Proceedings of the 2nd International Conference on Business and Policy Studies
DOI: 10.54254/2754-1169/10/20230455

Challenges and Improvement of National Security Clearance in M&A by Chinese MNCs

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Abstract: With the accelerated integration of the world economy and the gradual development of China's reform and opening-up, Chinese enterprises have been making outbound investments and cross-border mergers and acquisitions more frequently. In terms of the attitudes of countries around the world towards the entry of foreign capital, some countries welcome the entry of foreign capital. However, others restrict the cross-border M&A of foreign companies entering their countries for reasons of domestic resource, technology and industrial protection, or to protect the interests of their national industries. From the recent development trend, the national security of foreign capital is especially cleared. Hence, this paper mainly studies the national security clearance system of cross-border M&A in the United States and other developed Western countries through literature analysis and comparative analysis. It also tries to summarize the characteristics and rules from them in the light of China's national conditions, supplemented by systematic research on cases of failed cross-border M&A by Chinese enterprises that encountered national security. Based on this, it will be very beneficial to the future cross-border M&A activities of Chinese enterprises, laying a good foundation for Chinese enterprises in the world M&A field in the future.

Keywords: cross-border M&A, national security clearance, anti-monopoly, avoidance measures, political risk

1. Introduction

National security clearance is the first threshold of M&A of multinational companies and a concrete manifestation of national economic sovereignty. It can be said that there can be no M&A of multinational corporations without national security clearance. Along with the continuous promotion of economic globalization and the accelerated integration of economic resources of all countries, the importance of national security clearance is particularly highlighted as an important legal weapon for sovereign states to safeguard market competition and protect the interests of consumers. Yet on the other hand, it is also inevitably reduced to a protection tool for some sovereign countries to protect their enterprises from foreign competition, which gives a political color to national security clearance. Taking China as an example, the national security clearance of cross-border M&A activities of Chinese enterprises by western developed countries has basically started since the implementation of the "going out" policy of Chinese enterprises. As China's economy further integrates into the world economy, national security clearances of cross-border

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M&A in Western countries are becoming more and more frequent in the cross-border M&A activities of Chinese companies including the failed acquisition of Boeing's MAMCO by AVIC in 1990, CNOOC's failed bid for Uniko Oil Company in 2005. They have all reflected the national security clearance of China's capital injection by western countries. Even though there are examples of successful acquisitions, the home countries often impose cumbersome additional terms and conditions, which defeat the intention of China's enterprises to obtain commercial benefits. Therefore, the value of the M&A strategy is greatly diminished.

In light of this, China is actually facing quite serious international situation. In China, the research on M&A and cross-border M&A has been relatively adequate and the number of studies from the legal level has gradually increased. Yet they are mainly at the practical and operational level, rather than through systematic and in-depth theoretical analysis. In particular, there is a lack of in-depth and detailed research on new trends and dynamics of cross-border M&A of multinational companies, such as private equity (PE) and special purpose vehicles (SPV). Research in the investment community has been very extensive, but legal research is still rare. *Corporate Acquisitions: Law and Practice*, edited by Prof. Baoshu Wang, covers the frontier issues of corporate M&A. It made a comparison between the domestic and foreign of corporate acquisition systems. It also covered corporate acquisition and governance and policy analysis of corporate acquisition. In addition, it threw light upon the tender offers and agreed takeovers, anti-takeovers, management buyouts of listed companies, and improvement of the legal system of corporate takeovers in China [1]. It is an important study focusing on the legal issues of corporate M&A so far. The Legal Regulation of Cross-Border M&A by Ying Qi discusses the investment policy, competition policy and takeover of listed companies involved in cross-border M&A. Meanwhile it analyzes the history, system, progress and shortcomings of China's legal regulation of M&A of multinational companies [2]. Studies on cross-border M&A regulation are mostly introductory and basically cover both international and domestic, mainly focusing on the field of anti-monopoly clearance. Yet there are few studies on market access and national security clearance or revealing the intrinsic relationship between various regulatory regimes. Moreover, there is insufficient research on the latest developments and trends in regulatory policies.

This paper focuses on the national security clearance in cross-border M&A. Starting from the causes, problems and solutions, this paper analyzes the current situation and problems in cross-border M&A in China by drawing on the regulatory initiatives of the UK and the US and other Western countries, adapting to the actual needs of cross-border M&A of Chinese enterprises.

2. Current Legal Dilemmas

For one thing, too strict national security system clearance may impede free trade and investment, thus affecting economic development. In the era of economic globalization, capital mergers, acquisitions, and spin-offs have become more frequent than before as economic players from different countries join the market. Country risk has become a major concern for governments and enterprises. However, it should be noted that an excessively stringent national security clearance system may lead to the elimination of foreign capital injection channels, which is not conducive to social progress and economic development. Through comparative research and analysis of the system, countries should combine the current status of the national security system clearance. In addition to changing the legislative model and clarifying the legislative standards, countries should focus on how to regulate the law enforcement body that is the government behavior to provide comprehensive institutional support for social and economic development.

For the other, excessive discretionary power may lead to possible abuse of power. Taking the U.S. Exon-Florio clause as an example, the U.S. is bound to take various measures to give high priority to national security issues according to the new national security strategy. CFIUS, as the

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agency that evaluates and regulates foreign direct investment, will certainly be more active in implementing the Exon-Florio clause and clearing foreign M&A transactions in order to adequately protect national security, especially national economic security, which is its core and foundation.

It should be noted that economic security is the state of an entity's ability to survive and develop in the face of internal and external threats and unforeseen and unpredictable factors. The development and stability of the economy is crucial to ensuring economic security, and it can be said that development is the basic element to ensure economic security. The economy's ability to survive and resist internal and external threats will be greatly reduced without economic development. However, due to the unclear definition of "national security" in the act itself, CFIUS and the President have great discretion in determining whether foreign M&A transactions endanger "national security" [3]. The Exon-Florio provision is vulnerable to abuse and has become a tool of trade protectionism. Moreover, it is also contrary to the traditional U.S. policy of open investment.

How to define the scope of national security and to what extent it is possible to interfere with commercial activities on the grounds of national security have become issues that must be resolved by all countries in the world at present, especially those that occupy an important position in the world economy. Only by reaching a consensus on this issue can disputes arising from trade and investment among countries be effectively resolved, thus better promoting the development of the global economy and the common prosperity of all countries in the world. For countries, how to continue the traditional open investment policy while adequately protecting national security, especially national economic security from potential hazards from foreign investors [4], namely, finding an appropriate balance between developing the economy and protecting national security. It has become an issue that countries must address carefully.

3. Analysis of the Risk of National Security Clearance Chinese MNCs

3.1. Overly Sensitive Target Areas

The overly sensitive areas of cross-border M&A by Chinese companies are an important source of clearance risk. Western developed countries are very concerned about the fields that are related to their national lifelines and have great strategic significance, such as military, minerals, resources, science and technology, and finance [5]. A comprehensive analysis of decades of cross-border M&A blocked cases of Chinese enterprises reveals that Chinese enterprises suffer the highest risk of national security clearance in the following two areas when they engage in cross-border M&A. One is the capital field of science and technology, including industry, biotechnology, and the other is in the resource field such as non-ferrous metals, oil, and minerals. If Chinese companies' cross-border M&A is concentrated in these fields, it is expected that they will suffer from the security clearance of their cross-border M&A as they are not compatible with the taboos of Western host countries. For instance, CNOOC's failed acquisition of Chevron and Unico, China Pan's failed acquisition of Rio Tinto, and Jade Mining's failed acquisition of Noranda are all clear examples. If Chinese companies continue to implement cross-border M&A directly in these sensitive areas that are taboo to the host countries in order to achieve their strategic goals without being strategic, then such cross-border M&A security clearance risks will follow and cannot be eliminated in a short period of time.

3.2. Information Asymmetry of Cross-border M&A

Chinese companies' lack of understanding of the host country's legal system and information asymmetry increase the risk of being subject to national security clearance. Western developed countries are known for their perfect legal systems, especially their mostly complete laws in the field of cross-border M&A clearance, and most Western countries have follow-up remedial policies

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and measures for foreign investment security clearance. Since Chinese companies have not been conducting cross-border M&A for a long time and are unfamiliar with the foreign legal environment, their risk of being subjected to national security clearance is in effect increased, which is due to their own lack of attention to prior investigations and the lack of corresponding intermediaries in China. Since they are not familiar with the host country's legal environment and related policies, and will not take advantage of the host country's political ecology to lobby for their interests, not to mention the use of relevant relief measures, the risk of Chinese companies being subjected to national security clearance is doubled from the original one. This becomes an obstacle to the success of Chinese companies' cross-border M&A and is something that Chinese companies need to pay attention to in their future cross-border M&A.

3.3. China's Political System and the State-owned Background of the Companies

From the cases and data of Chinese companies' cross-border M&A encountering national security clearance in the past decade or so, most of the M&A failures due to national security clearance of foreign investment in western countries are Chinese state-owned enterprises or state-controlled enterprises. In addition, the success rate of M&A in the same field is much higher for Western companies and even for Asian companies than for Chinese companies. It is a clearly indicated that the nature of China's society and the state-owned background of the main body of the cross-border M&A firms are important reasons for the national security scrutiny of the target country and are key factors in the risk of national security scrutiny [6]. The nature of China's socialist state has always been scorned by Western countries and the enterprises that have the strength to engage in cross-border M&A are mainly state-owned enterprises. They have unparalleled advantages in terms of scale and quality and are the main force of China's enterprises going global. The social attributes of Western developed countries and the fact that they are currently in the mature stage of capitalism have determined that Western developed countries and governments give care to private ownership and privately owned enterprises. In their view, Chinese SOEs represent China's national will and execute China's national strategy. They are no longer mere autonomous profit-and-loss business units while they are an extension of China's national sovereignty and will. The nature of Chinese society and the state-owned nature of the subjects of cross-border mergers and acquisitions are important factors that expose them to the risk of national security scrutiny and failure.

Chinese companies' M&A in military, mineral, resource, science and technology, financial and other fields are subject to national security scrutiny by developed countries led by the United States. They are denied on national security grounds. Over the years, most Chinese companies implementing cross-border M&A are state-owned companies or state-controlled companies. Even if some of them do not have obvious state-owned nature or government background, they are labeled as state-owned by the Western media, public, partisans and government officials and are amplified due to the differences between China's political system, ideology and social culture and those of Western countries. It is a well-known that, since China's foreign-invested SOEs or state-owned holding companies are generally in dominant positions in their industries at home, cross-border investment is their inevitable choice to grow bigger and stronger. No matter what form of foreign direct investment they take, they are bound to encounter the problem of national security scrutiny and their special status of achieving dominant positions at home will in turn become a constraint in cross-border M&A. The special status of their dominant position at home will in turn become a political or ideological constraint in cross-border M&As, which in turn will become a dangerous bay for them to bypass when undergoing national security clearance.

It is worth noting that the political risks encountered by Chinese companies, especially SOEs, are not the same as other political risks in cross-border M&A when subject to national security clearance. For one thing, SOEs have a privileged political status at home, but their investor

DOI: 10.54254/2754-1169/10/20230455

identification is a controversial issue when it comes to cross-border M&A and they tend to worry the host country, which is the burden of market value recognition brought by the Chinese characteristic corporate system and the relationship between government and enterprises for Chinese companies in cross-border M&A. For the other, the national security clearance risk of cross-border M&A encountered by Chinese SOEs is not the same as the political risk encountered by international private investment, which includes expropriation risk, exchange restriction risk, war and civil unrest risk, and government default risk. These risks are political risks arising after investment and there are more mature practices in developed countries in the field of international investment law on how to deal with these types of risks. The national security clearance risks encountered by Chinese enterprises, especially SOEs, often occur before the investment acquisition. Such risks seem inevitable for Chinese enterprises, but only contingent for investors from other countries. Therefore, when Chinese SOEs appear in the capital market of cross-border M&A as transnational investors of traditional capital exporting countries, the original enterprise identification system and related systems of developed countries are bound to be impacted and it is understandable that the phenomenon of apprehension and even rejection will arise as a result. What kind of mentality and system developed countries use to deal with national security clearance of cross-border M&A by Chinese companies depends on the institutional arrangements of these countries and will not be shifted by our will in the short term. Yet what is needed is to focus on now is how Chinese companies can avoid or reduce the potential risk of M&A failure in the face of these national security clearance.

4. Improvement of National Security Clearance

4.1. Create a Favorable Policy Environment

The government should strive to create a favorable policy environment and provide solid background support for the cross-border M&A activities of domestic enterprises. In order to create a favorable policy environment for cross-border M&A of domestic enterprises, it is advisable to start from the following points:

Firstly, Chinese government should try hard to assist domestic enterprises in conducting preliminary investment environment surveys [6]. The government should, by virtue of its height, use all favorable resources to help domestic enterprises understand the legal environment of the investment destination country, clarify the attitudes of foreign governments in the field of investment, familiarize themselves with the local regulations of the region. The government should help enterprises conduct a comprehensive, multi-level investigation and weigh the risks of mergers and acquisitions.

Secondly, the government should create a favorable approval environment and create a liberal foreign exchange remittance and exchange policy. In China, although the Security Clearance Notice and the Security Clearance Regulations are operational rules and regulations, there are still a huge gap from specifically guiding the operation of the joint ministerial conference and helping foreign investors analyze the process and possible outcomes of specific security clearance. There are still many unresolved questions about the definition of criteria, scope and target audience. More importantly, although China is not a case law country, the absence of specific cases for foreign investors to refer to also increases their unpredictability of the outcome of the clearance. One of the existing provisions is a departmental regulation with low legislative ranking, while the other is a notice from the General Office whose legal effect is questionable.

It is worth learning that FINSA adheres to the two basic principles of overall openness and moderate management. It does not change the substantive open strategy of attracting foreign investment, but at the same time it regulates the foreign investment behavior by improving the

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standards, procedures and supervision to protect the U.S. national security. Its timely open and transparent characteristics and non-one-size-fits-all approach have instead improved the foreign investment environment in the U.S. [7] because predictability is inherently a necessary condition for multinational operations. For investors, clear legislation and a good legal environment are the most important prerequisites to ensure the conduct of multinational investment. Although there are principal regulations involving national security clearance in China, there is no clear standard for which industries are key industries and which industries or enterprises' M&A will affect or may affect national economic security. They are departmental regulations with low level of legislation.

A good legal environment is a major benefit for foreign M&A. Strengthening national security clearance legislation for foreign M&A will help improve the foreign investment environment instead of damaging the foreign investment environment. One of the lessons from FINSA is that the focus of China's future foreign investment efforts should not be on how to limit the size of foreign investment, but rather on regulating and guiding foreign investment in a public and transparent manner through legislative channels. Multiple policy objectives such as national security, industrial growth and national welfare should be taken into account to promote win-win cooperation between foreign capital and the Chinese economy at a higher level [8]. At present, China should refine its foreign investment clearance legislation to strengthen procedural requirements and transparency.

Thirdly, it is advisable to ensure uniformity in foreign M&A security clearance. Taking the U.S. as an example, CFIUS members strive to check and balance each other from their own perspectives in view of industry interests, and there are often divergent views on foreign M&A. Generally speaking, the Department of Commerce and the Department of the Treasury are relatively lenient to foreign M&A from the perspective of activating the economy and improving employment. Yet the Department of Defense, the Department of Justice, and the Department of Homeland Security always try to set up obstacles for foreign acquisition in order to alleviate their concerns about national security. For example, the Department of Defense (DoD) is more stringent in managing acquisitions in the telecommunications industry, especially in the network industry, and the DoD and the Department of Homeland Security (DHS) usually have a separate clearance process outside of CFIUS.

FINSA's reform of CFIUS authorizes the Chairman (Treasury) to designate a "lead department" based on the characteristics of each transaction, and the "lead department" is the lead agency for the main area of the transaction. Its representatives negotiate the mitigation agreement and are responsible for monitoring and implementing the agreement. This flexible institutional arrangement fully reflects the requirement of case-specific analysis of the clearance and is highly justified [9].

The above is the second insight for us, namely, the uniformity of the national security clearance of foreign M&A should be strengthened. The current sectoral legislation in China has the phenomenon of each sector competing for power and profit through legislation. In practice, there is a general problem of each department doing its own thing and not sharing information. This leads to blind areas of management in some areas and duplication of supervision by various departments in others, ultimately making administrative management inefficient and administrative resources wasteful. China can follow the practice of the United States when establishing a national security clearance body in the future. The unified legislation can be adopted to stipulate the composition of the clearance body, the specific responsibilities of each constituent department, the relevant organizational methods and operational procedures. It can strengthen the accountability of the chief executive of each department through legislation [10]. It can explicitly require the sharing of information and administrative resources among departments through legislation. Fourthly, it can flexibly and reasonably determine the "approval" of each case according to the specific circumstances of each case. According to the specific circumstances of each case, the "lead

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department" for the approval of the case is determined in a reasonable manner and it is mandatory to stipulate the obligations of the relevant departments to assist the "lead department".

Thirdly, it is suggested to reconcile security clearance and business development strategies. After China's rethinking of "market for technology" and concerns about "Latin Americanization" , there has been an over-exaggeration of "security" . The terms "financial security" , "industrial security", "economic security" and "cultural security" appear frequently in Chinese newspapers and online public opinion. They are often used to restrict foreign investment on the grounds of national security. This makes foreign investors feel that the future is unpredictable and makes it possible for foreign investors to abandon many mergers and acquisitions that would not otherwise involve national security. In fact, during the development of FINSA, while considering national security, the U.S. Congress agreed that foreign direct investment in the U.S. is different from foreign liquid capital in the U.S. Liquid capital may make the dollar and interest rates unstable, but foreign direct investment from China and the Middle East can help stabilize the dollar and interest rates, and foreign investment is largely beneficial to U.S. national security. Because of this, when safeguarding national security, it does not essentially change the open investment system of the United States. As a rapidly emerging beneficiary of the new round of globalization, China should not blindly follow the trend of excluding foreign investment just because there are serious "foreign investment restrictions" in specific countries around the world. China's foreign investment security clearance legislation should explicitly affirm its overall strategy and principles for opening up to the outside world to accurately convey China's overall openness message of welcoming foreign investment and clarify the false impression that China will gradually close its doors to openness, while avoiding reciprocal retaliation from other countries [11].

China's industrial development strategy and security clearance need to be better aligned. Security clearances are not investment protection tools and cannot be expanded without limits. Only industries that truly affect national security should be intervened with national security tunnels. The development of some new industries cannot be protected by security clearances. Even if they can be protected temporarily, it is not conducive to the improvement of the competitiveness of China's new industries.

4.2. Enhance Coordination and Cooperation with Host Countries

The development of China's current cross-border M&A agreements or bilateral and multilateral investment agreements generally lags behind. Now there are some macroscopic problems of unequal power of China in foreign investment protection and other aspects. In response to this problem, Chinese government should strengthen the coordination and communication with host countries from all aspects.

On the one hand, our government can appropriately take diplomatic means to establish a dialogue mechanism with the host country to establish a level playing field for our enterprises. The control behavior of the host country government on cross-border M&A of our enterprises can also be countered by setting up an approval system for foreign enterprises' M&A in China [12] to achieve mutual deterrence and compromise.

On the other hand, the regulatory behavior of the host country on cross-border M&A of Chinese enterprises can be weakened by signing bilateral or regional multilateral cooperation agreements and establishing a trade and investment free circle [13] to offset the rationality on which it relies. By Communicating with the government of the target country through various channels, including through some private friendship institutions, diplomatic departments, and business federations, it is helpful to promote the gradual establishment of a good and sincere good image of our enterprise group in the local area. It is necessary to negotiate with the host country to improve the international tax system. Our government should sign an investment agreement with the host country to avoid

DOI: 10.54254/2754-1169/10/20230455

double taxation in order to maintain the national treatment of our foreign M&A enterprises in foreign countries as well as investment security, fully solving the problem of disputes and disputes over interests.

5. Conclusion

In recent decades, cross-border mergers and acquisitions have become more frequent and their means of implementation have become more abundant and diverse. In order to overcome the negative effects of cross-border M&As, many developed countries in the West have used national security clearance systems to protect their own important interests. There is a tendency for countries to imitate them. However, from the perspective of national security clearance of cross-border M&A, it is only a measure to maintain the balance between the fundamental interests of foreign investment and national security in the host country. It also reflects the dynamic game between the host government and multinational corporations. For multinational enterprises from all over the world, including Chinese enterprises, how to ensure their own interests are maximized in this game is an issue that they all have to face and consider seriously in the future. For Chinese government and enterprises, the existence of the national security clearance system for cross-border M&A has its own rationality for the protection of the interests of the host country. Therefore, it is not necessary for our government and enterprises to overreact to it beyond the economic scope. More importantly, Chinese government should improve the legal system of domestic foreign investment, fully understand the foreign investment policy and legal environment of the host country, and do a good job of pre-M&A research and develop appropriate M&A strategies. Hence, the risk of national security clearance affecting Chinese enterprises' cross-border M&A can be truly minimized, thus fundamentally protecting the real and long-term interests of Chinese enterprises' cross-border M&A.

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