

Analysis and Prospects of Foreign Security Clearance in Various Countries

Jinyi Zhao

*Law Department, Zhongnan University of Economics and Law, Wuhan, China
18398436657@163.com*

Abstract: With the trend of economic globalization becoming more and more obvious, many enterprises nowadays adopt different ways to expand the scope of their business operations. Among them, investment, mergers and acquisitions (M&A) of enterprises in other countries are the most significant. Foreign mergers and acquisitions, investment in the host country to bring a positive impact on the stimulation of domestic industry, but if not controlled may endanger national security, in this case, different countries have adopted different ways of foreign business review. And China as a rapidly developing economy in recent years, his foreign investment system is worth studying, but there are still some defects. After analyzing the system of each country, we can make an outlook on the global economic development.

Keywords: foreign M&A, security clearance, supervisory

1. Introduction

Since the reform and opening up, China has been adhering to the basic national policy of opening up to the outside world, and after 1993, with the gradual entry of foreign capital, China's international cycle has been expanding [1], and by 2020, China's actual use of foreign capital had reached US\$149.34 billion. The report of the 20th CPC National Congress also explicitly proposed to accelerate the construction of a new development pattern with the domestic macro-circulation as the main body and the domestic and international double-circulation promoting each other.

The so-called foreign mergers and acquisitions refers to the capital expansion of foreign enterprises through capital combination, asset exchange, equity transfer, etc., realized through the transfer of ownership or control of the enterprise.

However, there is no clear definition of what constitutes “foreign capital”, and there are usually three international practices: the criterion of the place of registration, the criterion of the principal place of business and the criterion of capital control. The Law of the People's Republic of China on Foreign-funded Enterprises defines a foreign-funded enterprise as an enterprise established in China in accordance with the relevant Chinese laws and all of its capital is invested by a foreign investor, while the Law of the People's Republic of China on Foreign Investment defines a foreign investor as a foreign investor that includes a foreign natural person, an enterprise or an other organization.

The general trend of global economic integration has given TNCs broader market prospects, but at the same time it has also made them face more intense competition. Under the influence of these external factors, TNCs are constantly adjusting their business strategies, integrating resources on a global scale with a global perspective using market mechanisms, expanding their own advantages, and continuously improving their core competitiveness.

At the same time, most countries and regions have relatively liberalized the restrictions on foreign investment, especially the Chinese market has a better prospect, China is gradually transforming from a potentially large market into a real market, the investment is expected to be less risky but with high returns, and China's friendly open-door policy provides a better environment for foreign M&A activities, and more foreign investors hope to obtain great benefits in the Chinese market.

With the promulgation of the Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors in August 2006, foreign enterprises have entered China in large quantities, which has had a large impact on China's domestic economy until now.

2. Impact of Foreign Mergers and Acquisitions

2.1. Positive Impacts

In terms of positive impacts, firstly, M&A by foreign investors is conducive to the improvement of the quality of listed companies.

After foreign investors have acquired the non-circulating shares of the enterprises, it has changed the situation of “one share dominance” which was common in the past, and made the shareholding structure of the companies more reasonable, and at the same time, it has brought advanced technology and company management concepts to the listed companies.

Secondly, it is also conducive to the construction of the securities market, attracting more investors, making the entire securities market more active and stimulating China's economic development. Thirdly, it also enhances the competitiveness of other existing enterprises, promotes the development of the current industry pattern, and injects additional vitality into the market.

2.2. Risks

However, at the same time, there are certain risks associated with foreign M&A, the most important of which is the concern about the adverse impact on national security. National security mainly includes economic, political, military, scientific and technological, cultural and other aspects, and the concept of “national economic security” appeared in the “Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors” promulgated in 2006 [2].

First of all, M&A may generate industry risks, and Umit Yilmaz proposed anticipation effect, complicity effect and competition effect. Since foreign acquisitions reduce frictions that affect the target firm's ability to invest and realize growth opportunities, the impact of foreign acquisitions on the value of peer firms is significantly negative when the competitive effect is greater than the anticipatory effect or the complicity effect, and also foreign acquirers from more specialized industries are more likely to weaken the competitive position of their industry rivals and to strengthen the competitive position of the target firm by increasing the productivity of the target firms.

Thus Umit Yilmaz argues that the impact of foreign acquisitions on the value of peers is greater in growth-intensive industries and that the stock market reaction of industry peers increases as the difference in the degree of industry specialization between the acquirer and its peers increases. In addition, foreign capital M&A may also appear institutional risk, the scale of foreign capital M&A reaches a certain degree, based on the inherent profit-seeking nature of capital, foreign investors will use their economic strength to influence the host country's decision-making, which in turn threatens the host country's institutional security and accelerates the host country's institutional change. Under the influence of the above, we should impose certain restrictions on foreign-funded mergers and acquisitions, but we should also adjust the “proportion”, or else bury its positive impression.

3. The Development, Content and Shortcomings of Security Audits for Foreign Invested Mergers and Acquisitions

3.1. Establishment of Security Clearance for Foreign Mergers and Acquisitions

The security review system for foreign investment originated in the United States in the 1970s. And China first constructed a security review system for foreign mergers and acquisitions in the Circular on Establishing a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors issued in February 2011, which mainly encompasses the scope, content, working mechanism, and relevant procedures of merger and acquisition security review, adding practicability to the security review system.

In 2015, the Office of the State Council issued the Trial Measures for National Security Review of Foreign Investment in Pilot Free Trade Zones, which piloted the implementation of national security review measures for foreign investment in the Pilot Free Trade Zones, including Shanghai, Guangdong, Tianjin, and Fujian, that are compatible with the negative list management model.

However, up to this point, there was no legal support for the “national security review” system in China, and it was not until the Foreign Investment Law and its implementing regulations were introduced in 2019 that it was clearly stipulated that the country would establish a security review system for foreign investment [3], and formally established the pre-access national treatment plus negative list management system at the legal and regulatory levels.

In order to further refine the system, the National Development and Reform Commission and the Ministry of Commerce promulgated the Measures for the Security Review of Foreign Investment (hereinafter referred to as the “Review Measures”) in 2020, thus enriching the framework of the security review system for foreign investment, which has the significance of safeguarding the country's sovereignty, security and development interests [4].

3.1.1. Scope of Security Review

The scope of security review mainly covers foreign investments that affect or may affect national security, and the Measures for Review mainly list the areas related to national defense and security, including geographic location of investments in military facilities and military industrial facilities around the geographical area, as well as investments in important agricultural, manufacturing, cultural, financial, high-tech and other industries to obtain the actual control of the invested enterprise.

With regard to the former said actual control, the “Review Measures” focus on whether foreign investors can reach a decisive degree of decision-making on the enterprise, including not only foreign investors hold more than 50% of the equity of the enterprise, but also emphasizes the foreign investor can have a significant impact on the enterprise's business decisions, personnel, finances, technology and other circumstances.

3.1.2. Security Review Management Organization

The State has set up a working mechanism office for organizing, coordinating and guiding the security review of foreign investment, which is mainly located in the National Development and Reform Commission (NDRC). As a constituent department of the State Council, the National Development and Reform Commission is responsible for formulating and organizing the implementation of national economic and social development strategies, medium- and long-term plans and annual plans. It is responsible for the management of the security review system, which can comprehensively assess the impact of foreign investment on the country's economic development from a macroeconomic perspective, including the impact on the industrial structure, economic

growth, employment, etc., and ensure that the review work is in line with the country's overall economic development strategy.

3.2. Deficiencies in the Measures for Security Review of Foreign Investment

3.2.1. Lack of Constitutional Legal Support

At present, the Measures for Review, as a departmental regulation, has a low legal status, and the only laws related to security review are the Anti-Monopoly Law, the National Security Law and the Foreign Investment Law, and all three of them only make reference to the security review system.

Departmental regulations are less stable than laws. This may lead to the fact that the relevant provisions of the security review of foreign investment are easily affected by the adjustment of sectoral policies or other factors, and are subject to frequent changes, making it difficult for foreign investors to form stable expectations. Moreover, the lower legal rank may make the system in the overall legal system authority is not prominent enough, in conflict with other high-ranking legal norms or in judicial practice, may be faced with other legal norms prioritized application of the situation, affecting the effective implementation of the review system.

3.2.2. Scope of Review Needs to be Refined

With regard to foreign security review, the current “Review Measures” is mainly for foreign investors who have actual control over important industries related to national security. However, regarding the scope, there are still relevant definitions that need to be clarified.

First, regarding “foreign investors”, the Measures for Examination still do not define “foreign investment”.

Secondly, with regard to “actual control”, the Measures for Review define foreign investment as investment activities carried out by foreign investors directly or indirectly in the territory of the People's Republic of China, including the establishment of enterprises, mergers and acquisitions and other cases. Regarding the “actual control”, the document only briefly includes the situation of holding more than 50% of the shares and talking about its voting rights in a generalized way that can have a significant impact on the company's resolution, but it obviously ignores the situation of controlling the company by financial instruments, trusts and other control methods. For example, by VIE structure. It is not uncommon for domestic regulators to avoid regulating the entry of foreign investors.

Third, the Review Measures are too general in their description of the areas to be reviewed, with the review criteria simply described as “relating to national security”, but without a more detailed description of what constitutes “national security” and what constitutes “having an impact on national security”. However, there is no more detailed description of what constitutes “national security” and what “has an impact on national security”. Under such circumstances, it is easy to create unclear and inconsistent review standards, thus undermining the stability of the system. With the advent of the data era, data has become an extremely important resource, and data security has become an extremely urgent protection object, but the “Review Measures” is missing on this part of the data as the core services of foreign-funded enterprises review, still need to be improved.

3.2.3. Review Procedures are not Perfect

Article 35 of the Foreign Investment Law stipulates that “the security review decision made by the review body in accordance with the law shall be final”, which means that foreign investors often have only one opportunity for review.

And at the same time are not equipped with the corresponding relief channels for foreign investors' rights, coupled with the current review standards are vague, which makes the transparency of China's security review system reduced, and may affect the investment of foreign investors. This, coupled with the current vague review criteria, has reduced the transparency of China's security review system, and may affect the investment incentives of foreign investors.

4. Comparison of the Characteristics of National Foreign Merger Review Systems

At present, there is a continuing divergence in attitudes between developed and developing countries towards the introduction of foreign investment. According to the United Nations, 86% of the investment policies of developing countries will contribute to the introduction of foreign investment in 2023, while the proportion of developed countries is only 43%.

4.1. U.S. Foreign Investment and Mergers and Acquisitions Security Review System

In the past decade, the United States has further increased restrictions on foreign investment access by revising its foreign investment security review mechanism. With the historical evolution of the U.S. national security strategy, some specific foreign investment M&A cases have aroused widespread controversy and concern, such as the 2005 CNOOC acquisition of Unocal, which pushed the U.S. Foreign Investment and National Security Act of 2007 to be revised, strengthened the review of foreign investment M&A in areas involving energy, critical infrastructure, etc., and expanded the Commission on Foreign Investment in the Us (CFIUS); *Rawls Corp. v. Obama* from 2012 to 2014 prompted CFIUS to increase transparency in its reviews and require clearer disclosure of evidence. Overall, the U.S. National Security Review Act has become more expansive and procedurally rigorous, and CFIUS's enforcement powers continue to be strengthened [5].

4.1.1. Scope of Coverage

The Foreign Investment Risk Review Modernization Act of 2018 (hereinafter referred to as FIRRMA), which was issued in CFIUS 2020 and has been formally effective since February 13, 2020, issued its latest revisions, exhibits a clear protectionist bias.

The expansion of the scope of the subject of review is reflected in the fact that, generally speaking, CFIUS mainly reviews whether the jurisdictional transactions conducted by foreign investors in U.S. enterprises involve U.S. national security, but FIRRMA has modified the definitions of "U.S. enterprise" and "jurisdictional transaction". In defining a U.S. business, FIRRMA deleted the phrase "to the extent of its activities in U.S. interstate commerce," which means that CFIUS may also have jurisdiction over commercial activities located outside the U.S. if those activities have some connection to interstate commerce within the U.S. may likewise have jurisdiction.

FIRRMA also increases the scope of jurisdiction over TID U.S. companies. The regulations provide more detailed criteria for determining the control of non-controlling investments in each of these three types of businesses, and do not require the foreign investor to have controlling control of these businesses. In addition, FIRRMA adds jurisdiction over real estate transactions, the first time that review of real estate transactions has been statutorily authorized, authorizing CFIUS to review transactions in which a foreign investor purchases, leases, or acquires a franchise of U.S. real property.

It shows the expansion of the scope of the review object, the expansion of the authority of the review subject and the complexity and harshness of the review procedure, which obviously has protectionist tendency.

4.1.2. Review Authority

CFIUS is an inter-departmental committee of the United States, consisting of nine voting cabinet members, two non-voting ex-officio members and other members appointed by the President, in which the Secretary of the Treasury serves as the chairman of the committee.

FIRRMA provides CFIUS with greater enforcement authority to require counterparties and other interested persons to submit more types of documents and information, particularly with respect to transactions that are not voluntarily submitted for review or filing, and FIRRMA expands CFIUS's use of subpoenas as a means of investigating and evaluating the national security risks of unreported transactions, as well as extends the time period for filing petitions for reconsideration of fines and the deadline for CFIUS to respond to such petitions.

4.1.3. Review Mechanisms

The U.S. foreign security review system is still primarily divided into voluntary declarations for non-mandatory declarations of covered transactions, and FIRRMA has innovatively introduced “declaration” and “mandatory declaration” procedures. A declaration is more concise than a formal written notice and has a shorter review period. Generally, investors may voluntarily choose the “declaration” procedure, but if the foreign investor invests in a business that involves a TID U.S. enterprise and the foreign investor will receive a “substantial interest” in the business, the foreign investor will face the “mandatory declaration” procedure. Compulsory declaration” procedures.

4.2. EU Security Review System for Foreign Investments and Mergers and Acquisitions

At present, European countries, including the United Kingdom, France, Germany, Italy, and Austria, have established national security review mechanisms, and the security review mechanisms formulated by each country differ in terms of the review time, reasons for activation, and review contents. In terms of the EU scope, in 2017, Germany, France, and Italy jointly requested the European Commission to include foreign investment in the scope of EU scrutiny, and on March 19, 2019, Regulation 2019/452 of the EU Parliament and the European Council adopted the EU Regulation on the Scrutiny of Foreign Direct Investment (hereinafter referred to as the EU Scrutiny Regulation), which decided to implement a unified scrutiny of foreign direct investment at the EU level. The EU Review Regulation, which came into force on April 10, 2019 and will be formally implemented in October 2020, reflects the EU's determination to strengthen the review of foreign investment [6].

On January 24, 2024, the European Commission released the draft legislation related to the “European Economic Security Package”, in which the draft legislation on foreign investment access is the draft amendment to the EU Foreign Direct Investment Review Regulation (hereinafter referred to as the “Draft Amendment”), which can be seen that the EU aims to increase the intensity of foreign investment review to enter the EU, so as to increase the intensity of foreign investment review, so as to increase the intensity of foreign investment review. It can be seen that the EU aims to strengthen the protection of the so-called EU security and public order by increasing the scrutiny of foreign investment into the EU, thus strengthening the urgent demand.

4.2.1. Scope of Coverage

It should be noted that the EU Review Regulation does not require all EU member states to establish a foreign investment security review system, but in the Revised Draft, it is clearly stipulated that each EU member state shall establish a foreign investment review system in line with the provisions of the Draft.

In terms of coverage, the EU Review Regulation only targets foreign direct investment (FDI), but the Revised Draft expands the scope to include “foreign direct investment” and “offshore-controlled EU investment”. This draft clearly specifies the foreign investment areas that should be subject to foreign investment review, which notably covers a series of high-tech industries, including semiconductor technology, artificial intelligence technology, quantum technology, etc., which reflects the tightening of the investment policies of the EU countries in the hot areas of science and technology.

4.2.2. Review Content

The EU Review Regulation mainly examines whether foreign investment has negative impacts on the economy and national security of the country. The connotation of negative impacts includes critical infrastructure, defined critical technologies and dual-use products, the supply of key resources, sensitive information, and media freedom and pluralism.

In addition, the identity of the investor is also included in the review, and Article 13.4 of the draft adds that the review includes “whether the foreign investor itself, its beneficial owners, beneficiaries, any subsidiaries, or any other entity owned, controlled or directed by it, has been subject to a review of foreign investment in any EU Member State and has failed to obtain an authorization or has obtained a conditional authorization or whether it may be the policy of a non-EU country”. Whether the foreign investor or any of its subsidiaries has been involved in activities that adversely affect the security and public order of an EU member state, or has engaged in criminal activities”.

4.2.3. Review Mechanism

Regarding the review mechanism, the most distinctive feature of the EU Review Regulation is the establishment of an information-sharing and cooperation mechanism between EU member states and the European Commission for foreign investment.

The Revised Draft establishes a closer cooperation within the EU, which not only requires that EU Member States receiving opinions from other EU Member States should pay the highest attention to those opinions, but also establishes an active review procedure between different EU Member States, i.e., if other EU Member States or the European Commission in a non-target investor country believe that a certain foreign investment negatively affects the security and public order of that country, even if the target investor country has not initiated a review of foreign investment. Even if the target investor country has not initiated a foreign investment review, other EU member states and the EC can initiate a foreign investment review process on their own within at least 15 months after the completion of the foreign investment, and the target investor country should closely cooperate with the other EU countries or the EC that have initiated the review on their own during the review process. However, I believe that this amendment is suspected of infringing on national sovereignty and is expected to be difficult to be adopted.

5. Conclusion and Prospects

Looking at the foreign investment review systems of various countries, we find that there is still a wide gap between the systems of countries with advanced economies and those with average economic development.

It is important to note that foreign investment review is not just an economic and legal issue. It is related to international security and transactions between countries, which makes it somewhat political in nature. As the external system changes, it will also change with it. Therefore, when we consider the revision of China's foreign investment review system, we also need to pay attention to this issue.

And looking around the world, under the trend of economic globalization, it is still a question worth pondering as to how the foreign investment review system of each country should change.

References

- [1] LAU L. *China's twin circulations*[EB/OL].(2020-10-12)[2023-05-02]. <https://www.chinausfocus.com/finance-economy/chinas-twin-circulations>.
- [2] Gu Haibin & Li Changzhi (2019). *Annual report on China's economic security* Renmin University of China press,
- [3] Geng Zhiqiang (2021). *Research on the innovation and development of national financial security review system under the overall national security concept (doctoral dissertation, Southwest University of Political Science and Law) Doctor* <https://linktbprolcnkihtbprolnet-s.libvnp.zuel.edu.cn/doi/10.27422/d.cnki.gxzf.2021.001789> doi:10.27422/d.cnki.gxzf.2021.001789.
- [4] Xiao Haiyan, Li Xi. *Foreign Investment Security Review Standards: Deficiencies, Value Orientation and Way Forward--Taking the Overall National Security Concept as the Perspective* [J]. *Journal of Hunan University (Social Science Edition)*, 2023, 37 (05): 134-143. DOI:10.16339/j.cnki.hdxbskb.2023.05.018.
- [5] Chen Miao, Liu Yong. *Study on the Institutional Evolution, Implementation Characteristics and Response Strategies of the National Security Review of U.S. Foreign Investments and Mergers and Acquisitions* [J]. *Journal of International Relations and International Law*, 2020, 9 (00): 290-328.
- [6] Shen Wei, Ying Tian. *Background, rules and response to the EU Foreign Direct Investment Review Regulation*[J]. *Customs and Economic and Trade Research*, 2019, 40 (06): 42-70.