rivals: “A shift to Chinese dominance in 5G would have substantial negative national security consequences for the United States.”<sup>102</sup> The same objection could have been raised in the case of a UK acquirer, or a Swiss acquirer. Under the cover of Chinese NSB activity in the technology space, the US government has opened the door to a national industrial policy screen for all cross-border M&A. Thus, it will be in the interests of all long-term players in the cross-border M&A market – all institutional investors, asset managers, sovereign wealth funds, and intermediaries – to work together to fashion a regime that will visibly constrain the pursuit of national strategic

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<sup>101</sup> We are not persuaded by the objection that investments guided by national industrial policy are doomed to failure, so that the NSB problem is inconsequential. Nor do we think that the US or other nations should pursue their own version of national industrial policies. The success of the US Defense Department’s DARPA investments in initially organizing the internet counsels caution in assuming futility; the general pursuit of competitive national industrial policy investments is an invitation for a reopening of aggressive mercantilism.

<sup>102</sup> Letter from Aimen N. Mir, Deputy Assistant Secretary of the Treasury for Investment Security to Mark Plotkin and Theodore Kassinger, March 5, 2018, available at <https://www.qcomvalue.com/wp-content/uploads/2018/03/Letter-from-Treasury-Department-to-Broadcom-and-Qualcomm-regarding-CFIUS.pdf>.

objectives by cross-country acquirers, especially China. This is what our eligibility regime aims to do.

What is novel in the eligibility regime is the use of a corporate governance strategy to solve a problem of international relations. Over the past forty years private and government actors have increasingly looked to the board of directors to address difficult regulatory matters and have enhanced the demands for director independence and engagement. Perhaps the most successful uses have been in the control of accounting fraud and in the sale of the firm. The Sarbanes-Oxley regime – which includes Audit Committee oversight of outside accounting experts – helped assure that there was no significant accounting fraud among large financial players during the Financial Crisis, despite the enormous financial stress and the incentives for book-cooking. The Special Committee process allows the independent directors to marshal significant outside expertise to evaluate competing bids for the target and can produce the simulacrum of arm's length bargaining even in conflict cases. These examples lead us to the belief that an eligibility regime employing independent director investigation and certification can credibly evaluate an acquirer's motives for a transaction.

The final issue is whether China in particular would subject its firms to an “eligibility regime” for cross-border M&A. The proposal would not require China to give up the pattern of state ownership or state-guided industrial policy, but it would limit China's ability to use cross-border M&A as a mechanism for the pursuit of state strategy. The proposal would not require China to accede to an international agreement, merely to acquiescence in willingness of SOEs and POEs to submit to the eligibility regime, which will affect the ownership and governance of those firms. Obviously, such a regime would not be the first best choice of the Chinese leadership. But to emphasize what we wrote earlier: without some type of intervention along the lines we suggest, the present cross-border M&A regime may unravel. President Xi Jinping has spoken forcefully in favor of openness in trade and investment, emphasizing that “[t]o grow its economy, China must have the courage to swim in the vast ocean of the global market.”<sup>103</sup> Support for a multilateral regime that constrains mercantilist, national-strategic motivations for deals would demonstrate China's commitment to sound governance of the global market for cross-border M&A.

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<sup>103</sup> See *supra* note 15.