4

National Security Issues Related to Investments from China

As discussed in earlier chapters, much of the concern in the US Congress and the US media over foreign direct investment (FDI) in the United States during 2005, epitomized by the emotional debate over the China National Offshore Oil Corporation's (CNOOC) proposed acquisition of Unocal, focused on investment from China.[1] Such debates are often heated, emotional, and a topic of conversation throughout the country, not just in Washington.[2] The most recent debate, over the proposed acquisition of the Peninsular and Oriental Steam Navigation Company (P&O) by Dubai Ports World, is a case in point. The proposed acquisition had all of official Washington on the edge of its seat for much of early 2006, blanketed front pages of newspapers, and was the subject of countless hours of talk radio and cable television programming. From time to time, foreign acquisi-

1. See, e.g., the Sense of the Congress included in the fiscal 2006 Department of Defense authorization bill, discussed in chapter 1. Congress called on the president to develop a comprehensive strategy toward China, which included considering several changes to Exon-Florio. That Congress framed the possible changes in a China-specific provision of the bill demonstrates Congress's particular concerns with investment in the United States from China.

2. A CNN/Gallup/USA Today poll found that 66 percent of US voters opposed the sale of P&O to Dubai Ports World. Holly Yeager, "Ports Sale Unrest Deepens Bush Political Woes," *Financial Times*, March 9, 2006, A4. Further evidence of the emotional impact of these debates was the *Financial Times'* statement that the transaction presented President Bush with "one of the toughest political battles" in his presidency. Stephanie Kirchgaessner and Holly Yaeger, "Dubai Gets Approaches for Its US Terminals," *Financial Times*, March 9, 2006, 1.

tions of US companies hit a nerve in the United States, a pattern we have seen since the early 20th century.

The debate over investments from China is not the first time that anxiety and opposition have been directed toward a single nation. Both the US Congress and military were greatly concerned about the security implications of German direct investment in the United States during World War I. This concern motivated the passage of the Trading With the Enemy Act (TWEA) in 1917, as well as a number of sector-specific restrictions on FDI enacted during the early 1920s. Hostility toward German FDI in the United States reemerged in the 1930s. As we argued in chapter 1, some of the concern at that time was warranted, even if not all German FDI threatened US national security. Some of the FDI from Germany might actually have been to the military advantage of the United States, and not Germany, when war later broke out. In the late 1980s, Japanese investments were the subject of concern in Congress, the media, and academic circles, ultimately leading to the passage of the Exon-Florio Amendment. In hindsight, much of the furor over Japanese FDI in the United States now seems exaggerated or even downright silly.

Is, then, the present-day concern over possible security threats posed by Chinese direct investment in the United States warranted, as was concern over German FDI during the 1930s, or will it prove as exaggerated as that over investment from Japan in the 1980s? We seek to answer this question in this chapter.

China: A New Player in FDI

Throughout most of its long existence, China has been organized as a kingdom or an empire.[3] It has never been a fully functioning democracy, although a nominal democracy and, by most counts, ineffective one existed in the early 1900s. Chinese history is usually represented as falling into a series of powerful and advanced dynasties, interspersed with periods of weakness, internal chaos, and even civil war.

China has alternated between being a strong and relatively weak power. China arguably reached its apex as a world power during the Tang Dynasty, which lasted from 618 AD to 907 AD. An earlier period of strength occurred during the Han Dynasty, from 206 BC until 221 AD, coinciding to a large extent with the period during which the Roman Empire dominated in the West. A third period of significant Chinese power was the Song Dynasty (1127–1279), during which technology and industry rapidly advanced in China. Another high point was the early part of the Ming Dynasty, which lasted from 1368 AD until 1644 AD. Early in the Ming Dy-

3. Sources for information pertaining to the pre-1979 history of China in this section include Huang (1997), Levathes (1994), and Morton (1980).

nasty, China possessed what was by far the world's strongest navy, employing ships of advanced design and firepower that were not equaled in the West until the late 18th century. China also was relatively powerful during the early days of the Qing Dynasty (1644–1911).

However, at the end of the Han Dynasty, China splintered into three separate kingdoms that warred with each other. China was reunited under the Sui Dynasty, which was followed by the Tang Dynasty. The collapse of the Tang Dynasty was followed by another period of internal strife, during which China splintered into 15 separate entities. This ebb and flow continued until the 20th century, when China was ravaged by both internal strife and foreign intervention. This prolonged period of weakness ended only after the Communist victory in the civil war of 1947–49 and the establishment of the modern Communist state in China.

Even during periods of strength, China has often experienced internal problems. The Uighur, an ethnic minority in China but the dominant group in the western part of the Tang empire, staged a successful rebellion in 755 AD that resulted in the western lands becoming independent. The Uighur rebellion is still active in modern China. Likewise, during the Song Dynasty, the Han Chinese majority battled an ethnic minority, the Xia tribes, that occupied the upper reaches of the Yellow River valley. Defeated by the Han, many of the Xia migrated to what were then mostly unpopulated lands in the region now known as Tibet—part of China today, but also home to an active independence movement.

Thus one very important historical lesson is that the overthrow of incumbent dynasties in China, shifting borders, and ebbs and flows in the level of centralized control have often been precipitated by popular uprisings, and accompanied by bloody civil wars or periods of high social instability and economic downturn. The current Communist government was established in 1949 after a very prolonged period of internal strife, civil war, and foreign intervention. Mindful of both ancient and recent history, the Chinese leadership today constantly fears another period of popular uprising, social instability, and economic deprivation, especially if the currently high rates of growth and rising prosperity ends. These fears drive China's leaders to tightly control economic and political activity, and are invoked to justify undemocratic policies.

A second lesson is that, during periods of internal weakness and instability, China has on several occasions been subject to foreign domination and even conquest. As noted, Mongol invaders conquered a divided China in 1279–80 and established the Yuan Dynasty, which ruled until 1368. A rebellion in that year, leading to the Ming Dynasty, returned Chinese rule to China. But civil war in Ming Dynasty China in the early 1600s led to conquest by Manchurians, who created the Qing Dynasty, which stayed in power, at least nominally, until 1911. The internal weakness of the Qing Dynasty by the early 19th century led to China succumbing to British, Russian, and other foreign control or influence. Almost a century later, this

lengthy period of internal turmoil and sporadic civil war within China culminated in the Japanese takeover of Manchuria in 1937, war with Japan until 1945, and the civil war of 1947–49.

A major goal of the Chinese state under the Communist Party is to never again be controlled, let alone conquered, by foreign interests. All national governments hold similar goals, of course, but recent Chinese history lends a greater urgency to these goals than is found in most nations. To Americans, the idea of the United States coming under foreign control is repugnant, but also only remotely likely. The Chinese, by contrast, take the possibility of foreign takeover seriously. Foreign intervention, including military invasion, occurred frequently in China in the 20th century. Many living Chinese remember Japanese troops occupying major Chinese cities 60 years ago, and even more can recall American troops lined up along the Yalu River bordering North Korea, under the command of a US general who talked openly of bombing and invading China. Almost all Chinese of adult age can remember the massive deployment of Soviet troops on or near China's northern borders.

These lessons must be borne in mind today, as China seeks to build its military capacity and continues to stifle domestic dissent. In the United States, we might not like either development. But we must be cognizant of the historical factors and environment driving Chinese decision making.

The xenophobia kindled by foreign intrusion into China in the latter half of the 19th century and the first half of the 20th doubtlessly contributed to the insular policies that the Communist government pursued from its rise to power in 1949 until the late 1970s. These policies closed China to all foreign commercial presence, with the exception of some Soviet and Eastern bloc trade and investment that ebbed and flowed depending on Sino-Soviet relations. The Chinese government allowed little trade with the external world, had virtually no outward direct investment, and was almost completely closed to inward direct investment. Under Mao Zedong, the economy of China was, by almost any measure, among the most closed on the planet. Rather than trade or invest with the rest of the world, China attempted to become autarkic. By any objective account and measure, the attempt at autarky was unsuccessful.[4] In spite of its past power and wealth, in 1949 China was one of the poorest countries on earth on a per capita basis, and this was still the case more than 25 years later, when Mao Zedong died.

Shortly after Mao's death in 1976, Deng Xiaoping emerged as China's new head of state. Almost from the outset, he set about implementing major changes to Chinese economic policy that would eventually reorient China toward being a more open economy. In 1978 he initiated the "open door policy," allowing limited foreign investment in the country (Jia 1994). However, this legislative change was narrow in scope, reflecting concerns

4. The economic history of the Maoist period in China is summarized in Lardy (1994).

that FDI entering into the country would create competition with state-owned enterprises (SOEs). As a result, the reform achieved little; almost no FDI actually came into China (Rosen 1999).

In 1979, China passed a law to create special economic zones in which foreign investors could operate export-oriented manufacturing activities free from most Chinese regulations then in force. The special economic zones had two objectives: first, to expand exports and thus overcome what had been a major constraint to development under Mao, a shortage of foreign exchange; and second, to help China upgrade its technological capabilities in certain designated sectors.

The pace of growth in inward investment to and exports from the economic zones during the late 1980s was staggering. In 1980 total FDI inflows to China were only $57 million. By 1990, FDI to China had increased more than 60 times over, to almost $3.5 billion. Approximately 70 percent of overall direct investment into China in 1990 flowed to the economic zones. Similarly, in 1985, China generated about $27 billion in worldwide exports. By 1990, exports had more than doubled to over $62 billion, with almost $8 billion, or more than one-fifth of the increase, produced by "foreign-invested enterprises," to use the Chinese term. Most of the growth in Chinese exports came from the special economic zones.[5]

In 1992, in the course of what become known as his "trip to the South," Deng visited several of the zones, noted that activity there was booming, and asked rhetorically, but in a way that signaled a change of policy, why the rest of China should not emulate this success by ending many of the restrictions that foreign investors faced.[6] Accordingly, Chinese authorities lifted most of the restrictions limiting export-related privileges to firms located in the zones, and implemented other measures liberalizing policies with respect to FDI into China. These measures were followed in 1995 by the publication of comprehensive regulations on foreign investment in China that were more transparent than those they replaced, but still much more opaque than standards for regulations in the United States and other western countries (Rosen 1999). China continued to liberalize its rules on foreign investment, and joined the World Trade Organization (WTO) in 1999, resulting in new sectors and regions being opened to foreign investment.

FDI in China exploded in the 1990s, as did exports resulting from this investment.[7] As noted, in 1990 FDI inflows into China were a bit less than

5. For more detailed information on the history and performance of the SEZs, see Graham (2004).

6. Todd Lappin and Orville Schell, "China Plays the Market: Capitalist Leap," *The Nation*, December 14, 1992, 727.

7. Source of FDI data: *China Statistical Yearbook 2005* and *China Statistical Yearbook 1991* (both published by Beijing, China Statistical Press), tables 18-13 (2005) and 15-10 (1991). For a more comprehensive assessment of the effects of the 1991 reforms on FDI in China, see Wei (1996) and Graham (2004).

$3.5 billion; 15 years later, in 2005, inflows were over $60.3 billion. The stock of FDI in China, about $19 billion in 1990, grew to over $562 billion in 2005. Exports generated by foreign-invested firms were, as noted, slightly under $8 billion in 1990; by 2005 these exports had grown to $444.2 billion.[8] China's total exports grew from $62 billion in 1990 to almost $762 billion in 2005. Thus the increase of $543 billion in exports of foreign-invested enterprises accounted for almost 78 percent of total growth in exports. Foreign investment in China became the main "engine" propelling China's remarkable rise as an exporter and contributed significantly to overall Chinese economic growth.[9]

In the high-income countries of Western Europe and the United States, the vast majority of inward FDI is in the form of mergers and acquisitions (M&As). By contrast, in China, M&As account for only a small fraction of total inward FDI, in part because M&As have been and continue to be largely prohibited in China, although recently there have been some moves by Chinese officials to allow acquisitions, including hostile acquisitions.[10] In 2003, the reported value of takeovers of firms within China by foreign investors was slightly over $1.6 billion, or about 3 percent of reported inward FDI flow—and 2003 was a banner year for such takeovers. Only in 1998 has the reported value of takeovers of Chinese firms been higher, at $1.28 billion. In both 2002 and 2004, the reported values of M&As in China were only slightly more than $1 billion.

Whereas the Chinese government first fostered and later embraced large amounts of inward FDI, policies supporting outward foreign investment have only recently been put in place. In its "Tenth Five-Year Plan Outline on National Economy and Social Development of the People's Republic of China," the Chinese government in 2001 officially adopted a policy encouraging Chinese companies to invest abroad.[11] Since issuing this "going out" strategy, Chinese officials have amplified the policy is speeches. For

8. Source for export data: General Administration of Customs, PRC, *China's Custom Statistics*, December, 2005, tables 1 and 6. For more detailed information and analysis on FDI and Chinese exports, see Lemoine (2000) and Lemoine and Ünal-Kesenci (2004).

9. See, e.g., Dayal-Gulati and Husain (2000).

10. One reason for the liberalization might be that research within the Chinese government (the Development Institute of the State Council) has concluded that existing restrictions might in fact be counterproductive for China. See Long (2005).

11. Article 4 of this five-year plan states (translated from Chinese):

Carrying Out "Going Out" Strategy

Fourth, we need to implement a "going out" strategy, encouraging enterprises with comparative advantages to make investments abroad, to establish processing operations, to exploit foreign resources with local partners, to contract for international engineering projects, and to increase the export of labor. We need to provide a supportive policy framework to create favorable conditions for enterprises to establish overseas operations. We also need to strengthen supervision and prevent the loss of state assets. (ILO 2001)

example, Wu Bangguo, the vice premier responsible for Chinese economic policy, encouraged Chinese companies to "go global" in a 2001 speech at the Xiamen Investment and Trade Fair. In his speech, Wu stated that China's "outbound investment strategy will be integrated with the continuous effort to promote foreign capital inflow to boost China's overall involvement in global economic cooperation."[12] The "going out" policy has now started to show results. In 2005, Chinese companies invested about $5.5 billion abroad. Recent overseas investments have included TCL Group's acquisition of the television and DVD operations of Thomson, a French company; Lenovo's acquisition of IBM's personal computer division; and, the largest foreign investment to date, China National Petroleum Corporation's $4.2 billion acquisition of PetroKazakhstan. For the first time, Chinese brands have also started to see success in the globalized market, including Haier (home appliances), Konka (color televisions), Jianlibao (beverage), Tsingtao (beer), and Galanze (microwave ovens) (see Hongand Sun 2004). Chinese companies have made major acquisitions of mining and other natural resource companies in Australia, Canada, South America, and Africa. As discussed earlier and also in detail in chapter 5, the largest proposed acquisition of a US company by a Chinese company, CNOOC's $18.5 billion bid for Unocal, was withdrawn amid strong opposition in Congress during the summer of 2005. One report suggests that there have been approximately 900 Chinese investments in small US companies, worth a total of approximately $1 billion (Hildebrandt International 2005, 43). While outward investment from China has grown, it still pales compared with inward investment. Table 4.1 indicates yearly outward FDI flows from China from 1997 to 2004. As can be seen, the outward flow in 2004 ($1.81 billion) was less than 3 percent of the inward flow ($60.6 billion) and, even in 2001, when outward FDI from China was relatively high, it was only about 15 percent of inward FDI. The total stock of FDI in China was $ 562.1 billion, while the total stock of Chinese FDI abroad was about $44.8 billion. China's overseas direct investment thus represents less than 8 percent of the total direct investment in China.

Unique National Security Issues Associated with Chinese Investment

The growth in outward Chinese investment, including into the United States, has forced agencies in the Committee on Foreign Investment in the United States (CFIUS) to confront its national security implications. This section explores why investments from China have become a particularly difficult national security issue for CFIUS, resulting, in some cases, in controversial and contentious reviews.

12. " 'Go Global' Investment Strategy Needed for Chinese Enterprises," *People's Daily*, September 12, 2001.

Table 4.1 Outward and inward direct investment, China, 1997–2004 (millions of dollars)

Year	Outward FDI flows	Inward FDI flows
1997	2,563	45,256
1998	2,634	45,463
1999	1,775	40,319
2000	916	40,715
2001	6,884	46,878
2002	2,518	52,743
2003	152	53,505
2004	1,805	60,630
	Outward FDI stock at year end	**Inward FDI stock at year end**
2004	44,777	562,105

Note: For reasons not wholly clear to the authors, the FDI stock numbers for China are not the sum of the flow numbers. Flow numbers as reported above are on a balance of payments basis.

Source: China Statistics Press, *China Statistical Yearbook 2005*, tables 3.5 and 18.13.

In practice, Chinese acquisitions of US firms have received heightened CFIUS scrutiny. Of the six CFIUS "investigations," or extended reviews, between January 2003 and December 2005, two—Hutchison Whampoas' proposed investment in Global Crossing and Lenovo's acquisition of IBM's personal computing business—involved acquisitions by companies based in Hong Kong or China.[13] The proposed acquisition of Unocal by CNOOC in the summer of 2005 certainly would also have required a full investigation. The authors are aware of at least two other planned acquisitions abandoned by Chinese companies, after informal discussions with CFIUS agencies or US lawyers suggested that approval would be difficult, if not impossible, to obtain. China National Aero Tech's 1990 attempt to acquire a US aerospace company is the only transaction that the president has formally blocked using his powers under Exon-Florio, although a number of other transactions have been withdrawn to avoid a negative presidential decision.

From a broad, strategic perspective, Chinese acquisitions present CFIUS with different issues and concerns than do acquisitions by companies of other major trading partners. To begin (see table 4.2), of the United States' 10 largest trading partners, China is the only one not considered a strate-

13. Some CFIUS agencies reportedly treated Hutchison Whampoas as a Chinese company, even though it was based in Hong Kong.

Table 4.2 Ten largest trading partners of the United States

Country	Strategic/political relationship with the United States
Canada	The United States' largest trading partner by far, with major investment flows in both directions. Like the United States, a member of NATO, Group of Seven (G-7), North American Free Trade Agreement (NAFTA), Organization of American States (OAS), Organization for Security and Cooperation in Europe (OSCE), Organization for Economic Cooperation and Development (OECD), and Asia Pacific Economic Cooperation forum (APEC).
Mexico	Large-scale human exchanges in tourism and immigration; recent rapid economic integration via NAFTA. Also a member of the OECD and OAS.
China	Now the United States' third-largest trading partner. But no friendship, commerce and navigation treaty or bilateral investment treaty; classified by the United States as a nonmarket economy; political and security relationship remains tenuous at best. Member of APEC.
Japan	Broad political and economic cooperation between the two countries. Close security relationship: US-Japan Mutual Security Treaty (1951); US-Japan Missile Defense Agreement (2004); approximately 40,000 US troops based in Japan. Member of G-7, OECD, and APEC. US-Japan Friendship, Commerce & Navigation Treaty signed 1953.
Germany	Major economic partner and European ally. Member of NATO, G-7, OECD, and OSCE, as well as an important player in the EU-US relationship. US-Germany Friendship, Commerce & Navigation Treaty signed 1954.
United Kingdom	Close defense and intelligence ally and important economic partner. Member of NATO, G-7, OECD, and OSCE, and an important player in the EU-US relationship. US-UK Commerce & Navigation Treaty signed 1815.
Korea	Significant economic partner and long-standing Asian ally. US-Republic of Korea Mutual Defense Treaty (1954); approximately 30,000 US troops based in Korea. Friendship, Commerce & Navigation Treaty signed 1956. Member of OECD and APEC.
France	Important trading partner and European ally. Member of NATO, G-7, OECD, and OSCE, and an important player in the EU-US relationship. US-France Navigation & Commerce Treaty signed 1822.
Taiwan	Significant economic partner and regional ally. United States is a major arms supplier to Taiwan, pursuant to Taiwan Relations Act of 1979. US-Taiwan Friendship, Commerce & Navigation Treaty signed 1946 (administered on nongovernmental basis by American Institute in Taiwan since 1979).
Italy	Important trading partner and European ally. Member of NATO, G-7, OECD, and OSCE. Significant voice in EU-US relationship. US-Italy Friendship, Commerce & Navigation Treaty signed 1948.

gic or political ally. Five of the United States' top 10 trading partners are members of the North Atlantic Treaty Organization (NATO), the United States' principal security alliance. In Asia, the United States has strong security ties—including mutual defense treaties and the stationing of tens of thousands of troops—with both Japan and Korea. Finally, while the United States does not maintain formal relations with the government of Taiwan, it has been Taiwan's major arms supplier for two decades.

By contrast, the United States not only lacks a strategic or military partnership with China, but the US Department of Defense (DOD), other US national security agencies, and important opinion leaders in Congress view China with great suspicion (US DOD 2005). China stands out among the United States' largest trading partners in several respects relevant to CFIUS's review of proposed inward investments. Among the United States' largest trading partners, China is alone in its level of state ownership and control of companies, and in the espionage threat assigned to it by the Federal Bureau of Investigation (FBI) and other intelligence agencies.[14] Only China is regarded as a major proliferator of sensitive technologies, including nuclear weapons technologies.

Table 4.2 highlights the gulf between the United States' weak security ties to China, its third-largest trading partner, and the otherwise close relationships with the remainder of its top 10 largest trading partners.

For these reasons, investments from Chinese companies will continue to draw scrutiny from CFIUS agencies, particularly its national security agencies. We examine these issues more deeply, discussing whether tougher scrutiny of investments in the United States by Chinese corporations is warranted.

Chinese State Control of Corporations and the Byrd Amendment

As discussed in chapter 2, the 1993 Byrd Amendment to Exon-Florio, adopted in the wake of Thomson's failed acquisition of LTV, requires an "investigation"—an extended review—for transactions "in which an entity controlled by or acting on behalf of a foreign government seeks to engage in any merger, acquisition or takeover which could result in control of a person engaged in interstate commerce that could affect the national security of the United States."[15] Although the title of this subsection is "Mandatory Investigations," CFIUS has construed the language in the

14. Jay Solomon, "US Sees a Big Threat from Chinese Spies, but Businesses Wonder—FBI Builds Cases, but Vague Laws, Charges of Profiling Hinder Progress—Executives Fear Chilling Effect," *Wall Street Journal*, August 10, 2005, 10.

15. Exon-Florio Amendment, § 2170(b).

Byrd Amendment as requiring more than just state control. CFIUS considers two elements when evaluating whether an investment requires an investigation under the Byrd Amendment: whether there is state control, and whether the transaction could affect US national security.[16]

For China, the question of state control can be particularly complicated. Public information about ownership of Chinese companies listed on a stock exchange is opaque, so CFIUS agencies will likely, and perhaps erroneously, presume that virtually all Chinese companies investing in the United States are controlled by the Chinese government. A Chinese company seeking CFIUS approval will likely have the burden of convincing the committee that it is not controlled by the Chinese government. Notwithstanding CFIUS's presumption, whether the Chinese government controls a particular Chinese company is not always a straightforward or simple question in reality. Many Chinese companies are at least partly owned by the state, but frequently at a provincial or local level. Alternatively, several provinces can separately own pieces of a Chinese company and, because of bureaucratic rivalries or other reasons, resist cooperation or coordination. The Exon-Florio Amendment does not distinguish between national and local control by a foreign government.

The question of state ownership and control has been complicated further by rapid changes in the way Chinese companies are governed. Since 1978, the transformation of China's SOEs has occurred in three successive phases: devolution of managerial responsibilities from the central government to SOE managers, creation of state-owned corporations, and privatization of certain corporations at both the local and central government levels (Green and Liu 2005). To grasp the nature of state ownership of Chinese public corporations, it is important to understand first how company shares are classified and allocated.

In 1992 the Chinese government created three categories of shares that a restructured SOE could issue: state shares, legal person (LP) shares, and individual shares.[17] State shares are "nontradable" shares held by the government.[18] Since early 2003, the State-Owned Assets Supervision and Administration Commission (SASAC) has managed nontradable shares for many large Chinese companies (Green 2005, 125, 126–27). LP shares are owned by domestic institutions, which are defined as stock compa-

16. See also the discussion of the Byrd Amendment in chapter 2.

17. For a description of share classifications, see Green and Black (2003) and Xu and Wang (1997). Company shares are owned by five types of agents: the state, LPs (institutions), tradable A–share holders (mostly individuals), employees, and foreign investors. The first three groups of owners are the main shareholders, controlling roughly 30 percent each, with employees and foreign investors together holding only 10 percent (see Xu and Wang 1997, 3).

18. Nontradable shares can only be transferred among institutions with government approval, but are not traded on either of China's two stock exchanges. See Green and Black (2003), Liu and Sun (2005, 113), Liu and Sun (2004, 403).

nies, nonbank financial institutions, and SOEs not wholly government owned; like state shares, they cannot be traded on the stock market (Xu and Wang 1997, 7). Individual shares are the only type of shares that can be owned by individuals and openly traded.

By controlling the issuance of different classes of shares, the Chinese government has prevented large-scale and rapid privatization of large, publicly traded SOEs. In the initial stages of the privatization process, only one-third of most SOE shares were sold to the public; the remaining two-thirds were nontradable and state owned (Green 2003a). Chinese authorities have recently been selling additional shares to the public (Green 2003b). Despite this apparent move toward greater privatization, however, most large publicly traded enterprises in China still remain subject to substantial control by various parts of the Chinese state government. By contrast, there has been large-scale privatization of small and medium enterprises (SMEs) in China, particularly SMEs formerly owned by provincial, town, or village governments (TVEs, or town and village enterprises). Moreover, while there has been substantial privatization of SOEs in certain sectors, such as building materials, chemicals, forestry, food processing, textiles, and other light manufacturing, the state has strengthened its control over strategic sectors, including energy, defense, financial services, and telecommunications. Green and Liu (2005, 4–9) have called this the "retreat and retain" strategy, in that the government has retreated from ownership and control of sectors exposed to foreign competition, but retained control of strategic and monopoly sectors.[19]

Academics and researchers have used two models to assess the extent of government control over Chinese public corporations. The first model relies on the official share classification to determine the extent of state control, while the second traces the chain of control back to the state through the pyramid of state shareholding entities. The official share classification system is easier to use because of the greater availability of required data. However, the pyramid approach assesses the level of state ownership of corporations more realistically, in part because it pierces the veil of indirect ownership, focusing instead on the ultimate owner.

Using official Chinese government share classification data, in 2001 state-owned shares comprised 46 percent of all nontradable shares (state and LP shares) in China's publicly listed companies (Liu and Sun 2004, 114). Although multiple studies evaluating corporate performance distinguish between state shares and LP shares (e.g., Chen 2001; Sun, Tong, and Tong 2002; Xu and Wang 1997), Green and Black (2003) argue that many LP shares are ultimately owned either by the state or by state-controlled entities (Green and Black 2003, 3). Assuming that the state ultimately

19. Green and Liu (2005) argue that the Chinese government has strengthened its control in strategic sectors—energy, telecommunications, and financial services—despite high-profile foreign investments in these SOEs.

owns all LP shares, state ownership increases to 65 percent of all available shares in Chinese publicly listed corporations (Liu and Sun 2004, 114).[20]

Analyzing state ownership of corporations through "pyramid controlling mechanisms"[21] results in an even higher figure of state control of Chinese corporations. One recent study estimates that by the end of 2001, the Chinese government employed a pyramidal holding company strategy to exert ultimate ownership control over 81.6 percent of the 1,136 publicly listed Chinese companies (Liu and Sun 2005, 7). Although the state exerted direct control over only 9.0 percent of listed firms, it indirectly controlled a further 72.6 percent. The state exercised its indirect control through state-controlled publicly listed firms (2.6 percent), SOEs (58.9 percent), state-controlled unlisted firms (10 percent), and state-owned academic institutions (1.1 percent) (Liu and Sun 2004, 121). Other academics and analysts concur. Pieter Bottelier of Johns Hopkins University estimates that, of approximately 1,300 publicly listed companies in China in 2004, only about 20 were genuinely private; the rest were all ultimately controlled by the state.[22] No matter which method is used to assess state ownership of public companies, the state remains strongly involved in China's economic sector.

In addition to controlling a company through owning shares, the central or local government, or frequently the Communist Party of China, can control publicly traded corporations by influencing the composition of corporate boards and the corporation's management team (Tenev and Zhang 2002; Xu and Wang 1999). In 1997, a World Bank study found that in 80 percent of incorporated SOEs, the original managers and party officials continued to occupy key positions on the boards and supervisory committees of new stock companies (Xu and Wang 1997, 11). Similarly, a 1995 survey of 154 Chinese corporations found that government officials held 50 percent of available board seats, though the government owned in aggregate only 30 percent of the companies' stock (Xu and Wang 1997, 12).[23] When the study split firms into state-dominated and LP-dominated

20. In reality, the LP classification does not identify the entity that owns the shares, so the LP shareholder could be the state or a completely private entity. Recently, a Beijing-based investment consulting company found that the state controls "64 percent of the 1,379 companies that have raised funds by selling A shares" on Chinese stock exchanges. Matthew R. Miller, "Defying Risks to Invest in China," *International Herald Tribune,* April 5, 2005, available at www.iht.com (accessed March 14, 2006).

21. See La Porta, Lopez-de-Silanes, and Shleifer (1999). Their model looks beyond the official share-based ownership classification described above, by following the corporate ownership path back to the ultimate shareholder.

22. See testimony of Pieter Bottelier before the US-China Economic and Security Commission, April 16, 2004.

23. Moreover, "[t]he management actually has a greater influence on decision making if we include lower ranking officers such as general managers of subsidiaries in calculating the manager/board ration" (Xu and Wang 1997, 12).

firms according to share ownership, government officials filled more than 70 percent of board seats in state-dominated firms, but only 20 percent in LP-dominated firms (Xu and Wang 1997, 13). In either scenario, individual stockholders held no more than 0.3 percent of board seats on average, despite owning roughly one-third of the companies' stock (Xu and Wang 1997, 12).

A more recent survey of 257 companies listed on the Shanghai Stock Exchange reached similar conclusions about the extent of state control over the governance of China's public corporations. The state maintained "absolute control" over companies by directly or indirectly selecting roughly 70 percent of all directors appointed by shareholders (Tenev and Zhang 2002, 83). The study also showed that parent companies controlled the boards of publicly listed subsidiaries (Tenev and Zhang 2002, 85). Most telling was the study's finding that 73 to 76 percent of the companies' executive and nonexecutive directors were formerly employed by SOEs, and 12 to 24 percent of them had served in a government ministry (Tenev and Zhang 2002, 90).

Thus it is clear that the state, at a minimum, controls a very large number of publicly listed Chinese corporations. But the nature of ownership and frequency of listings by Chinese corporations is changing rapidly.[24] China is making important moves to reform state-owned and publicly listed enterprises. On August 24, 2004, the China Securities Regulatory Commission, the agency that regulates China's securities markets, authorized the 1,300 Chinese listed companies to sell, over time, large amounts of stock currently owned by the state.[25] In July 2005 the first privately owned petroleum company, Great United Petroleum Holding Co. Ltd. (GUPC), was formed without government support or involvement.[26] GUPC's creation was authorized by a February 2005 decision of the State Council, China's highest executive and policy-making organ, to allow pri-

24. China has two stock exchanges: the Shanghai Stock Exchange (SHSE), established in 1990, and the Shenzhen Stock Exchange (SZSE), established in 1991 (see Xu and Wang 1997, 6). The number of listed companies has grown 62 percent annually, from 53 publicly listed companies in 1992 to 1,380 in 2005 (839 listed on SHSE, 541 listed on SZSE) (see Tian 2001). An aggregate dataset of publicly listed companies found that the average total assets of these corporations was $180 million, including current, fixed, and other asset classes. The average fixed asset was $50 million (see Tian 2001, 5). The average age of these corporations was fourteen years, with a median of seven years, as most listed companies were newly formed or restructured during the reform period (Tian 2001, 4). Note that the data sample excludes fund-managed companies and firms that do not issue shares for domestic investors. The dataset includes 287 companies in 1994, 311 in 1995, 517 in 1996, 719 in 1997, and 826 in 1998.

25. Peter S. Goodman, "China to Allow More Stock Sales: $270 Billion of State Assets Put in Play," *Washington Post*, August 25, 2005, D1.

26. "China's First Private Oil Group Established," *Asia Times Online*, July 8, 2005, available at www.atimes.com (accessed March 8, 2006).

vate companies to be formed in "crucial industries like power, telecommunications, railways, civil aviation and oil exploration."[27]

Despite these recent positive moves toward more meaningful privatization of SMEs, until there has been substantial further reform in China, most publicly traded Chinese companies seeking approval from CFIUS will face a strong presumption of state control.[28] Another complex question that CFIUS will need to consider for Chinese acquisitions of US entities is whether privately held Chinese corporations are still under state control. At both central and regional levels, the Chinese government has an extraordinarily strong hold on many aspects of society, and certain agencies within CFIUS might argue that a company owned by private Chinese citizens, with no government ownership, still might be under government control. As one China expert told the authors, "The strong working presumption has to be that even 100 percent privately owned companies in China are very, very 'responsive' to the Chinese government."[29] The authors are unaware of specific cases in which CFIUS has made a control determination about a privately held Chinese corporation acquiring a US entity. We can, however, anticipate an active debate on the subject.

Failure to overcome this presumption of control will mean, in effect, that the company in question has satisfied the first prong of CFIUS's test for applying the Byrd Amendment. CFIUS next analyzes whether the acquisition "could affect the national security of the United States."[30] Included in this analysis is the traditional evaluation that Exon-Florio requires, including an assessment of the acquisition's impact on the US defense industrial base—particularly if the target company has contracts with the DOD and other security agencies—and the likelihood of transfer of export-controlled technologies. At the time of this writing, Congress was actively debating whether to eliminate any discretion for CFIUS in the second prong of the Byrd Amendment. If it does, most Chinese companies should expect to face a full 90-day review. In its traditional security analysis, CFIUS is also likely to consider a number of issues unique to Chinese acquisitions, including the risk that sensitive technologies will be transferred to third countries, the potential for the Chinese government to conduct espionage through the acquiring company, and the possibility that a particular acquisition will strengthen the capabilities of the Chinese government and military. We turn to these issues next.

27. "China's First Private Oil Group Established," *Asia Times Online,* July 8, 2005.

28. CFIUS regulations do not distinguish between the thresholds for determining control in general and the threshold for government control. As discussed below, the CFIUS control test is very broad. CFIUS is likely to determine that a government controls a corporation any time the government owns or controls 10 percent or more of a Chinese corporation.

29. Interview with China expert in Washington. The expert preferred to remain anonymous.

30. Exon-Florio Amendment, § 2170(b).

Export Controls

The possibility of sensitive, export-controlled technology being transferred to countries that raise national security concerns for the United States is a factor in virtually all CFIUS reviews,[31] regardless of the home country of the acquirer. It tends to be a particular concern for acquisitions by Chinese companies, however, in large part because of a series of high-profile breaches of US export control laws and regulations by Chinese companies in the late 1990s and early 2000s. China has improved its internal export control mechanisms significantly—by publishing new export control regulations, making agreements with other countries on end-use verification procedures, and training Chinese companies on the subject—but China's exports of technology to Iran, Libya, Pakistan, and North Korea trouble US officials (US CIA 2003, US Department of State 2003). Chinese companies have been subjected to import, procurement, and other sanctions by the US government on several occasions over the past few years. Among others, the United States imposed sanctions against Xinshidai, a firm that handles exports for Chinese military contractors, because it exported missile technology to sanctioned countries in 2004; Norinco, China's largest military conglomerate, for aiding Iran's long-range missile program in 2003; and nine small Chinese entities for exporting technology and goods to Iran in 2002.[32]

CFIUS scrutiny of potential transfers of sensitive and dual-use technology is also consistent with the US government's heightened concern with the transfer of such technologies to China.[33] Recent testimony by Acting Undersecretary of Commerce Peter Lichtenbaum before the US-China Economic and Security Review Commission concisely summarized the Bush administration's position:

> From a security standpoint, the US Government remains concerned about China's modernization of its conventional military forces and the risk of diversion of sensitive dual-use items and technology to Chinese military programs. For example, building state-of-the-art semiconductor plants could increase China's ability to apply this technology and equipment in military programs. Advanced telecommunications equipment—if illegally diverted to military end-users—could provide the Chinese missile, nuclear weapons and other military programs with the means to enhance performance capabilities in military radar applications.[34]

31. The Exon-Florio Amendment requires the president or his designee to consider, as a factor, "the potential effects of the proposed or pending transaction of sales of military goods, equipment, or technology to any country" to which the United States controls exports of particular goods, services, and technologies. Exon-Florio Amendment, § 2170(f)(4).

32. "US Sanctions Chinese Weapons Supplier," Associated Press, September 23, 2004. See also Jennifer Lee, "US Officials Complain That Chinese Companies Supply Rogue Nations," *New York Times,* November 12, 2001, C2.

33. Dual-use items are those that have both commercial and military uses.

34. See statements of Acting Undersecretary of Commerce for Industry and Security Peter Lichtenbaum before the US-China Economic and Security Review Commission, *Hearing on US-China Trade Impacts on the US Defense Industrial Base*, June 23, 2005.

Because of these concerns, and consistent with aspects of the so-called Tiananmen Square sanctions that have been in place since 1990,[35] the Bush administration has adopted a blanket policy against approving licenses to export controlled technology or goods for "military end users or end uses within China."[36] Further, the administration will not issue licenses for sales of "dual-use items and technology to China if the item or technology will make a direct and significant contribution to the People's Republic of China's (PRC) electronic and anti-submarine warfare, intelligence gathering, power projection, or air superiority."

Decisions to approve a license to export controlled technology to China are distinct from CFIUS's evaluations of risks associated with a particular transaction. CFIUS typically evaluates the sensitivity of the export-controlled technology that a target company owns or controls, but those agencies with responsibility for regulating the export of such technologies have made it clear that CFIUS does not make decisions on export license applications. Even if CFIUS approves an acquisition by a foreign company, US government agencies with export-control responsibilities—the Departments of State, Commerce, Defense, and Energy—could still deny that company a license to export a particular technology from the United States to China, including the release of technology in the United States to Chinese nationals (so-called deemed exports). Conversely, the US government could approve an application to export a particular technology to China, but CFIUS could block an acquisition by a Chinese company involving the same technology.

While CFIUS does not make decisions on specific export license applications, it does evaluate the risk of allowing an acquisition of a US company that owns export-controlled technology. This evaluation turns on the sensitivity of the technology involved, and the likelihood, in CFIUS's view, that the acquirer will abide by US export control laws and regulations if the transaction in question is approved. CFIUS is likely to have significant reservations about approving a transaction in which a foreign company that previously violated US export regulations seeks to acquire a US company with sensitive, controlled technology. CFIUS agencies scour the records of Chinese companies acquiring US companies with controlled technologies to determine whether the acquirer or its affiliates have previously run afoul of US export control laws and regulations. CFIUS also reviews the target company's record of compliance. Since Chinese com-

35. Following the events in Tiananmen Square, Congress imposed a number of restrictions on technology export licensing to China subject to presidential waiver. See *Foreign Relations Authorization Act, Fiscal Years 1990 and 1991,* Public Law 101-246, codified at *US Code* 22, 2151 (1990), note § 902.

36. Testimony of Acting Undersecretary of Commerce for Industry and Security Peter Lichtenbaum before the House Armed Services Committee and the House International Relations Committee, *EU Arms Embargo Against China, Hearing on the European Union's Plan to Export Arms to China*, 109th Congress, 1st sess., April 14, 2005, 2.

panies have been subjected to multiple enforcement actions or retaliatory sanctions in recent years, Chinese acquisitions of US companies with export- controlled technologies will continue to receive extra scrutiny.[37]

Espionage

In recent years, China's espionage activities have become an increasing concern and a higher priority to the relevant US government agencies involved in counterintelligence activities, including the Department of Justice (DOJ), the DOD, the Department of Homeland Security (DHS), and the FBI. The specter of significant, targeted Chinese espionage activities in the United States first hit public consciousness in the late 1990s with a widely publicized and controversial report by a select committee of the House of Representatives, chaired by Christopher Cox (R-CA)—the so-called Cox Report—and the allegations that Wen Ho Lee, a scientist working at Los Alamos National Laboratory in New Mexico, shared nuclear secrets with the Chinese.[38] The espionage charges against Wen Ho Lee were ultimately dropped, although he did plead guilty to a lesser charge of mishandling classified information. The Cox Report found, among other things, that China had stolen design information on the United States' most advanced thermonuclear weapons, and that Chinese penetration of US national laboratories reached back several decades (US House of Representatives 1999, overview section ii). The report concluded that the United States did not have adequate safeguards against Chinese espionage at US national laboratories. China had mounted a "widespread effort to obtain US military technology by any means—legal or illegal" and US counterintelligence efforts had been "complicate[d]" because China conducted espionage activities in a "less centralized" manner than did the Soviet Union during the Cold War (US House of Representatives 1999).

Subsequent reports and articles suggest that Chinese espionage activities are receiving increased attention from the US counterintelligence community. In an August 10, 2005, front page *Wall Street Journal* report, entitled "FBI Sees Big Threat from Chinese Spies," David Szady, the FBI's top counterintelligence official, stated, "China is the biggest [espionage] threat to the US today." The FBI had "sent hundreds of new counterintelligence agents" throughout the United States, many with "a specific focus on China." Further, the perceived threat was much different from that posed previously by the Soviet Union. Unlike the Soviets, literally "thousands of Chinese nationals" come every year to the United States as "stu-

37. China is not alone. CFIUS has also demonstrated similar concerns with other countries, including Israel.

38. See US House of Representatives (1999); James Risen, "US Fires Scientist Suspected of Giving China Bomb Data," *New York Times,* March 9, 1999, A1.

dents and businessmen." These Chinese nationals, the story continued, are contacted by Chinese government officials, who press them into service to "acquire military or industrial technology illegally."[39]

The *Wall Street Journal*'s coverage echoes public reports by the Central Intelligence Agency (CIA). In their 1999 *Report to Congress on Chinese Espionage Activities Against the United States,* the CIA and FBI conclude that "much of China's intelligence collection in 1998 continued to be accomplished by a network of nonprofessional individuals and organizations acting outside the direction and control of the intelligence services." Further, "some of the thousands of Chinese students, scientists, researchers, and other visitors to the United States also gather information, working mostly for the benefit of government-controlled, end-user organizations and other scientific bureaus, research institutions, and enterprises." Finally, "China's commercial entities play a significant role in the pursuit of proprietary US technology. According to the CIA, the vast majority of Chinese commercial entities in the United States are legitimate companies; however, some are a platform for intelligence collection activities" (US CIA and FBI 1999). It seems clear that US officials involved in counterintelligence activities view China as a real threat, and have identified Chinese companies, students, and researchers as a conduit for state-sponsored commercial and military espionage activities.

How does this affect a CFIUS analysis of a Chinese acquisition in the United States? We suspect that, at a minimum, the potential for espionage almost certainly will be a factor in many CFIUS reviews of acquisitions of US companies by Chinese entities. CFIUS agencies will also likely scrutinize a Chinese company's leadership and their ties, or alleged ties, to Chinese intelligence agencies and the military. If CFIUS agencies have concerns about the increased risk of espionage because of a transaction, they may block the transaction, or impose safeguards to mitigate the risk.

Strengthening the Chinese Military

The Pentagon's 2005 report to Congress on China's military power (Pentagon Report) states in unequivocal terms that the growth and strengthening of China's military threatens US interests (US DOD 2005). In the executive summary, it states, "If current trends [toward strengthening of China's military] persist, PLA [People's Liberation Army] capabilities could pose a credible threat to other modern militaries operating in the region." In addition to describing what it regards as worrying trends in China's force structure, strategies, and defense procurement budgets, the Pentagon Report makes clear that the DOD views the development of

39. Jay Solomon, "FBI Sees Big Threat from Chinese Spies," *Wall Street Journal,* August 10, 2005, A1.

China's economy and technology base, and the strengthening of its military, as intertwined. It quotes Chinese President Hu Jintao as saying, "It is necessary to establish a mechanism of *mutual promotion* and *coordinated development* between national defense building and economic development," inferring from President Hu's statement that "China's modernization indicates a buildup of armaments that reinforces this notion of coordinated, integrated civilian and military development" (US DOD 2005, 11). The report also asserts that China is actively seeking dual-use and military technologies from the European Union, Israel, Russia, and other countries (US DOD 2005, 23) and that China seeks to "accelerate its military development by using more of its civil production capacity for military hardware" (US DOD 2005, 13).

To illustrate how CFIUS might distinguish between acquisitions of the same US entity by companies based in three different countries, assume that either a Chinese or Pakistani entity were buying a small US company that owned sensitive, export-controlled technologies. If CFIUS was concerned that the technology or manufacturing within this company was critical to US defense capabilities, and that the technology would be transferred offshore, CFIUS would either reject the acquisition, or use a mitigation agreement to prohibit the transfer of technology or movement of manufacturing offshore. If CFIUS was concerned that there would be no way to control technology transfer, or have assurances that it would not happen, CFIUS would likely reject the acquisition by both the Chinese and Pakistani entities. However, if the sole concern of the sale was that its acquisition would strengthen the military capabilities of the acquirer, then the Chinese company might be turned down while the Pakistani company was allowed to proceed, since Pakistan's military is not seen as a threat to the United States.

As long as the Pentagon takes such a negative view of China, CFIUS will likely assess Chinese acquisitions of US companies in part on their impact on China's military strength. This approach turns the traditional CFIUS approach on its head. Rather than focusing on whether an acquisition threatens to reduce the DOD's and other national security agencies' access to goods and services for US national defense, CFIUS instead will consider whether an acquisition strengthens the Chinese military's access to goods and services. Thus weakening the United States and strengthening our enemies can be seen as two sides of the same national security coin.

CFIUS will therefore likely analyze not only the sophistication of dual-use technologies owned or developed by a target company, but also the ties of the Chinese acquirer to the Chinese military-industrial complex. Recent testimony by Evan Medeiros, an expert on China's military at the Rand Corporation, a think tank influential with the Pentagon, identifies 11 SOEs that "have historically always been involved in production of mili-

tary goods."[40] These SOEs are the China National Nuclear Group Corporation (www.cnnc.com.cn), China Nuclear Engineering and Construction Group Corporation (www.cnecc.com.cn), China Aerospace Science and Technology Group Corporation (www.cascgroup.com.cn), China Aerospace Science and Industry Group Corporation (www.casic.com.cn), China Aviation Industry Group Corporation I (www.avic1.com.cn), China Aviation Industry Group Corporation II (www.avic2.com.cn), China State Shipbuilding Group Corporation (www.cssc.net.cn), China Shipbuilding Industry Corporation (www.csic.com.cn), China North Industries Group Corporation (www.norincogroup.com.cn), China South Industries Group Corporation (www.chinasouth.com.cn), and China Electronics Technology Group Corporation (www.cetc.com.cn).

If the Pentagon agrees with Medeiros's assessment, these 11 companies (and other companies on DOD's own list) could face additional challenges in clearing CFIUS, depending on the sensitivity of the target company in the United States.[41] Any Chinese acquirer must accordingly account for and, if necessary, rebut perceptions about its relationship with the Chinese military to navigate the CFIUS process successfully.

State Subsidies

The issue of Chinese government subsidies, in the form of low- or no-interest loans, became a hotly debated topic in the context of the proposed acquisition of Unocal by CNOOC. Members of Congress, the financial press, and other analysts criticized the CNOOC transaction for being heavily subsidized by the Chinese government. Allan Sloan, an economics columnist for *Newsweek,* suggested that CNOOC "is counting on $7 billion in ultra cheap loans from its parent to help fund its $19 billion Unocal offer." Sloan pointed to a $2.5 billion no-interest loan and a $4.5 billion, 3.5 percent 30-year loan from CNOOC's parent company, observing that CNOOC would not have had access to these loan terms in the commercial financial markets. All told, Sloan concluded, the preferential loans provided CNOOC with a $400 million annual subsidy, representing a value for CNOOC of approximately $9.50 per Unocal share.[42]

40. Testimony of Evan S. Medeiros before the US-China Economic and Security Review Commission, *Analyzing China's Defense Industries and the Implications for Chinese Military Modernization,* 108th Congress, 2nd sess., February 6, 2004.

41. Norinco has also been the subject of US sanctions for violating the Iran Nonproliferation Act of 2000, available at www.state.gov (accessed March 8, 2006).

42. Allan Sloan, "Lending a Helping Hand: The Math Behind CNOOC's Rich Offer to Buy Out Unocal," *Newsweek,* July 18, 2005, available at www.newsweek.com (accessed March 12, 2006).

In the past, CFIUS's review of the national security impact of inward investment has not focused on state support in the form of financial subsidies. Of course, no one knows how CFIUS would have analyzed the alleged CNOOC subsidies because, as discussed in chapter 5, it never reviewed the CNOOC-Unocal transaction. We anticipate, however, that favorable loans or other state-supported subsidies could affect CFIUS reviews of future Chinese acquisitions in two ways.

First, to the extent that any ambiguity exists over whether a Chinese company is controlled by the Chinese government, direct state subsidies or favorable loan terms will add weight to the argument that a particular firm is government-owned or -controlled. After all, to determine control, the CFIUS regulations contemplate review of, among other things, "contractual arrangements" and "pledge or other transfer of any or all of the principal assets of the entity."[43] Since a loan agreement is a "contractual arrangement," and presumably such loans require the "pledge" of certain of the acquirer's assets as collateral, favorable or subsidized state-supported loans will likely be scrutinized as a factor in determining whether a company is controlled by the Chinese government.

Second, the reaction to CNOOC's bid for Unocal suggests that favorable, noncommercial loan terms in transactions involving Chinese companies are likely to be a significant factor in determining whether a particular transaction is politicized in Congress. In the proposed CNOOC transaction, Senators Charles Grassley and Max Baucus, the highly respected chairman and ranking member of the Senate Finance Committee respectively, wrote jointly to the president:

> The offer by CNOOC Ltd. for Unocal raises an important question; namely, whether it is appropriate for state-owned enterprises to subsidize investment transactions to acquire scarce natural resources that are in high demand. When government subsidies are directed toward the acquisition and development of scarce resources, any ensuing market distortions should be of particular concern. Such subsidies may facilitate the allocation of scarce resources to inefficient or less-efficient producers. Any review by CFIUS should take into account the impact this type of subsidized acquisition may have on the US economy and its potential threat to our national security interests.[44]

In the wake of the CNOOC transaction, as well as the Dubai Ports controversy, it is likely that both CFIUS and Congress will scrutinize the financial terms of transactions to determine whether they suggest state ownership and control. In our view, such scrutiny is warranted and appropriate for CFIUS to determine whether a foreign acquirer is actually controlled by a foreign government, and, if so, whether that control raises specific national security issues for a particular transaction. We also be-

43. *Code of Federal Regulation,* title 31, § 800.204.

44. Senators Charles E. Grassley and Max Baucus, "Grassley, Baucus Express Concern Over Potential CNOOC-Unocal Deal," press release, July 13, 2005, available at grassley.senate.gov.

lieve that the US government should continue its policy of actively encouraging foreign governments to privatize state-owned entities.

Policy Implications for Future CFIUS Reviews of Chinese Acquisitions

How should the United States deal with Chinese investment, given the unique issues that such investments potentially raise from a national security perspective? First, there is the overarching question of whether Chinese investment should be viewed as a benefit or detriment to the US economy. It is our view that the United States should continue to support China's integration into the global economy, and that Chinese outward foreign investment should be viewed as a natural and positive evolution in China's economic development. For close to two decades, through Republican and Democratic administrations, the United States has encouraged China to lower tariffs, eliminate nontariff barriers to trade, privatize SOEs, and participate in—and play by the rules of—the global economy. The United States has also continually pressed China to eliminate barriers to FDI by US and other foreign companies. Successive US administrations have correctly pursued these policies, not only for the economic and commercial benefit of US companies and workers, but also in the belief that adopting market-based economic policies will facilitate democratic reform in China.

But the United States cannot have it both ways. A US policy that encourages investment by American companies in China while frowning upon Chinese investment in the United States is neither sustainable nor sound from an economic perspective. Rather, the United States should simultaneously encourage China to allow FDI and make clear that Chinese investment in the United States is not only welcome but encouraged. Enhanced FDI from China would bring substantial economic benefits to the US economy, just as investment from other countries already does (see chapter 3). Chinese investment in the United States will create jobs, promote research and development (R&D) in the United States, and enhance US exports to China, including through intracompany trade.

Additional investment from China would also produce important ancillary benefits for the United States consistent with broader US strategic and political objectives. China has already bought a substantial number of US Treasury notes, helping the United States to finance its large and growing current account deficit; it is one reason why the federal government's sustained deficit has not triggered significant increases in interest rates. Further, while a strong and growing US economy is already in China's economic interest, given that the United States is China's largest export market, large-scale ownership of US Treasury securities further aligns China's eco-

nomic interests with US objectives. China played a stabilizing role in the Asian financial crisis in the late 1990s by not devaluing its currency.

Some experts and commentators (not including the authors) believe that the large-scale ownership of Treasury securities gives China leverage over the United States.[45] If Chinese authorities wished to express their displeasure with the United States, some argue, they would need only to signal that they would either refrain from buying additional Treasury securities or sell existing holdings. By doing so, China could potentially destabilize US financial markets, cause interest rates to increase, and possibly lead other governments to shun US Treasury notes. The mere possibility of China using its ownership of US debt to wreak havoc on the US economy creates leverage for the Chinese government, and undermines the US government's freedom of action for fear of offending China.

We do not subscribe to these arguments, but if they are correct, then it follows that additional Chinese direct investment—as opposed to investment in Treasury securities—would reduce any incentive the Chinese government may have to disrupt US financial markets. If Chinese companies owned substantial fixed assets and publicly traded US equities, China would be shooting itself in the foot by dumping Treasury securities on the market for political purposes. Chinese FDI in fixed assets and US companies would further align Chinese and US economic interests, and provide a disincentive to politically driven Chinese government sales of US Treasury instruments.

Greater Chinese ownership of and investment in US companies, as well as involvement in the world economy, would have the additional benefit of exposing Chinese companies to global legal norms, including requirements for enhanced transparency. Partnerships, supply relationships, and joint ventures would enable Chinese management to access and develop international management skills. Travel to the West would increase, as would Western travel to China. Interactions between Chinese and Western businesspersons would further integrate China into the global economy, creating greater pressure within China for democratic reform, the rule of law, and cooperation with the United States and the West. Chinese companies successfully operating in the United States would help create a new constituency within China for open trade, just as the US business community consistently presses Washington to liberalize trade and investment in the United States because of its substantial commercial interests abroad. The United States stands to benefit substantially, both directly and indirectly, from increased levels of Chinese direct investment within its borders.

45. See, e.g., William Pesek Jr., "Forget Unocal. Real China Risk Is Treasuries," *Bloomberg News,* July 7, 2005, available at www.bloomberg.com; Floyd Norris, "Who's in Charge of Determining US Interest Rates? It May Be Beijing," *New York Times,* May 13, 2005, C1; and Liam Halligan, interview with Paul Krugman, "China Is the Financial Nexus," *Sunday Telegraph,* June 19, 2005, available at www.telegraph.co.uk (accessed March 10, 2006).

In sum, Chinese investment in the United States creates clear economic benefits, and will ultimately move China toward the West. At the same time, the US government is still obliged to protect US national security, including through implementation of the Exon-Florio Amendment. Where should CFIUS strike the balance in its scrutiny of Chinese investments in the United States?

We believe that, proceeding on a transaction-by-transaction basis, CFIUS should focus solely on the incremental risk associated with particular investments. Notwithstanding the serious and legitimate policy concerns relating to espionage, technology transfer, and state control of many Chinese corporations, CFIUS should focus on the marginal increase in risk to US national security, if any, that a particular transaction creates. It should not try to resolve the broad set of problems associated with the US-China economic relationship by regulating individual transactions.

For discussion purposes, let us take two examples at opposite ends of the national security spectrum. In the first example, a Chinese-controlled private equity firm, with no involvement with or ties to the Chinese government, decides to acquire a major US ice cream company. The ice cream company has no special technology and does not directly supply the US government. Hard-liners could argue that the acquisition provides a vehicle for Chinese espionage to each one of the company's major ice cream factories located near a US military base, or an R&D center for a US technology company. It would be absurd for CFIUS to be concerned about this investment. Any legitimate concerns about espionage risks should be dealt with through other laws, and through prudent security practices by the military bases and R&D centers near the ice cream factories. For similar reasons, we suspect that the proposed (but ultimately abandoned) 2005 acquisition of Maytag, the white good manufacturer, by the Chinese company Haier would have easily cleared CFIUS. Arguably, the transaction should not have even been filed with CFIUS.

At the other end of the spectrum, suppose Lockheed Martin, the United States' largest defense contractor, decided to spin off a division involving sophisticated, state-of-the-art precision guidance systems for missiles. Obviously, CFIUS would never, nor should they, allow a Chinese company to access the most sophisticated weapons technologies in the United States, or to own a company that sells unique, sophisticated, and controlled technologies to the DOD. These were doubtless the reasons that President George H. W. Bush rejected the proposed acquisition of a US aerospace company by a Chinese company in 1990.

Transactions that fall in the middle of the spectrum are, perhaps not surprisingly, harder to judge. As discussed in chapter 5, the DHS has identified 12 sectors, including energy and telecommunications, as "critical infrastructure" worthy of special protection. CFIUS has approved telecommunications transactions from dozens of other countries, including many European countries, Korea, Singapore, Taiwan, India, and, most recently,

Bahrain. Certain of these telecommunications acquisitions were made by state-owned companies (Deutsche Telecommunications of Germany, Telnor of Norway, and Singapore Technologies Telemedia). Some of them required negotiating extraordinarily tough network security agreements (NSAs) to get CFIUS approval, even when the assets being acquired were insignificant from a critical infrastructure perspective (see the discussion of NSAs in chapter 3).

But should CFIUS allow Chinese companies to acquire US telecommunications companies? What about Chinese state-owned companies? In our view, CFIUS should ensure that the DOJ and the FBI can pursue sensitive criminal investigations without the knowledge of foreign nationals or governments. If the US telecommunications company being acquired is sufficiently large or sensitive to be considered "critical infrastructure," appropriate safeguards can and should be put in place. But there should not be a blanket ban on Chinese ownership of US telecommunications assets, nor should NSAs for Chinese companies be so onerous as to effectively amount to the same thing.

In the energy sector, it is apparent from CNOOC's failed bid for Unocal that Chinese acquisitions of US energy assets also potentially raise national security concerns, at least in the view of members of Congress. The importance of protecting energy infrastructure was painfully evident in the aftermath of Hurricane Katrina, which ravaged the Gulf Coast, flooded 80 percent of New Orleans, and temporarily drafted 10 percent of US refining capacity, causing substantial energy price increases and gas shortages in the South. Yet it is unclear how Chinese ownership of oil and gas assets in the Gulf of Mexico would have had any negative impact on efforts to restart drilling and repair rigs, pipelines, and refineries. Foreign-owned firms have just as much incentive to get their idle assets running again as American-owned firms do. At the same time, there are legitimate national security questions surrounding the acquisition of US energy assets by Chinese companies, including whether Chinese energy firms will seek to supply gas and oil exclusively to China, as opposed to selling to global markets. When Gazprom, the Russian state-owned natural energy giant, cut off natural gas supplies to the Ukraine in the middle of the winter in 2006, the action was widely seen as ordered by the Russian government to express displeasure with Ukrainian policies.[46] Widely condemned in the United States and Western Europe, the incident will likely lead CFIUS to cast a more critical eye on future acquisitions of US energy assets by certain foreign state-owned energy companies, including those in China and Russia. In addition, certain US energy companies possess dual-use technologies, which may be too sensitive to sell to China, particularly if there are concerns in exporting or sharing technologies with the Chinese military.

46. "Gazprom Halts Gas Shipments to Ukraine," *Reuters,* January 1, 2006, available at www.iht.com (accessed March 10, 2006).

Notwithstanding these caveats, in general, Chinese investment should be welcomed. Chinese investments in sensitive sectors such as telecommunications and energy will make for difficult CFIUS cases, and Chinese companies would be wise to invest in less sensitive sectors and build a good track record, allowing CFIUS to gain comfort, before moving on to more sensitive areas. There should, however, be a very high threshold before the president moves to block a particular transaction. If national security issues do arise in relation to a transaction, CFIUS agencies have a wide array of tools, including security agreements, to mitigate their concerns. Further, the United States has other laws at its disposal, including comprehensive export control and counterespionage laws, to protect US national security interests. Indeed, often forgotten in discussions of CFIUS is the statutory requirement that authorizes the president to block a transaction only if (1) there is credible evidence that leads the president to believe that the foreign interest exercising control might take action that threatens to impair the national security, *and* (2) provisions of law, other than Exon-Florio and the International Emergency Economic Powers Act, do not in the president's judgment provide adequate and appropriate authority to protect national security.[47]

In other words, if a particular transaction raises export control concerns, the president can block the transaction only if he finds that existing US export control laws are inadequate to address those concerns.

In sum, we believe that increased Chinese investment in the United States would bring important benefits to both the United States and China. The US should thus make clear to China that it welcomes FDI so long as such investments do not compromise US national security. Undoubtedly, however, Chinese investments create issues for CFIUS that do not frequently arise for investments from other major trading partners. For transactions that raise specific national security concerns, CFIUS should work with the involved parties to craft narrowly tailored arrangements to mitigate the incremental risks created by a particular transaction. Finally, the president should only block Chinese acquisitions of US companies in which unique and significant national security issues arise, and other laws or measures cannot adequately mitigate the risk.

CFIUS reviews, however, do not take place in a bureaucratic vacuum, but amid a political process, and they are not, and perhaps cannot be, immune to politicization. Through congressional pressure, corporations and politicians can pressure CFIUS to reject acquisitions that it might otherwise accept, adding tension to CFIUS's already difficult mandate of balancing what is good for the economy against the needs of national security. The next chapter deals with these issues.

47. Exon-Florio Amendment, § 2170(e).