

When China's National Champions Go Global: Nothing to Fear but Fear Itself?

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Due to the success of the 'Go Global' policy, in recent years there has been a dramatic increase in overseas direct investment made by Chinese state-owned enterprises (SOEs). However, Chinese SOEs' overseas investment has been viewed with suspicion and several attempted acquisitions discontinued in the face of strong opposition from host countries. This article analyses the plausibility of some common fears about Chinese SOEs' overseas direct investment and evaluates critically the regulatory responses of the US, Canada, Australia and the European Union motivated by such fears. The article argues that though some fears are legitimate, they are grossly exaggerated in view of the SOE reforms in China over the past three decades. The policy implications of this finding for both host countries and China's ongoing SOE reforms are also explored.

1 INTRODUCTION

As an essential part of its government-directed development model, China has adopted a government-mandated 'Go Global' policy since 2000. The essence of the 'Go Global' policy is to promote the international operations of capable Chinese firms through outbound foreign direct investment (OFDI) with a view to enhancing their international competitiveness.¹ This policy has been very successful to date. In recent year there has been a dramatic increase in Chinese OFDI and an even larger potential for growth.² In 2008, while global OFDI fell by 15% as a consequence of the global financial crisis, Chinese OFDI flows more than doubled.³ In 2009, when global OFDI plummeted by

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¹ Wayne M. Morrison, *China's Economic Conditions*, Congressional Research Service (4 May 2013), at 20; Mitchell Silk and Richard Malish, *Are Chinese Companies Taking over the World?* 7 Chi. J. Int'l L. 105, 112 (2006).

² Nargiza Salidjanova, *Going Out: An Overview of China's Outward Foreign Direct Investment*, US-China Economic & Security Review Commission Staff Research Report (30 Mar. 2011), at 3.

³ Ken Davies, *Outward FDI from China and Its Policy Context*, Columbia FDI Profiles (18 Oct. 2010), at 5.

43%, Chinese OFDI still managed to maintain its upward trajectory.⁴ In 2012, global OFDI slid 17% amid uncertainties facing the world economy, whereas Chinese OFDI rose 17.6% and hit a record high of USD 87.8 billion, compared to USD 12.3 billion in 2005. Overall, Chinese companies have made OFDI totaling approximately USD 531.94 billion by 2012.⁵ The Heritage Foundation predicted that the Chinese OFDI stock would likely reach USD 100 billion annually by 2016.⁶ Some well-known international brands such as IBM, Volvo, Chateau Viaud vineyard, Ferretti luxury yachts and AMC theatres are now under the control of Chinese companies. Large scale takeover bids made by Chinese investors have been regularly in media spotlight in recent years.⁷

However, the ambitious overseas expansion of Chinese companies has not always been successful. At least 80% of all Chinese OFDI has been funded by Chinese state-owned enterprises (SOEs), among which central SOEs, the largest SOEs financed and owned by the Chinese central government and the most likely national champions, contributed almost 90%.⁸ Because of the close connections between Chinese SOEs and the Chinese government, investments made by Chinese SOEs have been viewed with suspicion and alarm in some Western countries.⁹ At least partly driven by concerns of Chinese SOEs' investments, a number of countries enacted or revamped their foreign investment laws in recent years purporting to address potential risks from Chinese SOEs. A telling example is Canada. After the approval of the China National Offshore Oil Corporation's (CNOOC) acquisition of Nexen Inc. on 7 December 2012, the Canadian government on the same day announced new and more onerous policy guidance with respect to future proposed

⁴ UNCTAD, *World Investment Report 2010: Investing in a Low Carbon Economy* (New York and Geneva, 2010), at 3.

⁵ UNCTAD, *World Investment Report 2013* (New York and Geneva, 2013), at 4; Xinhua, *China's Outbound Investment has Great Growth Potential despite Overheating Risk*, http://news.xinhuanet.com/english/indepth/2013-09/19/c_132734146.htm.

⁶ Derek Scissors, *Chinese Investments in the US: Facts and Motives*, <http://www.heritage.org/research/testimony/2013/05/chinese-investment-in-the-us-facts-and-motives>.

⁷ Angela Huyue Zhang, *Foreign Direct Investment from China: Sense and Sensibility*, 34 *North Western Journal of Law & Business* 395 (2014), at 405.

⁸ Adrian Wooldridge, *The Visible Hand*, *The Economist* (January 2012), at 15. SOEs also play an important role in some other emerging markets, such as Russia and Singapore. See Karl P. Sauvart et al. (eds), *Sovereign Investment: Concerns and Policy Reactions*, 10–11 (Oxford U. Press 2012).

⁹ Colonel Heino Klinck, *The Strategic Implications of Chinese Companies Going Global*, US Army War College Civilian Research Project (2011), at 74; Alan H. Price et al., *Facing the Challenges of SOE Investment Abroad*, presented to the North American Steel Trade Commission, 12–14 (June 2011).

acquisitions by foreign SOEs.¹⁰ As if the newly updated SOE policy guidance was not adequate to address the concerns, the Economic Action Plan 2013 Act (Bill C-60) introduced several further steps in restricting investments by foreign SOEs in Canada in June 2013.¹¹

As a consequence of ambiguity and trepidation towards FDI from China, several major attempted acquisitions by Chinese SOEs discontinued in the face of strong opposition from host countries.¹² A flurry of tightened regulations and the increasingly unpredictable regulatory environment in some countries caused Chinese investors to believe that some Western governments are unfairly hostile to them.¹³ These incidences bring to the forefront some challenging conceptual and practical questions. Why are some host countries so concerned about investments from China and especially Chinese SOEs? How do host countries respond to the perceived threats from Chinese investors? Are their concerns and the corresponding regulatory responses justified? Does the recent global expansion of Chinese SOEs call for additional international legal rules? If so, how could these rules be designed and implemented? This article addresses these questions. Part II explains motivations and policy incentives underlying the recent meteoric rise of Chinese OFDI. Also explained in part II are reasons why Chinese SOEs cause unique concerns in the cross-border context. Part III reviews regulatory responses of the US, Canada, Australia and the European Union (EU) in addressing the alleged challenges posed by Chinese SOEs' investment. Part IV reflects on whether the intensified regulatory responses are overwrought in view of China's SOE reforms in the past three decades. The plausibility of certain common fears about Chinese SOEs is analysed and refuted. Part V explores policy implications for host countries in handling foreign investment by Chinese SOEs and China's ongoing SOE reforms. Part VI concludes.

¹⁰ Industry Canada, *Guidelines – Investment by State-owned Enterprises – Net Benefit Analysis*, <http://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk00064.html#p2>; Stikeman Elliott, *Investment Canada Act: SOE Guidelines and CNOOC/Nexen*, <http://www.stikeman.com/cps/rde/xchg/se-en/hs.xsl/17141.htm>.

¹¹ Madelaine Mackenzie et al., *Bill C-60: A More Restrictive Approach to Foreign State-owned Enterprises Investment in Canada* (June 2013), <http://www.lexology.com/library/detail.aspx?g=54765cc9-2869-4eb2-bb2b-7bf3bc1772b8>.

¹² Snell & Wilmer LLP, *China under the Microscope: The Role of CFIUS in Chinese Acquisitions of U.S. Assets*, <http://www.jdsupra.com/legalnews/china-under-the-microscope-the-role-of-72836/>.

¹³ Sudeep Reddy, *Failed US Deals Stir Tensions with China*, Wall St. J. (18 Oct. 2012); Tess Fitzgerald, *Chinese FDI in the US: Beyond the Smoke Screen*, AmCham China News (18 Jul. 2011).

2 EXPLAINING CHINA'S OFDI: MOTIVATIONS, POLICY INCENTIVES AND CONCERNS

2.1 DRIVERS OF CHINA'S OFDI

The conventional wisdom holds that in China's highly controlled economic system, the policy and strategy of the Chinese government have been always among the most significant determinants in explaining the development of China's OFDI.¹⁴ This observation however does not mean that China's OFDI policy is not rooted in China's economic reality. Indeed, the rapid growth of Chinese OFDI is a result of Chinese economic necessity.¹⁵

First, over the last thirty years, policies aiming at promoting export growth have allowed China to accumulate mammoth foreign exchange reserves, nearly USD 3.95 trillion in the first quarter of 2014.¹⁶ China's sovereign wealth funds (SWFs) and its central bank act as portfolio investors, buying bonds such as US Treasury securities. These investments, however, bear low interest rates and China has been seeking alternative channels to diversify its investment and realize higher returns.¹⁷ The vast foreign exchange reserves also give pressure on China to achieve equilibrium in its international financial flows by revaluing its currency the Renminbi.¹⁸ While China has been gradually making its foreign exchange regime more flexible and the Renminbi has appreciated 34% against the US dollar since 2005, adjustments would not be enough to starve off the revaluation pressure effectively.¹⁹ In the meantime, a policy of encouraging capital outflows including OFDI would help reduce the currency pressure by partially offsetting vigorous capital inflows to China.

¹⁴ OECD, *OECD Investment Policy Reviews- China 2008: Encouraging Responsible Business Conduct*, 66 (OECD Publishing, 2008).

¹⁵ Daniel H. Rosen and Thilo Hanemann, *China's Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications*, Peterson Institute for International Economics Policy Brief PB09-14 (June 2009), at 7.

¹⁶ Josh Nobel, *China's Foreign Exchange Reserves near Record \$4tn*, Financial Times (15 Apr, 2014).

¹⁷ Salidjanova, *supra* n. 2, at 14.

¹⁸ Jingtao Yi, *China's Rapid Accumulation of Foreign Exchange Reserves and Its Policy Implications*, 10 University of Nottingham China Policy Institute Brief Series (2006), at 6.

¹⁹ C Fred Bergsten and Joseph E. Gagnon, *Currency Manipulation, US Economy and the Global Economic Order*, Peterson Institute for International Economics Policy Brief PB12-25 (December 2012), at 6.

Second, massive domestic investment, rapid urbanization and production for domestic and foreign consumption have given rise to an unprecedented demand for resources such as oil, iron ore, copper and aluminum.²⁰ Presently, China is consuming more than 25% of the world's total annual production of minerals. Over the past two decades, China has moved from being the largest oil exporter in East Asia to becoming the world's second largest importer of oil. It is also forecasted that China's dependence on foreign oil and gas will rise from 51.2% and 5.8% in 2008 to 60% and 30% in 2015, and continue to be up to 70% and 50% in 2030.²¹ This huge demand cannot be met by China's limited domestic deposits of most resources and China faces severe shortage in key raw materials.²² China therefore must build trade linkages with Australia, Canada, Russia, Brazil and other resource-rich countries to secure long-term supplies. Against this background, it is unsurprising that energy exploitation and development have consistently been the prime locus of China's OFDI, accounting for 70% of the total value from 2005–2013.²³

Third, in a competitive global market where the gains from increasing the scale of production have played out, external consumer demand growth is flat, and lower-wage countries are increasing taking market share at the lower end, many Chinese enterprises are aware of the need to shift their strategy from one of competing on low cost and aggressive pricing to one of competing on innovation, brand image and services with higher profit margin.²⁴ By targeting distribution networks, retail, management, state-of-the-art technologies and foreign brands, Chinese firms can 'leapfrog' several stages of development, without incurring large expenses on R&D, international marketing campaigns and development of an overseas customer base.²⁵

Fourth, Chinese firms face fierce competition in domestic markets. In the face of saturated domestic market and falling profit margins, Chinese enterprises have been

²⁰ Daniel H. Rosen and Trevor Houser, *China Energy: A Guide for the Perplexed*, China Balance Sheet Project Paper, 6–14 (May 2007).

²¹ Wensheng Cao and Christoph Bluth, *Challenges and Countermeasures of China's Energy Security*, 53 *Energy Policy* 381, 384 (2013).

²² *Ibid.*

²³ Zhang Yuzhe, *China's OFDI Hits New Record*, <http://finance.caixin.com/2013-10-16/100592439.html>.

²⁴ OECD, *supra* n. 14, at 98.

²⁵ Salidjanova, *supra* n. 2, at 8.

forced to turn to overseas markets and establish production bases outside China.²⁶ In addition, OFDI has the benefit of helping Chinese enterprises circumvent international trade barriers erected by foreign countries. The successful expansion of Chinese exports has been causing protectionist reaction in many countries. Statistics show that China has been the world's biggest victim of anti-dumping investigations since 1995 and also the most targeted in anti-subsidy investigations since 2006.²⁷ In addition, the mushrooming of bilateral and regional trade agreements may have trade-diversion effects on China's otherwise competitive exports.²⁸ Therefore, OFDI at appropriate locations can help Chinese companies to secure stable and preferential market access to the targeted markets.

2.2 GOVERNMENT SUPPORT FOR OFDI IN CHINA

Soon after the launch of the 'Go Global' strategy in 2000, the Chinese government has begun a gradual liberalization of the OFDI regulatory regime. The process comprised multiple prongs, including decentralization of investment verification and approval at the provincial level, relaxation of foreign exchange controls, and stimulus packages to ease the transition of Chinese companies onto the world stage.²⁹

To begin with, the Chinese government has continuously reduced the number of stages enterprises have to go through for examination and approval of outward investment projects. Prior to July 2004, all international investments larger than US Dollars (USD) 1 million required approval from both the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM). The authorities would examine detailed information on the commercial value, the financing arrangements, and even the technical aspects of each proposed transaction.³⁰ In July 2004, the State Council decentralized the approval authority of OFDI projects to the provincial level with both

²⁶ John Wong and Sarah Chan, *China's outbound Direct Investment: Expanding Worldwide*, 1 (2) China: An Intl. J. 273, 284 (2003).

²⁷ Li Jiabao, *Trade Cases against China on the Rise*, China Daily (18 Dec. 2012).

²⁸ Peter Van den Bossche & Werner Zdouc, *The Law and Policy of the World Trade Organization* 651 (3rd ed., Cambridge U. Press 2013).

²⁹ Cristelle Maurin and Pichamon Yeophantong, *Going Global Responsibly? China's Strategies towards 'Sustainable' Overseas Investments*, 86 Pacific Affairs 281, 283 (2013).

³⁰ OECD, *supra* n. 14, at 88.

the NDRC and the MOFCOM.³¹ The projects in the natural resources category with a total investment of less than USD 30 million and projects in other categories less than USD 10 million are now approved by the Development and Reform Commission at provincial level.³² The projects with a total investment of more than USD 10 million but less than USD 100 million are approved by the provincial-level MOFCOM.³³ The application procedures and materials required were also simplified and time taken for authorization shortened.³⁴ In a new round of reforms, the NDRC proposed that the threshold for the central-level NDRC examination and approval of OFDI projects in the natural resources category be raised from USD 30 million to USD 300 million, while the threshold for other categories of OFDI projects be raised from USD 10 million to USD 100 million.³⁵ It is also reported that relevant government authorities are actively studying proposals to further simplify the OFDI regulatory system in the near future.³⁶

In parallel, the Chinese government has gradually liberalized the restrictions on the use of foreign exchanges for OFDI purposes.³⁷ The authority of scrutinizing the legitimacy of foreign exchange use for OFDI projects up to a certain size has been decentralized to the local-level branches of State Administration of Foreign Exchange (SAFE). The long-imposed quota of USD 5 billion per annum on foreign exchange allocation for OFDI was eliminated in 2006. Compulsory repatriation of overseas profits back to China and the deposit required to guarantee remittance of overseas profits have been abolished.³⁸ In 2009, the SAFE removed the requirement for an early-stage review and companies now

³¹ The State Council, *Decision of the State Council on Reforming the Investment System* (16 Jul. 2004).

³² NDRC, *Interim Measures for the Administration of Examination and Approval of the Overseas Investment Project* (19 Oct. 2004).

³³ MOFCOM, *Measures for Overseas Investment Management* (4 Mar. 2009).

³⁴ Huang Wenbi and Andreas Wilkes, *Analysis of Chinese Overseas Investment Policies*, Centre of International Forestry Research Working Paper 79 (2011), at 11.

³⁵ NDRC, *Measures for the Administration of Examination and Approval of the Overseas Investment Project* (Comments-seeking version, 16 Aug. 2012).

³⁶ Liu Yuxing, *The Examination and Approval of Enterprises' OFDI will be Drastically Reduced*, <http://finance.sina.com.cn/china/20130417/173015180837.shtml>.

³⁷ Wei Shen, *Is SAFE Safe now? – Foreign Exchange Regulatory Control over Chinese Outbound and Inbound Investments and a Political Economy Analysis of Policies*, 11 (2) *J. World Inv. & Trade* 227, 235 (2010).

³⁸ OECD, *supra* n. 14, at 84.

only need to lodge a record with the SAFE when making transfers of foreign exchanges.³⁹ All these policies have helped boost Chinese companies' OFDI flows.

The Chinese government has also offered a range of financial and non-financial incentives to support the overseas expansion of Chinese enterprises. The financial support takes a number of different forms, including access to loans below market rates, government special funds, direct capital contribution and subsidies associated with the official aid programs.⁴⁰ For example, to encourage and support Chinese companies engaging in overseas resources investment and economic and technical cooperation, the Ministry of Finance (MOF) and the MOFCOM allocated special funds to reimburse Chinese companies' pre-investment costs in 2004. Eligible projects included oil resources and metal resources. In 2005, a supplementary circular expanded the scope of eligible projects and simplified the funding application procedures.⁴¹ In 2011, the MOF and the MOFCOM continued to allocate special funds to support certain OFDI projects.⁴²

Other than funds from government ministries, two policy banks, the China Development Bank (CDB) and the China Export and Import Bank (Exim Bank) are major providers of financial incentives.⁴³ For example, the NDRC and the Exim Bank jointly announced in 2004 that the Exim Bank would earmark a portion of its budget for OFDI projects supported by the Chinese government with at least a 2% interest rate discount and possibly other preferential lending terms. The MOF will cover the gap between the actual market rate and the subsidized rate offered by the Exim Bank.⁴⁴ In 2009, the CDB supported the Chinese telecommunication companies Huawei and ZTE to open up to the overseas market. Huawei received USD 30 billion to reduce its cost of capital and offer financing to its buyers. ZTE Corporation received a USD 15 billion

³⁹ SAFE, *Regulations on Foreign Exchange Administration of Overseas Direct Investments by Domestic Companies* (13 Jul. 2009).

⁴⁰ OECD, *supra* n. 14, at 90.

⁴¹ Huang & Wilkes, *supra* n. 34, at 12.

⁴² MOF and MOFCOM, *Notice of Application of the 2011 Special Funds of Foreign Economic and Technology Cooperation* (April 2011).

⁴³ See generally Erica Downs, *China's Superbank: Debt, Oil and Influence, How China Development Bank Is Re-writing the Rules of Global Finance* (John Wiley & Sons, 2013).

⁴⁴ NDRC and Exim Bank, *Circular on the Supportive Credit Policy on Key Overseas Investment Project Encouraged by the State* (October 2004).

credit line from the CDB and USD 10 billion from the Exim Bank.⁴⁵ Not only the policy banks, but also major state-owned commercial banks have been active in extending loans to OFDI projects in response to the Chinese government's 'Go Global' policy. For example, in its bid for Unocal, CNOOC borrowed USD 6 billion from the Industrial and Commercial Bank of China, a Chinese state-owned commercial bank. Another USD 7 billion came in the form of subsidized loans from CNOOC's government-owned parent company. For the USD 7 billion loan, USD 2.5 billion was interest-free for two years with the potential to remain that way for up to thirty years; interest on the remaining USD 4.5 billion could be waived by the parent company in the event that CNOOC's credit rating dropped below investment grade.⁴⁶

Non-financial support includes information services such as investing country guidance. For example, the MOFCOM provides information on sectors that are encouraged by recipient countries, on common problems encountered in overseas investment and on investment-related laws, taxation policies and market conditions of recipient countries.⁴⁷ The Chinese government points out that its regulation of overseas investment is not intended to control the scope and direction of these investment, but to strengthen macroeconomic guidance. The key policy of 'government guidance, enterprise decision-making' is necessary because Chinese enterprises have only been taking part in international competition for a short time and lack experience.⁴⁸ Increasingly, the emphasis in OFDI policies is on risk reduction rather than various forms of encouragement and targeting, while avoiding excessive interventionism.⁴⁹

2.3 CONCERNS ABOUT CHINESE SOES' GLOBAL EXPANSION

⁴⁵ Alessandro Provaggi, *China Development Bank's Financing Mechanisms: Focus on Foreign Investment*, Stanford Global Projects Centre (May 2013), at 3.

⁴⁶ Gary Hufbauer et al., *Investment Subsidies for Cross-border M&A: Trends and Policy Implications*, United States Council Foundation Occasional Paper No. 2 (April 2008), at 2; Thomas P. Holt, *CNOOC-UNOCAL and the WTO: Discriminatory Rules in the China Accession Protocol is a Latent Threat to the Rule of Law in Dispute Settlement Understanding*, 15 Pac. Rim L. & Policy J. 457, 458 (2006).

⁴⁷ For example, MOFCOM and Ministry of Foreign Affairs, *Circular of Distributing Industrial Guidance Catalogue of Investment to Foreign Countries* (August 2004).

⁴⁸ Jiang Guocheng, *Privately-Owned Enterprises 'Going Global' Possess Unique Competitive Advantages and Significant Implications*, http://www.gov.cn/zwhd/2012-08/08/content_2200600.htm.

⁴⁹ Ken Davis, *China Investment Policy: An Update*, OECD working paper on International Investment (2013/01), at 39.

The meteoric rise of OFDI by Chinese SOEs presents to host countries a vexing policy dilemma. On one hand, the influx of foreign capital would bring much-needed new capital and job growth that would have positive economic and political ramifications to host countries. On the other hand, foreign SOEs' investment can raise some genuine concerns.⁵⁰ The first key argument against Chinese SOEs is that they could choose to make investment and corporate decisions on political and strategic rather than commercial and market considerations.⁵¹ Chinese SOEs may effectively serve as 'Trojan horses', through which the Chinese government may acquire increasing power and influence abroad, and potentially engage in other actions such as obtaining access to sensitive information or technology and even commercial and state espionage. This will jeopardize the national security, energy security and economic security of a host country.⁵² One example frequently cited to illustrate this type of risk was the Russian energy giant Gazprom's decision to cut off gas supplies to Ukraine in early 2006. The episode was characterized as driven by the Kremlin's desire to demonstrate its dissatisfaction with policies emanating from Kiev.⁵³

Second, in most instances, SOEs enjoy government-created subsidies, privileges and immunities that are not available to their privately owned competitors.⁵⁴ These privileges give SOEs a competitive advantage over their rivals.⁵⁵ This raises concerns that SOEs may cause market distortions in host countries because such subsidies may facilitate the allocation of scarce resources to inefficient or less efficient producers, and SOEs can afford to operate and survive regardless of the economic conditions or their market

⁵⁰ OECD, *Foreign Government- Controlled Investors and Recipient Country Investment Policies: A Scoping Paper* (2009), at 7.

⁵¹ Elizabeth J Drake, *Chinese State-owned and State-controlled Enterprises: Policy Options for Addressing Chinese State-owned Enterprises*, Testimony before the US-China Economic and Security Review Commission (15 Feb. 2012); See also Christopher Cox, *The Role of Government in Markets*, Keynote Address and Robert R. Glauber Lecture at the John F. Kennedy School of Government, Harvard University (24 Oct. 2007).

⁵² David N. Fagan, *The U.S. Regulatory and Institutional Framework for FDI*, Investing in the United States: A Reference Series for Chinese Investors (Vol. 2, 2008), at 20; Andreas Lunding, *Global Champion in Waiting: Perspectives on China's Overseas Direct Investment*, Deutsche Bank Research Paper (August 2006), at 5.

⁵³ Alan P. Larson & David M. Marchick, *National Security and Foreign Investment: Getting the Balance Right*, Council of Foreign Relations No. 18 (July 2006), at 21.

⁵⁴ Andrew Szamosszegi & Cole Kyle, *An Analysis of State-owned Enterprises and State Capitalism in China*, Report to U.S.-China Economic and Security Review Commission (2011), at 58.

⁵⁵ OECD, *Competitive Neutrality in the Presence of State Owned Enterprises*, DAF/CA/PRIV(2010)1 (2 Apr. 2010), at 6.

behavior. The playing field between SOEs and privately owned enterprises in both the domestic market and global market is tilted in favour of the former.⁵⁶ Indeed, much of the public criticism of Chinese SOEs' takeover bids has focused on the perception that the bids were facilitated by the subsidized financing from the Chinese government.⁵⁷

Third, Chinese SOEs' OFDI spree has caused reciprocity concerns. Senator Charles Schumer of New York for instance demanded that when any SOE sought to acquire an American company, an additional study be performed on trade reciprocity.⁵⁸ China currently runs a far more restrictive FDI regime than many other countries.⁵⁹ Foreign companies are likely to face limits to access in China when such access potentially harms financial interests of Chinese SOEs or contradicts the interests of the Chinese government.⁶⁰ If the Chinese government would not approve similar investment projects made by foreign investors in China, critics argue that such projects launched by Chinese investors should not be approved by host countries.

Fourth, there are also concerns relating to China's OFDI in economically disadvantaged regions such as Africa and Latin America. The economic, social, and environmental framework within which Chinese companies operate is different from – and inferior to – the best-practice standards that the major established Western companies typically maintain. As a consequence, there is a risk that individual host countries in the developing world may be exposed to 'Resource Curse' practices of illicit payments, graft, and corruption, plus poor worker treatment and lax environmental standards.⁶¹

Finally, a deeper cause of concern is the inherent suspicion in some Western countries that foreign state capital is a threat to the free market at home. This is especially the case for countries where recently privatized corporate entities face competition or the prospect

⁵⁶ Price, *supra* n. 9, at 12.

⁵⁷ Fagan, *supra* n. 52, at 19.

⁵⁸ John Bussey, *Playing Hardball with Chinese Investors*, Wall St. J. (25 Oct. 2012).

⁵⁹ OECD 2012 FDI Regulatory Restrictiveness Index, http://www.oecd.org/daf/inv/ColumnChart-FDI_RR_Index_2012.pdf.

⁶⁰ Szamoszegi & Kyle, *supra* n. 54, at 84.

⁶¹ Barbara Kotschwar et al., *Chinese Investment in Latin America Resources: The Good, the Bad and the Ugly*, Peterson Institute for International Economics Working Paper 12-3 (February 2012), at 2. Namukale Chintu and Peter J. Williamson, *Chinese State-owned Enterprises in Africa: Myths and Realities*, Global Business (April 2013).

of takeover by foreign SOE rivals. Where doubts linger about the commercial and financial autonomy of the foreign SOEs this situation has repeatedly led to concerns about ‘renationalization’ of national champions through a foreign government.⁶² In a statement that made clear the Canadian government’s antipathy towards SOEs, Prime Minister Stephen Harper stated in 2012:

All investments are not equal... purchases of Canadian assets by foreign governments through state-owned enterprises are not the same as other transactions...To be blunt, Canadians have not spent years reducing the ownership of sectors of the economy by our own governments, only to see them bought and controlled by foreign governments instead.⁶³

According to a 2008 survey in Australia, more Australians are opposed to foreign ownership of major Australian companies than the death penalty, the Iraq war, or even ‘illegal immigration’. Importantly, 85% of respondents felt that companies controlled by foreign governments should be more strictly regulated than foreign private investors, with the most opposition (78%) directed at companies controlled by China.⁶⁴ These concerns could fuel sentiment of economic nationalism and draw states into a downward spiral of protectionism. Such a scenario would have disastrous consequences for the global economy.

3 REGULATORY RESPONSES

The principle of sovereignty in international law gives states ample leeway to prevent foreign investors from taking over domestic companies. This freedom may be restricted by bilateral investment treaties (BITs). However, an overview of the BITs shows that these treaties largely focus on the question of the extent to which cross-border investments are protected once they have been made, for example, against arbitrary expropriation.⁶⁵ Even though some recent BITs extend the principles of national treatment and most favoured nation treatment to the pre-entry phase of the investment, countries undertaking such commitments regularly include reservations and exemptions

⁶² OECD, *SOEs Operating Abroad: An Application of the OECD Guidelines on Corporate Governance of State-Owned Enterprises to the Cross-border Operations of SOEs*, 4–5 (2010).

⁶³ State by the Prime Minister of Canada on Foreign Investment (7 Dec. 2012), <http://www.pm.gc.ca/eng/media.asp?category=3&featureId=6&pageId=49&id=5195>.

⁶⁴ Megan Bowman, *Australian Foreign Investment Policy: Fertile Soil or Shifting Ground?*, <http://www.clmr.unsw.edu.au/article/compliance/mergers-%26-acquisitions/australian-foreign-investment-policy-fertile-soil-or-shifting-ground>.

⁶⁵ Andreas Heinemann, *Government Control of Cross-Border M&A: Legitimate Regulation or Protectionism*, 15(3) *J. Int’l. Econ. L.* 843, 855 (2012).

with respect to certain sectors.⁶⁶ In addition, exceptions for the protection of national security are often added and they are exempted from the dispute settlement process provided in the treaty.⁶⁷ As a result, host countries keep control over the admission of foreign investment, including the power to protect strategic sectors and pursue industrial policy.⁶⁸

Various concerns about Chinese SOEs' OFDI sparked heated policy debate in host countries. In response, several countries have recently clarified or strengthened their investment policies regarding investment from foreign SOEs.

3.1 US

Unlike some countries that apply an economic interest test when reviewing foreign investment such as Canada and Australia, the regulatory focus of the US foreign investment law is on the potential impact of the proposed foreign investment on national security. In the US, the Exon-Florio Amendment of the Omnibus Trade and Competitiveness Act of 1988 (Exon-Florio) represented the first time that the US possessed a system devoted to the vetting of foreign investment when it affects national security.⁶⁹ The passage of the Foreign Investment and National Security Act of 2007 (FINASA) further overhauled the Exon-Florio process.⁷⁰ The authority to administer FINASA rests with the Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee including the Secretaries of State, the Treasury, Homeland Security, Commerce, Defense, Energy, Labour and others. As a result of a CFIUS review, the President could suspend or prohibit any acquisition if he has credible evidence showing that the transaction threatens to impair national security.⁷¹

⁶⁶ For example, Art. 3 of the US Model Bilateral Investment Treaty.

⁶⁷ UNCTAD, *Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking*, 142 (New York and Geneva 2007); See also UNCTAD, *supra* n. 4, at 87.

⁶⁸ Heinemann, *supra* n. 65, at 853.

⁶⁹ Section 721 Defense Production Act of 1950, as amended by section 5021 of the United States Omnibus Trade and Competitiveness Act of 1988. Jose E. Alvarez, *Political Protectionism and United States International Investment Obligation in Conflict: The Hazards of Exon-Florio*, 30 Va. J. Int'l. L. 1 (1989); Joseph Mamounas, *Controlling Foreign Ownership of U.S. Strategic Assets: The Challenge of Maintaining National Security in a Globalized and Oil Independent World*, 13 L. & Bus. Rev. Am. 381, 388 (2007).

⁷⁰ Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49 (26 Jul. 2007).

⁷¹ *Ibid.*, s. 6.

FINASA requires CFIUS to review all ‘covered’ foreign investment transactions to determine whether a transaction threatens to impair the national security, or the foreign entity is controlled by a foreign government, or it would result in control of any ‘critical infrastructure’ that could impair the national security.⁷² A ‘covered’ foreign investment transaction is defined as any merger, acquisition or takeover ‘which could result in foreign *control* of any person engaged in interstate commerce in the United States’.⁷³ According to the US Treasury Department, ‘control’ means the power to determine, direct, take, reach or cause decisions regarding important matters affecting an entity, no matter whether or not exercised and how it is exercised. By contrast, investments undertaken solely for the purpose of investment, i.e. investments in which the foreign investor has no intention of directing the basic business decision of the issuing company, such as an investment of no more than 10% of the voting securities of the firm, are not reviewable transactions.⁷⁴

The CFIUS review consists of three distinct parts: a voluntary notification to CFIUS and a thirty-day review; a forty-five-day investigation period for those transactions that raise national security concerns during the thirty-day review; and a fifteen-day presidential determination stage.⁷⁵ Though voluntary, foreign firms saw it as in their best interest to submit to the CFIUS review early. This is because FINSA has no statute of limitations, meaning that reviews and investigations could be conducted on deals concluded long ago where no approval had been obtained.⁷⁶ Unlike comparable review processes in Japan and France, a CFIUS decision is not subject to judicial review.⁷⁷

The exact meaning of ‘national security’ was not clearly defined. It was purposefully left ambiguous, in theory giving the President flexibility to deal with future and as yet

⁷² *Ibid.*, s. (2) (b) (2) (B).

⁷³ *Ibid.*, s. (2) (a) (3).

⁷⁴ See Department of the Treasury, *Regulations Pertaining to Mergers, Acquisitions and Takeovers by Foreign Persons*, RIN 1505-AB88 (18 Nov. 2008).

⁷⁵ James K. Jackson, *The Committee on Foreign Investment in the United States (CFIUS)*, Congressional Research Service 7-5700, 11–12 (16 Sep. 2012).

⁷⁶ See Edward M. Graham & David M. Marchick, *U.S. National Security and Foreign Direct Investment* (Peterson Institute for International Economics, 2006), at 37.

⁷⁷ Jonathan Masters, *Foreign Investment and U.S. National Security*, Council on Foreign Relations Renewing America (27 Sep. 2013), <http://www.cfr.org/foreign-direct-investment/foreign-investment-us-national-security/p31477>.

unforeseen threats.⁷⁸ Previously CFIUS was directed to focus its review on the potential impact of foreign investment on the US national defense security and only five factors need to be considered. Now FINASA includes a list of twelve factors that CFIUS must consider. The additional factors include the potential effects on ‘critical infrastructure’ and ‘critical technologies’ and ‘the long-term projection of the US requirements for sources of energy and other critical resources and materials’.⁷⁹ FINSA also vests in CFIUS the power to negotiate, enter into, impose, and enforce any agreement or condition with any party to the covered transaction in order to mitigate any resulting threat to the US national security.⁸⁰

At first, Exon-Florio was silent on appropriate actions that CFIUS may take with regard to investment made by state-controlled entities. This weakness was arguably revealed in the CATIC-MAMCO transaction in 1989. In November 1989, the state-owned Chinese National Aero-Technology Import and Export Corporation (CATIC) acquired the American Corporation MAMCO, a producer of metal parts for civilian aircraft, for USD 5 million. After determining that MAMCO was in possession of technology that was subject to export controls, President George H. W. Bush ordered CATIC to divest itself of its new American subsidiary.⁸¹ Though a seemingly simple exercise of presidential authority, the MAMCO episode was marked by confusion and an ad hoc approach to the definition of national security. It was unclear what threat, if any, CATIC’s control of MAMCO actually posed to American national security. Most arguments against the deal boiled down to the fact that CATIC was essentially an arm of the Chinese government.⁸²

The Congress amended Exon-Florio and enacted the Byrd Amendment in 1993. The Byrd Amendment imposed a mandatory forty-five-day investigation for transactions involving foreign government-controlled firms which ‘could affect’ national security, arguably establishing a broader standard than the previous one, which encompassed only

⁷⁸ Deborah M. Mostaghel, *Dubai Ports World under Exon-Florio: A Threat to National Security or a Tempest in a Seaport?*, 70 Albany L. Rev. 583, 592–593 (2007).

⁷⁹ FINASA, s. 4.

⁸⁰ *Ibid.*, s. 5.

⁸¹ Jim Mendenhall, *United States: Executive Authority to Divest Acquisitions under the Exon-Florio Amendment- The MAMCO Divestiture*, 32 Harv. Int’l L. J. 286, 290 (1991).

⁸² Mostaghel, *supra* n. 78, at 600.

transactions that ‘threaten to impair’ national security.⁸³ Unlike the Byrd Amendment, which still allowed some leeway in its mandatory investigation, FINSA now expands on the Byrd Amendment’s mandate and requires CFIUS to investigate *all* foreign investment deals where the overseas entity is owned or controlled by a foreign government.⁸⁴ Some argued that this change shifted the burden of proof from CFIUS to foreign firms to show that they do not present a national security threat.⁸⁵

Since its creation, Exon-Florio has been criticized as a potential tool of economic protectionism.⁸⁶ The vague standards and lack of transparency rendered the review process easily abused to discriminate against foreign investors.⁸⁷ In recent years, the politicization of the Exon-Florio review has emerged as an even greater threat to foreign investors in the US.⁸⁸ Factors external to both the transaction and national security were frequently taken into consideration when making final decisions. Consequently, rather than addressing national security concerns, unrestricted political interference based on political gamesmanship and economic protectionism result in a chilling effect on potential foreign investment to the US.⁸⁹ The alleged victims of the politically charged national security review process are Chinese SOEs and even Chinese private enterprises which are suspected to have close connections with the Chinese government.⁹⁰

The failed attempt to acquire Unocal by CNOOC in 2005 was a case in point. As one of the three majority state-owned petroleum companies in China, CNOOC made an unsolicited all-cash offer of USD 18.5 billion to Unocal, an oil company based in California, through a Hong Kong subsidiary CNOOC Ltd. CNOOC Ltd provided a number of highly attractive terms in its bid, including a willingness to divest certain parts

⁸³ *Ibid.*, at 601.

⁸⁴ FINASA, section 2 (b) (2) (B) (i) (II).

⁸⁵ Master, *supra* n. 77.

⁸⁶ Thomas W. Soseman, *The Exon-Florio Amendment to the 1988 Trade Bill: A Guardian of National Security or a Protectionist Weapon?*, 15 J. Corp. L. 597, 611 (1990).

⁸⁷ Stanley Lubman, *China’s State Capitalism: The Real World Implications*, Wall St. J., (1 Mar. 2012); Paul Rose, *Sovereigns as Shareholders*, 87 N. C. L. Rev. 83, 117 (2008); Henry J. Graham, *Foreign Investment Laws of China and the United States: A Comparative Study*, 5 J. Transnat’l L. & Pol’ Y 253, 257–258 (1996).

⁸⁸ Rose, *supra* n. 87, at 130. See Graham & Marchick, *supra* n. 76, at 123.

⁸⁹ Yiheng Feng, *We Wouldn’t Transfer Title to the Devil: Consequences of the Congressional Politicization of Foreign Direct Investment on National Security Grounds*, 42 N.Y.U. J. Int’l L. & Pol. 253, 255 (2009).

⁹⁰ Fagan, *supra* n. 52, at 18–21.

of Unocal if necessary as well as a willingness to retain substantially all existing Unocal personnel.⁹¹ This latter concession stood in stark contrast to another bidder, Chevron, who offered USD 16.5 billion mixed cash and stock and announced plans to exact hundreds of millions of dollars of cost savings, likely by implementing layoffs.⁹² However, reaction to CNOOC's bid on the floor of Congress was intense. Displeased at the thought of a Chinese-owned American oil subsidiary, the House first called for a thorough presidential review of the transaction, then cut off funding to CFIUS prohibiting the use of treasury funds to approve any deal between CNOOC and Unocal, and finally made it practically impossible for CNOOC to present its offer to Unocal shareholders before their vote in time.⁹³ CNOOC finally abandoned the acquisition.

Viewing the facts, it could be strongly argued that the congressional reaction was severely out of proportion when compared to the actual importance of Unocal for American energy needs. By 2005, Unocal was no longer a major player in the energy industry. In 2004, the year before the transaction, Unocal produced only about 1% of the US natural gas consumption.⁹⁴ It possessed no refineries in the US and its most valuable assets were located primarily overseas, which was the primary reason why CNOOC found it so attractive in the first place. To assuage the national security concerns, CNOOC had announced its willingness to divest itself of Unocal's American holdings.⁹⁵ In light of these facts, the congressional description of the CNOOC-Unocal deal as a threat to 'vital US energy assets' was a mischaracterization at best and pure hyperbole at worst.⁹⁶ Starting from CNOOC's unsuccessful bid in 2005, a series of attempted acquisitions by Chinese investors in US failed to pass muster the national security review.⁹⁷ Most recently, President Obama ordered the China-based Ralls Corp to divest four Oregon wind farms it had previously acquired from Innovative Renewable Energy

⁹¹ CNOOC Ltd. Press Release, *CNOOC Limited Proposes Merger with Unocal Offering USD 67 Per Unocal Share in Cash* (23 Jun. 2005), <http://www.cnooltd.com/encnooltd/newszx/news/2005/957.shtml>.

⁹² Holt, *supra* n. 46, at 474.

⁹³ Feng, *supra* n. 89, at 276.

⁹⁴ Dick K. Nanto et al., *China and the CNOOC Bid for Unocal: Issues for Congress*, CRS Report for Congress (2005), at 9.

⁹⁵ CNOOC Ltd. Press Release, *CNOOC Limited Proposes Merger with Unocal Offering USD \$67 Per Unocal Share in Cash* (23 Jun. 2005).

⁹⁶ Joshua W. Casselman, *China's Latest 'Threat' to the United States: The Failed CNOOC-Unocal Merger and its Implications for Exxon-Florio and CFIUS*, 17 *Ind. Int'l & Comp. L. Rev.* 155 (2007).

⁹⁷ Snell & Wilmer LLP, *supra* n. 12.

LLC on September 2012. Ralls Corp sued the US government, including President Obama, in the first legal challenge to a CFIUS decision. The US Court of Appeals ruled allowing Ralls to obtain evidence on why its bid for Oregon wind farms was rejected. However, the ruling did not have a major impact on the actual decision made by CFIUS because the court did not rule that CFIUS and Obama had no power to block the Ralls Corp deal.⁹⁸

Despite the impressive growth in recent years, Chinese investment in the US market remains small, especially by comparison to the strong equity investment flows from the rest of the world to the US. Nevertheless, the small slice of investment from China has attracted the most substantial reviews and objections from CFIUS.⁹⁹ As a result, Chinese firms now frequently cite regulatory and political obstacles against Chinese investment to explain their cautious approach to investing in the US.¹⁰⁰

3.2 CANADA

In Canada, any investment by a non-Canadian investor resulting in the *acquisition of control* of a Canadian business must first receive approval of the federal Minister of Industry under the *Investment Canada Act* (ICA) if the aggregate book value of the assets of the Canadian business to be acquired exceeds Canadian Dollars (CAD) 354 million (2014 threshold). An acquisition by a non-Canadian of 33.3% or more of the voting rights of a Canadian business is presumed to be an acquisition of control unless there is evidence to the contrary. By contrast, any acquisition of less than 33.3% is deemed not to be an acquisition of control.¹⁰¹

When a proposed acquisition of control exceeds the asset value threshold, the investor must file an application to the Minister of Industry (the Minister) for review. A

⁹⁸ Shannon Tiezzi, *Chinese Company Wins Court Case against Obama*, The Diplomat (17 July 2014), <http://thediplomat.com/2014/07/chinese-company-wins-court-case-against-obama/>

⁹⁹ David M. Marchick, *Fostering Greater Chinese Investment in the United States*, Council on Foreign Relations Policy Innovation Memorandum No. 13 (February 2012).

¹⁰⁰ David F. Gordon, *The Competitive Challenges Posed by China's State-owned Enterprises*, Testimony before the US-China Economic and Security Review Commission (15 Feb. 2012); Yu Qiao & Zhang Shuqing, *Research on External Environment of Chinese Overseas Investment in U.S.*, Brookings-Tsinghua Centre for Public Policy, Policy Report Series (May 2013), at 4.

¹⁰¹ Section 28(3) of the ICA.

reviewable transaction may not be completed until the Minister is satisfied that the investment is likely to be of ‘net benefit’ to Canada. In making such an assessment, the Minister will take into account six factors: (i) the effect of the investment on the level and nature of economic activity in Canada; (ii) the degree and significance of participation by Canadians in the Canadian business and in any industry or industries in Canada; (iii) the effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada; (iv) the effect of the investment on competition within any industry or industries in Canada; (v) the compatibility of the investment with national industrial, economic and cultural policies; and (vi) the contribution of the investment to Canada’s ability to compete in world markets.¹⁰²

In respect of acquisitions of Canadian businesses by foreign SOEs, the Canadian government issued SOE Guidelines in December 2007. The purpose of enacting the SOE Guidelines was to clarify the application of the ICA in response to considerable public concern over foreign SOEs’ acquisition of prominent Canadian businesses.¹⁰³ In December 2012 the Canadian government issued the updated SOE Guidelines. In June 2013, the Economic Action Plan 2013 Act introduced several amendments to the ICA, imposing further restrictions on foreign SOEs’ investment in Canada.¹⁰⁴ Under the new rules, the definition of an SOE is expanded to cover ‘an enterprise that is owned, controlled or *influenced*, directly or *indirectly* by a foreign government’. An individual acting under the direction or influence, directly or indirectly, of a government is also covered. Given that the term ‘indirect influence’ is not defined, the Canadian government would have greater discretion to label a foreign investor as an SOE. Arguably, such a broad definition even covers some Chinese privately owned enterprises if they keep too close connections with the Chinese government.

Not only is the definition of SOE expanded, the revised ICA appears to give the Canadian government power to review some SOE-involved transactions that previously fell out of its ambit. Under the new rules, the Minister may declare that a proposed acquisition by a foreign SOE is an acquisition in control *in fact*, even where the 33.3%

¹⁰² Section 20 of the ICA.

¹⁰³ Industry Canada, *supra* n. 10.

¹⁰⁴ Elliott, *supra* n. 10.

threshold is not met, if the Minister is satisfied that the entity is under the control of one or more of SOEs after considering ‘any information and evidence’.¹⁰⁵ Furthermore, under proposed amendments, the review threshold is to progressively increase to CAD\$1 billion. However, the review threshold for SOE investments will be amended such that the existing CAD 354M threshold will remain in place.¹⁰⁶ .

When making the ‘net benefit’ assessment involving a foreign SOE acquirer, the Minister must be satisfied with the proposed investment’s: (i) commercial orientation; (ii) freedom from political influence; (iii) adherence to Canadian laws, standards and practices that promote sound corporate governance and transparency including, for example, independent members of the board, independent audit committees, and equitable treatment of shareholders; (iv) commitment to Canadian laws and practices and (v) positive contributions to the productivity and industrial efficiency of the Canadian business.¹⁰⁸ Pursuant to the SOE Guidelines, the Minister will examine how and the extent to which the non-Canadian is owned and controlled by the foreign government. Foreign SOEs are required to identify their controller, including any direct or indirect state ownership or control, and address the inherent characteristics of SOEs, specifically that they are susceptible to state influence. The burden of proof is on foreign SOEs to demonstrate to the satisfaction of the Minister that proposed investments are likely to be of ‘net benefit’ to Canada.¹⁰⁹

The acquiring SOEs are encouraged to submit specific undertakings relating to certain aspects of the business, including the appointment of Canadians as independent directors; the employment of Canadians in senior management positions; the incorporation of business in Canada; and the listing of shares of the acquiring company or the Canadian business being acquired on a Canadian stock exchange.¹¹⁰ These undertakings have been actively enforced by the Canadian government.¹¹¹ The recent transactions showed that

¹⁰⁵ Section 28(6) of the ICA.

¹⁰⁶ Oliver J. Borgers and Michele Siu, *Is net Benefit to Canada Different for State-owned Enterprises Investments* (31 July 2014), <http://www.canadianenergylawblog.com/2014/07/31/is-net-benefit-to-canada-different-for-state-owned-enterprise-investments/>

¹⁰⁸ Industry Canada, *supra* n. 10.

¹⁰⁹ *Ibid.*

¹¹⁰ *Ibid.*

¹¹¹ *United States Steel Corporation v. Canada* (Attorney General), 2011 FCA 176, affirming 2010 FC 642

foreign SOEs have made commitments mirroring the examples in the SOE Guidelines.¹¹² Under the ICA, undertakings are monitored and usually have duration of three to five years. However, in the case of an investment by an SOE, undertaking relating to corporate governance and commercial orientation will survive for as long as the SOE controls the Canadian business.¹¹³

Except the ‘net benefit’ assessment, the ICA also has a national security review procedure. In September 2009, the ICA was amended, authorizing that if the Minister has reasonable grounds to believe that an investment by a non-Canadian could be injurious to national security, the federal Governor in Council has power to review and prohibit such investment, regardless of its size. The term ‘national security’ is not defined in the Act or the regulations thereunder and there has been no formal guidance issued in relation to what constitutes an investment that could be injurious to national security. However, the Canadian government does not presume that an investment by an SOE, even in the natural resources sectors, will necessarily give rise to national security issues and a number of recent acquisitions involving SOEs have not involved national security reviews.¹¹⁴

After a flurry of amendments of laws and guidelines, SOEs will likely face a substantially changed foreign investment review regime in Canada. The Prime Minister announced in 2012 that no more takeovers of oil sands operations by foreign SOEs would be approved unless on an exceptional basis. The enhanced discretion to review and block investment by SOEs introduced in recent amendments signaled the Canadian government’s general antipathy to public sector involvement in the private sector.¹¹⁵

(leave to appeal to the SCC denied).

¹¹² For example, CNOOC’s acquisition of Nexen in 2012. CNOOC Ltd. Press Release, *CNOOC Limited Receives Industry Canada Approval on Its Proposed Acquisition of Nexen Inc* (8 Dec. 2012).

¹¹³ Brian A. Facey and Joshua A. Krane, *Investing in Canada: Strategic Considerations for State-owned Enterprises during a Fragile Economic Recovery* (June 2012), http://www.blakesfiles.com/pdf/JOK/Investing_in_Canada_Strategic_Considerations_for_State_Owned_Enterprises_during_a_Fragile_Economic_Recovery.pdf.

¹¹⁴ Omar Wakil & Phil Mohtadi, *Recent Developments in National Security Reviews of Foreign Investments in Canada*, 4 ABA International Antitrust Bulletin (2009), at 10.

¹¹⁵ Paul Booth, *State-Owned Enterprises and Foreign Investment in Canada*, <http://iveybusinessjournal.com/topics/global-business/state-owned-enterprises-and-foreign-investment-in-canada>.

3.3 AUSTRALIA

In Australia, the regulatory framework under which foreign companies can invest in Australian businesses comprises the *Foreign Acquisitions and Takeovers Act 1975* (the Act), the *Foreign Acquisitions and Takeovers Regulations 1989*, and Australia's Foreign Investment Policy (the Policy). Under the current regime, the Foreign Investment Review Board (FIRB) reviews foreign investment proposals on a case-by-case basis and makes recommendations to the Australian Federal Treasurer. The Treasurer has ultimate responsibility for decision-making under Australia's foreign investment regime and has a broad discretion to decline or apply conditions to a proposed investment that he or she considers to be against the 'national interest'.¹¹⁶

The Policy stipulates that any 'direct investment' in Australia by a 'foreign government investor' is required to notify FIRB and FIRB will review the proposed investment. At the same time, both 'direct investment' and 'foreign government investor' are defined widely. Entities in which a foreign government has a direct or indirect aggregate interest of 15% or more are considered to be a 'foreign government investor'. 'Direct investment' is defined as any investment of an interest of 10% or more although it may be less than 10% where the acquiring foreign government investor is building a strategic stake in the target, or can use that investment to influence or control the target.¹¹⁷ Examples include the foreign government investor obtains preferential, special or veto voting rights, the ability to appoint directors and contractual rights. These broad definitions ensure that all major foreign investment involving Chinese SOEs need to be reviewed by FIRB.

Once a review is triggered, chief consideration is given by FIRB to whether the proposed investment will be contrary to the national interest. Despite the obvious importance of knowing what the national interest is in order to protect it, the phrase is not

¹¹⁶ George Gilligan & Megan Bowman, *What is the State of Play? The Effects of State Capital Investment in Australia and Regulatory Implications*, CIFR Working Paper No. 004/2013, at 17; Vivienne Bath, *Foreign Investment, the National Interest and National Security- Foreign Direct Investment in Australia and China*, 34 Sydney L. Rev. 5, 14 (2012).

¹¹⁷ Australia's Foreign Investment Policy 2013, at 14.
http://www.firb.gov.au/content/_downloads/AFIP_2013.pdf.

legislatively defined.¹¹⁸ In practice, proposals are reviewed on a case-by-case basis. The FIRB considers the impact of the proposed investment on Australia's national security interests, competition, impact on the economy and community, other government policies such as tax revenues and environmental impact and the character of the investor.¹¹⁹

When determining the impact of proposed investment by an SOE on the national interest, the proposal is assessed on the same basis as a private sector proposal. However, due to the special nature of SOEs, some additional factors will be considered. The key consideration is whether the investment is commercial in nature or whether the investor may be pursuing broader political or strategic objectives.¹²⁰ This includes assessing whether the acquiring SOE's corporate governance arrangement could facilitate actual or potential control by a foreign government. Proposed transactions that operate fully at arm's length and on commercial basis are less likely to raise national interest issues. Other mitigating factors include the existence of external partners in the investment, arrangements to protect Australian interests from non-commercial dealings and whether the target will be listed on the Australian securities exchange or other securities markets.¹²¹ The Treasurer does not necessarily block an investment that is not operating fully on commercial basis, but clearly retains full discretion to do so on the grounds of 'national interest'.

In May 2009, Aluminum Corp of China (Chinalco) announced a USD 19.5 billion investment for an 18% stake in Rio Tinto, the world's third-largest miner and owner of rich iron-ore and copper mines in Australia and elsewhere. One month later the Rio Tinto board withdrew its support amid public debate on the growing level of Chinese ownership of Australia's natural resources.¹²² In 2012, The Australian government banned the Australian unit of Huawei from tendering for the USD 38 billion National Broadband Network contracts.¹²³ The ban was upheld after a review in 2013.¹²⁴

¹¹⁸ Bowman, *supra* n. 64.

¹¹⁹ Australia's Foreign Investment Policy 2013, at 8.

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² Dana Cimilluca et al., *Rio Tinto Scuttles its Deal with Chinalco*, Wall St. J. (5 Jun. 2009).

¹²³ Gavin Lower and Andrew Critchlow, *Huawei Voices Dismay at Australian Network Exclusion*, Wall St. J. (26 Mar. 2012).

¹²⁴ Agence France-Presse, *Australia Maintains Ban on Huawei for Broadband Network*, South China

3.4 EUROPEAN UNION

Unlike the US which can fend off Chinese takeover bids on national security grounds, the EU has not established a similar security review regime.¹²⁵ Nevertheless, as the trend of Chinese companies acquiring European companies has accelerated in recent years, the European Commission has strengthened the monitoring of Chinese SOEs' acquisitions in Europe on grounds of competition policy.¹²⁶

The applicable law is the EU Merger Regulation (EUMR). Two conditions must be met before the EUMR is applicable to a particular transaction. First, the transaction can be qualified as a 'concentration', i.e. a number of previously separate undertakings come under the control of an undertaking or person on a lasting basis.¹²⁷ An 'undertaking' under the EUMR is broadly defined and covers any entity having an economic activity, regardless of its legal form and the way in which it is financed.¹²⁸ An SOE is therefore an 'undertaking' for the purpose of the EUMR. Second, the 'concentration' has a European Union dimension, i.e. meets the turnover thresholds set out in the EUMR.¹²⁹ These thresholds refer to the turnover achieved by the 'undertakings concerned', i.e. the undertakings participating in a concentration. In the event that the undertaking concerned belongs to a 'group', not only its turnover but also the turnover of the group must be taken into account for the purpose of assessing whether the turnover thresholds are met.

The EUMR does not explicitly define the concept of a 'group'.¹³⁰ Article 5(4) of the EUMR makes reference to a range of rights and powers held by or in an undertaking concerned that should be taken into account in turnover calculation. These include

Morning Post (30 Oct. 2013).

¹²⁵ While recognizing that EU Member States may take appropriate measures to protect certain 'legitimate interests' such as public security, plurality of the media and prudential rules, Member States have rarely been successful in blocking foreign acquisition on 'legitimate interests' grounds. Angela Huyue Zhang, *The Single-Entity Theory: An Antitrust Time Bomb for Chinese State-owned Enterprises?* 8 J. Comp. L. & Econ. 805, 807 (2012).

¹²⁶ The flows of foreign direct investment coming from China have increased from USD 2.9 billion in 2003 to USD 10 billion to 2011. See Thilo Hanemann & Daniel H. Rosen, *China Invests in Europe: Patterns, Impacts and Policy Implications*, Rhodium Group Report, 64-5 (June 2012).

¹²⁷ Article 3(1) of the EUMR.

¹²⁸ Case C-41/90, Hofner and Elserv Macrotron GmbH, 1991 ECR I-1979, at 21.

¹²⁹ Article 3(1) of the EUMR.

¹³⁰ Paragraph 130 of the Commission's Consolidated Jurisdictional Notice under Council Regulation No. 139/2004 on the Control of Concentrations between Undertakings (OJ 95/1 dated 16 Apr. 2008, the 'Jurisdictional Notice'.

owning more than half of the capital or business assets; the power to exercise more than half of the voting rights and to appoint more than half of the members of any boards/bodies legally representing the undertaking; or the right to manage the undertaking's affairs.¹³¹

Applying the concept of 'group' to an SOE is problematic because the relevant group would have comprised the state and each and every company in which the state exercises control.¹³² This would have led to an overly wide concept of 'group' and practically every concentration involving an SOE would have been caught under the EUMR. Precisely for this reason, Recital 22 of the EUMR creates an exception to the group determination involving SOEs. It states that, in order to respect the principle of non-discrimination between the public and private sectors, calculation of the turnover of undertakings concerned in a concentration needs to take account of *undertakings making up an economic unit with an independent power of decision*, irrespective of the way the capital is held or of the rules of administrative supervision applicable to them.

Therefore, for the purposes of calculating turnover involving SOEs, only those SOEs belonging to the same economic unit and having the same independent power of decision are to be considered. Paragraph 194 of the Jurisdictional Note reads:

Thus, where a State-owned company is not subject to any coordination with other State-controlled holdings, it should be treated as independent for the purposes of Article 5, and the turnover of other companies owned by that State should not be taken into account. Where, however, several State-owned companies are under the same independent centre of commercial decision-making, then the turnover of those businesses should be considered part of the group of the undertaking concerned for the purposes of Article 5.

In practice, the Commission adopts a two-step approach. First, it analyses whether the SOE has an independent power of decision. Second, if this is not the case, it identifies the ultimate state entity and which other undertakings owned by this entity need to be considered as one economic entity.¹³³ The turnover of that state entity and all other undertakings controlled by that entity should be taken into account in calculating turnovers of undertakings concerned. Then, how to assess whether an SOE has

¹³¹ Article 5(4) of the EUMR. Paragraph 178 of the 'Jurisdictional Notice'.

¹³² Craig Pouncey and Kyriakos Fountoukakos, *Transactions Involving States or State-owned Enterprises*, Eur. Antitrust Rev. 14 (2013).

¹³³ Case No COMP/M.6082 – CHINA NATIONAL BLUESTAR/ELKEM (31/03/2011), para.12.

independent decision-making power or not? This assessment is guided by the *possible* power of the State to influence the companies' commercial strategy and the *likelihood* for the State to actually coordinate their commercial conduct, either by imposing or facilitating such coordination.¹³⁴ In previous cases, the Commission has taken into account factors such as the degree of interlocking directorships or the existence of adequate safeguards ensuring that commercially sensitive information is not shared between such SOEs.¹³⁵

Starting from 2011 until 2014, the European Commission applied the EUMR to at least twelve takeovers and joint venture transactions involving Chinese SOEs.¹³⁶ One thorny issue before the Commission is to assess to what extent the Chinese SOE concerned has an independent power of decision from the Chinese State. The answer to this question is crucial both to the determination of the jurisdiction of the EUMR and the substantive assessment of the competition implications of the proposed concentration. In all these cases, the European Commission declined to conclude whether the Chinese SOEs involved possess an independent power of decision. The parties explained that the State Assets Supervision and Administration Commission (SASAC) directly under the State Council and regional SASACs only exercise ownership functions on behalf of the State as a non-managerial trustee. The limited statutory power of the SASAC prevents it from exercising a decisive influence over SOEs under its supervision and that the SASAC does not intervene in the strategic decision-making process (e.g. by approving business plans or budgets), nor does it interfere in SOEs' production and operation activities.¹³⁷ There are also no interlocking directorships between central or local SASAC-owned companies. In one case, the Commission agreed that there was no evidence showing that the central SASAC would be able to align the market behavior of firms under the authority of regional SASACs.¹³⁸ Still, the Commission relied on several legal provisions, information on the SASAC's website and some external sources as suggesting that the

¹³⁴ *Ibid.*

¹³⁵ *Ibid.*

¹³⁶ Kyriakos Fountoukakos et al., *European Commission Seeks Harmonization on Merger Control Reviews of Chinese State-Owned Enterprises* (18 Jul. 2013), <http://careers.herbertsmith.com/insights/legal-briefings?page=25>.

¹³⁷ *Supra* n. 132, para. 14.

¹³⁸ *Ibid.*, para. 30.

SASAC and the Chinese State could influence Chinese SOEs' commercial behavior through formal and informal channels.¹³⁹

The Commission was able to avoid the sensitive question in all these cases because even the Commission adopted a worst case scenario approach, i.e. taking into account *all* the Chinese SOEs, including central SOEs and regional SOEs, in the sectors concerned as part of a single economic unit, the proposed transaction would not raise any competition concerns. Indeed, recent decisions show that the Commission no longer tries to ascertain whether or not the Chinese SOEs involved have independent decision making power. Instead, it becomes a general practice that the Commission *presumes* that all Chinese SOEs in the same sector are one economic unit, 'the China Inc.', and then assess the competition implications of such a worst case scenario.¹⁴⁰

The Commission's cautious 'worst case scenario' approach regarding Chinese SOEs makes sense in view of the complex nature between Chinese SOEs and the Chinese government. It also retains some flexibility for the Commission in dealing with the future cases. However, such an approach has created huge legal uncertainty and imposed heavy financial costs on transactions involving Chinese SOEs. Suppose that a central SOE is contemplating an acquisition of a target company in Europe. The turnover of the central SOE, together with the turnover of the target European company, does not satisfy the turnover thresholds under the EUMR. However, if assessed by the current approach adopted by the Commission, the turnover thresholds are met. Should the companies concerned file a notification of concentration to the Commission? The SOE would find itself in a Catch-22 situation. Non-notification may lead to imposition of hefty fines if the Commission were, at some future point, to conclude that the central SOE was not an independent entity and that all Chinese SOEs in the same sector combined satisfied the turnover thresholds. Yet notification would mean prejudicing its own claim of being an independent market player.¹⁴¹ For the sake of prudence, the Chinese SOE involved in the

¹³⁹ *Ibid.*, para. 15.

¹⁴⁰ See for example Case COMP/M.6151 – PetroChina/ Ineos/JV (13/05/2011) and Case COMP.6807-Mercuria Energy Asset Management/ Sinomart KTS Development / Vesta Terminals (07/03/2013).

¹⁴¹ Kiran Desai & Manu Mohan, *Fear of the Chinese or Business as Usual at the European Commission? EU Merger Regulation and the Assessment of Transactions Involving Chinese State-owned Enterprises*, CPI Antitrust Chronicle, August 2011 (2), 8–9.

transaction may choose to file the notification. This however means that the companies concerned need to address the target's horizontal and vertical relationship, not with the acquiring Chinese SOE group, but with the entire public economy of China.¹⁴² As a result, the scope of the information required to fill out the notification form would be gargantuan. Moreover, what if a worst scenario assessment concludes that the proposed concentration has competition implications in the EU market? The Commission would then be forced to make a firm decision on whether the Chinese SOE involved is a genuine market entity enjoying independent decision-making power.

4 ARE FEARS ABOUT CHINESE OFDI OVERWROUGHT?

The intensified and sometimes politicized investment review processes have created huge uncertainties for Chinese investors with negative economic and political consequences.¹⁴³ It has given third parties, including competing bidders, business rivals and other stakeholders, the opportunity to utilize the national FDI review process in the name of national security or national interest to obtain leverage over the parties or to impact the timing and certainty of the transaction.¹⁴⁴ The increased completion risk sometimes forces Chinese companies to compensate sellers with a 'Chinese buyer premium'.¹⁴⁵ The Heritage Foundation reckons that over USD 200 billion-worth of potential deals have fallen through due to political opposition and some surprising regulatory obstacles.¹⁴⁶ The high-handed treatment of Chinese SOE investments also raises the specter of discrimination. First, should national FDI regulations treat state capital differently from private capital? Second, do national FDI regulators treat equally state capital from different sources? For the first question, the US, Canada and Australia, with the notable exception of the EU, subject state capital to clearly enhanced level of scrutiny. For the second question, Stemsrud made the following sharp comments:

One could never dare to say that the [European] Commission appears to apply the same legal standard to Chinese SOEs as it does towards European SOEs... In *CNB/Elkem* the acquiring entity is a highly commercialized company established in France (Bluestar), which is in addition to the

¹⁴² Odd Stemsrud, 'China Inc' under Merger Regulation Review: The Commission's Approach to Acquisitions by Chinese Public Undertakings, 10 Eur. Comp. L. Rev. 481, 486 (2011).

¹⁴³ Graham & Marchick, *supra* n. 76, at 141.

¹⁴⁴ Ilene Knable Gotts et al., *Is your Cross-Border Deal the Next National Security Lightning Rod?* Bus. L. Today, 31, 34 (2007).

¹⁴⁵ Silk & Malish, *supra* n. 1, at 126.

¹⁴⁶ The Economist, *China's Overseas Investment: ODI-Lay Hee-Ho* (19 Jan. 2013).

80% shareholding of the Chinese SOE (ChemChina), is 20 percent owned by the NYSE listed Blackstone Group. One could be tempted to ask the question: if Bluestar's parent was a German SOE, a French SOE, or an UK SOE, would the Commission still have market-tested Elkem against the entire public economy of that country as they did in *CNB/Elkem*? The answer to that question would, in my opinion, be: 'Of course, not'.¹⁴⁷

Then, what is so special about Chinese SOEs? Are fears about Chinese SOEs' OFDI justified? To answer these questions, we must review the nature and the status of SOEs in the Chinese political-economic context.

4.1 THE REFORM OF CHINESE SOES

Since China adopted the policy of reform and opening up to the outside world in 1978, market-oriented reforms in China have enabled China's GDP to grow at an average rate of 9.5 % per year and its international trade by 18% in volume terms over the past thirty years. As a result, China is presently the world's second largest national economy, a powerhouse in international trade, and a major destination for foreign investment.¹⁴⁸ However, China's economic development model is fundamentally different from the western liberal capitalism model. A recent US State Department report noted that the state-owned sector accounts for approximately 40% of China's GDP.¹⁴⁹ The SOEs comprise 950 of the 1000 largest firms in China. All but 100 of the 2037 firms listed on the Chinese stock exchange in 2012 were SOEs.¹⁵⁰

It is important to understand that modern Chinese SOEs are fundamentally different from their predecessors. In the socialist planned economy era, SOEs were basically production units rather than autonomous profit-seeking corporations. The planning commissions in national and local governments decided for each SOE what to produce, how much SOEs received of allocated materials, and where to sell the output and what price to sell.¹⁵¹ The absence of autonomy and incentive were widely recognized as the central problems facing SOEs in the period prior to reform. After the reform of SOEs began in 1980s, the Chinese government has taken a gradual, experimental and pragmatic

¹⁴⁷ Stemsrud, *supra* n. 141, at 486.

¹⁴⁸ Morrison, *supra* n. 1, at 3.

¹⁴⁹ US Department of State, *Background Note: China* (April 2008).

¹⁵⁰ John Lee, *The Reemergence of China: Economic and Strategic Implications for Australia*, 45 *Austral. Econ. Rev.* 484 (2012).

¹⁵¹ Becky Chiu & Mervyn Lewis, *Reforming China's State-owned Enterprises and Banks*, 61 (Edward Edgar Publishing 2006).

approach of ‘crossing the river by touching the stone’.¹⁵² SOE reforms were deemed necessary in order to reduce economic losses, increase economic growth and raise living standards, from which the Chinese Communist Party (CCP) derives its governing legitimacy.¹⁵³

There is a large body of literature on Chinese SOE reforms.¹⁵⁴ Suffice to highlight here three main features of the reforms. First, the Chinese government has promoted the concentration of state-owned capital on strategic and pillar industries, and specified that SOEs should play a leading role in the key sectors. In order to achieve this objective, the Chinese government has provided selected SOEs with a range of financial and regulatory advantages.¹⁵⁵ Second, the State Assets Supervision and Administration Commission (SASAC), a quasi-governmental, ministerial-level agency operating directly under the State Council, was established to oversee the management of the SOEs. The Law on State-owned Assets of Enterprises in 2008 formally recognizes the SASAC as an ‘investor’ and assigns the SASAC the legal rights and duties of a shareholder, holding SOE shares on behalf of the State.¹⁵⁶ As an investor, the SASAC enjoys an owner’s equity rights and assumes legal liabilities under Chinese Company Law but it does not intervene directly in SOE operations, so that the ownership rights are separated from those of management.¹⁵⁷ Chinese leaders and SASAC officials have repeatedly emphasized that the SASAC must not meddle in the business operations of SOEs.¹⁵⁸ Third, after extensive reforms over the past two decades, the number of central SOEs was reduced from 196 in 2003 to 114 by 2014 under the oversight of the SASAC. Chinese SOEs have evolved from being parts of government ministries to legally stand-alone

¹⁵² Xu Chenggang, *The Fundamental Institutions of China’s Reforms and Development*, 49 J. Econ. Lit., 1076–1151 (2011); Lin Justin Yifu et al., *Competition, Policy Burdens, and State-owned Enterprise Reform*, 88 Am. Econ. Rev. 422–427 (1998).

¹⁵³ Xi Li et al., *A Model of China’s State Capitalism* 9 (2012).

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2061521

¹⁵⁴ Donald Clarke, *Corporate Governance in China: An Overview*, 14 China Econ. Rev. 497–507 (2003); See generally Sheng Hong and Zhao Ning, *China’s State-owned Enterprises: Nature, Performance and Reform* (World Scientific Publishing, 2012).

¹⁵⁵ Yongheng Deng et al., *Monetary and Fiscal Stimuli, Ownership Structure, and China’s Housing Market*, NBER Working Paper 16871 (2011), at 10.

¹⁵⁶ Chapter 2 of PRC Law on State-owned Assets of Enterprises.

¹⁵⁷ Chiu & Lewis, *supra* n. 150, at 122.

¹⁵⁸ LM Hou, *SASAC Chief says that the SASAC will not be SOEs’ Popo and Boss*, <http://money.163.com/08/0810/16/4J0FNR4U002510B6.html>.

enterprises that are empowered to make their own managerial, operational and production decisions. Modern corporate governance system has been established in Chinese SOEs and some of them could even rival the best private companies in the world. Many SOEs are listed in domestic and international stock exchanges and operate in compliance with the most rigorous stock market regulations. Chinese SOEs have improved their financial performance in the past decade and they have proactively engaged in global partnerships and acquisitions.¹⁵⁹

Nevertheless, these achievements cannot shield the fact that the management of SOEs continues to be influenced by policy considerations. This is because the CCP wields tremendous power in China. The CCP is the real decision maker when it comes to making senior personnel decisions in Chinese SOEs.¹⁶⁰ The principle of ‘absolute control of (SOE) executives by the CCP’ is enshrined in various government regulations. The CCP and the SASAC have developed a sophisticated performance evaluation system for top executives of Chinese SOEs.¹⁶¹ It is important to highlight that the financial performance of a SOE under the executive’s stewardship, though an important indicator, is not the sole criteria. ‘Political quality’, i.e. how well SOE executives adhere to CCP priorities and government directions, is also an important criterion against which managerial performance of SOE executives is evaluated.¹⁶² In short, the CCP and the SASAC are able to ensure the control over China’s most powerful business groups by having the power to appoint and remove their top management.¹⁶³

SOE executives therefore face two sets of incentives. On the one hand, they want the SOEs they manage to be profitable because their evaluations are based on the firm’s financial performance. On the other hand, their career paths are ultimately determined by the CCP which is equally, if not more, concerned with how well the executives respond

¹⁵⁹ Aldo Musacchio & Francisco Flores-Macias, *The Return of State-owned Enterprises*, Harvard Int’l. Rev. 5 (2009).

¹⁶⁰ Szamosszegi & Kyle, *supra* n. 49, at 76; Mingxin Pei, *The Dark Side of China’s Rise*, Foreign Policy (March 2006).

¹⁶¹ *Provisional Measures Concerning the Integrated Evaluation of the Top Management Teams and Managers of the Central Enterprises*, CCP Organization Department Doc. No. 17 (2009).

¹⁶² *Ibid.*, Art. 9 and Art. 10.

¹⁶³ Carl E Walter and Fraser JT Howie, *Red Capitalism*, 193 (John Wiley & Sons Ltd 2012); Richard McGregor, *The Party: The Secret World of China’s Communist Rulers*, 49 (Harper Perennial 2011).

to the government directions and carry out the goals of the State. A top SOE executive judged unresponsive to the CCP policies risks not being promoted or even demoted, even if the SOE performs well.¹⁶⁴ These dual criteria for evaluating SOE top executives – to deliver profits and serve the government’s interest – many times align. However, in the situation where an SOE’s financial interest and the State goal are in conflict, the incentives that SOE executives face will strongly encourage them to choose State interest over financial interests of the company and other non-state shareholders.¹⁶⁵ Numerous researches have revealed that the goals of the state are dominant in SOE executives’ decision-making processes. For example, Yang and his colleagues found that winning political promotion is more important than financial compensation in shaping SOE executives’ behavior.¹⁶⁶ There is also evidence that top executive turnovers in listed Chinese SOEs are significantly less related to financial performance indicators than in other listed firms.¹⁶⁷

4.2 EXAGGERATED THREATS OF CHINESE SOES’ OVERSEAS INVESTMENT

Despite extensive SOE reforms, the transformation in the role of the state in China is by no means complete, and the Chinese government still retains power to intervene in high-profile deals. However, the *possibility* that the Chinese government may influence the decision-making of SOEs should not be the end of the inquiry. A relevant question is how likely will the Chinese government exercise this power and direct an SOE to engage in politically charged activities. Such a possibility must also be balanced against protectionism that could ultimately harm the markets and companies of host countries. I submit that possible threats from Chinese SOEs taking over domestic enterprises have been grossly exaggerated. Even if the Chinese government controls the appointment and the removal of SOE executives, it does not necessarily lead to the conclusion that the

¹⁶⁴ Deng et al., *supra* n. 154, at 16.

¹⁶⁵ Szamoszégi & Kyle, *supra* n. 49, at 79.

¹⁶⁶ Yang Ruilong, Wang yuan and Nie Huihua, *The Promotion Mechanism of ‘Quasi-officials’: Evidence from Chinese Central Enterprises*, GuanLi ShiJie (2013), <http://cfos.ruc.edu.cn/Article/UploadFiles/201304/2013040112405165.pdf>.

¹⁶⁷ ZY Zhao, ZS Yang and CE Bai, *The Empirical Study of the Effect on the Top Management Turnover in China’s Listed Companies*, J. Fin. Res.76–89 (2007).

Chinese government is behind all major OFDI decisions or that Chinese SOEs are pursuing a coordinated political agenda.¹⁶⁸

To begin with, contrary to theories that depict Chinese OFDI as part of a grand political game or an emerging world power struggle, Chinese OFDI policies are based on simple economics. China's desire for natural resources and advanced technology is open and well-known. The foundations for Chinese OFDI are neither subtle nor dangerous.¹⁶⁹ In reality, Chinese SOEs have been evincing strong commercial motivations in making OFDI decisions and these decisions are being exercised to a large extent independently of their sovereign sponsor.¹⁷⁰ For example, the Chinese government encourages the National Oil Corporations (NOCs) to go global and help ensure China's energy supply security. The Chinese NOCs have made tremendous progress in securing equity oil from foreign countries.¹⁷¹ However, not all the equity oil produced abroad was shipped back to China despite China's huge domestic demand. In 2006, two thirds of all oil production that China's NOCs pumped abroad was sold on the international market.¹⁷² In Sudan, Chinese companies have at times sold much more of their oil production to Japan than they have sent home.¹⁷³ Part of the reasons may be that it makes more economic sense for Chinese NOCs to sell it at world market price than transporting back to China.¹⁷⁴ In CNOOC's acquisition of Unocal in 2005, it was later revealed that the CNOOC bid was undertaken almost entirely at the initiative of CNOOC, and over the fierce objection and stubborn hesitation of the central government.¹⁷⁵ The 'China Inc' image, where all Chinese SOEs are following a centrally coordinated strategy, cannot be further from the truth. The extensive corporatization and marketization in the past decades have transformed Chinese SOEs into market-oriented and self-interest motivated players.¹⁷⁶ There has been fierce

¹⁶⁸ Rosen & Hanemann, *supra* n. 15, at 11.

¹⁶⁹ Scissors, *supra* n. 6.

¹⁷⁰ OECD, *supra* n. 14, at 93; Margaret Cornish, *Behavior of Chinese SOEs: Implications for Investment and Cooperation in Canada* (February 2012), at 15.

¹⁷¹ Chen Shaofeng, *Has China's Foreign Energy Quest Enhanced its Energy Security?* 207 *China Q.* 600, 608 (2011).

¹⁷² Erica Downs, *China's Quest for Overseas Oil*, *Far Eastern Econ. Rev.* (September 2007).

¹⁷³ Geoff Dyer and Sundeep Tucker, *In Search of Illumination*, *Financial Times* (4 Dec. 2007).

¹⁷⁴ Chen, *supra* n. 170, at 608 and 622.

¹⁷⁵ Nicolas C. Howson, *China's Acquisitions Abroad- Global Ambitions, Domestic Effects*, *Law Quadrangle Notes* 73, 76 (Spring 2006).

¹⁷⁶ Julie Jiang and Jonathan Sinton, *Overseas Investments by Chinese National Oil Companies: Assessing*

competition among SOEs. Sometime the competition is so fierce that Chinese NOCs bid against each other over foreign projects, such as PetroChina and Sinopec in Sudan and Libya as well as between CNOOC and Sinopec in Brazil.¹⁷⁷

Furthermore, except some ultra-sensitive areas such as the transfer of military technology, it is difficult to see what exactly Chinese SOEs could do to threaten the national security of a host country. Moran offered a framework to separate plausible national security threats from implausible claims. According to Moran, the first category of threat springs from the prospect that the proposed acquisition would make the host country dependent upon a foreign-controlled supplier of goods or services crucial to the functioning of the national economy. The second category embodies the concern that the proposed acquisition would allow transfer of technology or other expertise to a foreign-controlled entity that might be deployed by the entity or its government in a manner harmful to that host country's national interests. The third category of threat is that the proposed acquisition would allow insertion of some potential capability for infiltration, surveillance, or sabotage into the provision of goods or services crucial to the functioning of that economy.¹⁷⁸ Applying Moran's framework to a number of blocked or withdrawn transactions, it is apparent that national security concerns could be easily abused to hide protectionist motives. In the *CNOOC- Unocal* controversy, concerns were expressed that CNOOC might divert Unocal's energy supplies exclusively to meet Chinese needs. But facts were that Unocal accounted for only 0.8% of US production of oil and national gas and the majority of its reserves and production were outside the US. Even if CNOOC rerouted all Unocal's US production to China, which is economically penalizing for CNOOC and its controller, it would not harm the US interest because US buyers could easily replace Unocal's miniscule production with imports from the international market, leaving net imports and US balance of payments in energy unchanged.¹⁷⁹ Indeed, even in

the Drivers and Impacts, International Energy Agency Information Paper (February 2011), at 25; Cornish, *supra* n. 169, at 15.

¹⁷⁷ Kang Wu and S. L. Han, *Chinese Companies Pursue Overseas Oil and Gas Assets*, 103 *Oil & Gas J.* (2005).

¹⁷⁸ Theodore H. Moran, *Foreign Acquisition and National Security: What are Genuine Threats? What are Implausible Worries*, paper presented at OECD Global Forum on International Investment (December 2009), at 3.

¹⁷⁹ *Ibid.*, at 5.

the event of hostility, since FDI is illiquid and cannot be withdrawn, the acquired foreign assets actually would represent a hostage in a host country's hands.

Next, multiple external parties are involved in Chinese SOEs' OFDI decision-making process. These parties include international investment banks, law firms, accounting firms, rating agencies, corporate partners and financiers. An OFDI decision cannot be made solely by a government entity.¹⁸⁰ The strong commercial motivations of Chinese SOEs in their OFDI are testified by international experts working on the transactions. Moreover, a range of economic and political factors limit the likelihood that Chinese SOEs will be used by the Chinese government as a political tool in reality. First, there is evidence that politically motivated investments often do not make much economic sense.¹⁸¹ The commercial pressure on Chinese SOEs is growing rapidly and it is implausible to assume that Chinese SOEs' OFDI can always be made with little consideration of economic feasibilities. Second, a Chinese SOE's OFDI project, once completed, is fully subject to the regulatory framework of the host country. A rigorous enforcement of the laws of the host country is likely to deal with most of the concerns presented by the SOE investment. For example, corporate laws impose robust fiduciary duties on the controlling shareholder and the directors and senior management of the company. These fiduciary duties place a liability restraint on SOEs as a controlling shareholder and their appointed directors.¹⁸² Most significantly, if Chinese SOEs engage in politically charged activities against economic interests in a host country, then they risk political, economic and legal responses with dire consequences. Such activities could surely bring heightened political and regulatory scrutiny of all the investments in the host country and probably in every jurisdiction in which Chinese SOEs have invested. Given the suspicion generally surrounding SOEs' investments and the fact that they usually operate under unique scrutiny, Chinese SOEs will act hyper-cautiously. The costs of political activity would seem to far outweigh any potential benefits.¹⁸³

¹⁸⁰ Megan Bowman et al., *China: Investing in the World*, CIFR Research Working Paper Series (September 2013), at 11.

¹⁸¹ Christopher S. Rugaber, *Offshore Investors Take Low Profile to Avoid Political Resistance to Deals*, *Toronto Star* (2 Dec. 2007).

¹⁸² Rose, *supra* n. 88, at 120–122.

¹⁸³ *Ibid.*, at 119.

Finally, it may be understandable to exaggerate the potential risk that Chinese SOEs' OFDI might pose to a host country. But after China has implemented the 'Go Global' policy for more than a decade, to what extent do the available data support the argument that Chinese SOEs pose unique risks to a host country? Statistics from Australia show that Chinese investors usually acquire a passive minority interest at the corporate level. Approximately 50% of completed investments were for the acquisition of a 10% or 20% shareholding interest.¹⁸⁴ Even if Chinese investors gain a controlling interest, they rely heavily on local talent to manage Australian companies. During the period 1 January 2005 to 31 December 2012, Chinese nationals were appointed as Chief Executive Officer only in 32% of acquisitions and Chief Operating Officer in only 10% in the energy and resources sectors.¹⁸⁵ A report from the Organization for Economic Cooperation and Development (OECD) also shows that experience-sharing among recipient countries has not revealed any serious problems related to investment made by foreign government-controlled investors.¹⁸⁶

5 POLICY IMPLICATIONS

It is important not to overstate the impact of China's OFDI on the global investment system. Despite the media buzz, China's OFDI is still relatively small and only represents a miniscule presence in Western countries. The assertion that China is 'buying up the world' is simply not true. The reasons why Chinese OFDI have attracted so much media attention are simply the phenomenal rate at which it is growing- it multiplied ten times between 2005 and 2011 and significant investment in the energy sector.¹⁸⁷ Similarly, the claim that Western countries are indiscriminately biased against Chinese investors is not supported by facts. To be fair, except a small number of high-profile blocks in energy, mining and telecommunication industries, the vast majority of China's OFDI projects were reviewed and approved without much controversy. In September 2013, CFIUS allowed Smithfield Foods Inc., the world's largest hog and pork producer, to be acquired

¹⁸⁴ Clayton Utz, *Digging Deep: Chinese Investment in Australian Energy and Resources*, http://www.claytonutz.com/publications/edition/14_march_2013/20130314/digging_deep_chinese_investment_in_australian_energy_and_resources.page.

¹⁸⁵ *Ibid.*

¹⁸⁶ OECD, *supra* n. 50, at 4.

¹⁸⁷ Chintu & Williamson, *supra* n. 61.

by China's Shuanghui International Holdings Ltd. in what would be the biggest Chinese purchase of a US firm.¹⁸⁸ Still, the controversy over Chinese SOEs' OFDI is a textbook example of how misperception and a lack of trust can set road blocks for international business transactions.

5.1 IMPLICATIONS FOR HOST COUNTRIES

History repeats itself. The current debate over China's OFDI could be a case of déjà vu reminding the world that similar stories happened to Japan three decades ago.¹⁸⁹ In 1988, the US Congress approved the Exon-Florio provision in response to concerns over foreign acquisition of certain types of US firms by Japanese firms. Two decades later, Japanese firms have not taken over the US and indeed, the US economy has benefited enormously from the inbound foreign investment.¹⁹⁰ Arguably current concerns are partly due to the vulnerability of some Western economies after the unprecedented global financial crisis and the subsequent legitimacy crisis of liberal capitalist ideals.¹⁹¹ Still, when formulating policies addressing Chinese SOEs' OFDI, it is helpful to recall how alarmists may successfully generate unfounded fears which may in turn strain international economic relations with negative economic consequences.

As Part III of this article shows, host countries enjoy ample leeway and possess adequate instruments which allow them to monitor foreign investment and block any projects which threaten to compromise national security. Current international law imposes little constraint on host countries to exercise this self-judging power. The real problem is the opposite: from time to time, national FDI review process falls victim to populism and protectionism. In view of the already highly politicized FDI review process in some countries, the suggestion that host countries seek additional unilateral measures to block Chinese SOEs' investments seems to be misconceived.¹⁹²

¹⁸⁸ Shruti Date Singh & Bradley Olson, *Smithfield Receives U.S. Approval for Biggest Chinese Takeover*, Bloomberg (7 Sep. 2013).

¹⁸⁹ Curtis J. Milhaupt, *Chinese Investment: A Case of Déjà vu for the United States*, East Asian Forum Quarterly (August 2012), at 34.

¹⁹⁰ James K. Jackson, *Foreign Investment and National Security: Economic Considerations*, Congress Research Service RL34561 (4 Apr. 2013), at 2.

¹⁹¹ Bowman, *supra* n. 64.

¹⁹² Price, *supra* n. 9, at 20.

In order to make critical business decisions, both Chinese and foreign executives of a host country need to determine beforehand whether the bids may be rejected on national security or national interest grounds. Greater clarity on this issue would benefit all parties both by maximizing the assets value and preventing tit-for-tat treatment abroad.¹⁹³ This is of course not to suggest that national security is not a legitimate concern. The point is only that national security clauses should be applied with restraint and should not be a general escape clause for host countries to renege on commitments to open investment policies.

Several OECD reports provide a useful framework to balance the delicate relationship between national security and an open investment environment. *The OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies* was adopted by the OECD Council in June 2008.¹⁹⁴ As the policy concerns raised by SOEs are similar to SWFs, the principles outlined for the regulation of SWFs are also applicable to SOEs.¹⁹⁵ The OECD Declaration is hoped to foster mutually beneficial situations where SWFs enjoy fair treatment in recipient country markets and recipient countries can confidently resist pressures for protectionist responses. Within this context, national security is recognized as a legitimate limitation only if the national security principles are narrowly drawn. However, sovereign investment might serve as a legitimate basis for protection when a home country uses it for foreign policy rather than commercial purposes, to obtain sensitive technology, or to aid the intelligence capabilities of a foreign country that is hostile to the host country.¹⁹⁶ The *OECD Guidelines for Recipient Country Investment Policies Relating to National Security* were adopted in May 2009.¹⁹⁷ This framework suggests that recipient countries should not erect protectionist barriers to foreign investment and discriminate among investors in like circumstances. Where such national security concerns do arise, investment policies by recipient countries should be guided by

¹⁹³ Rosen and Hanemann, *supra* n. 15, at 2.

¹⁹⁴ OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies, C/MIN(2008)FINAL, <http://www.oecd.org/daf/internationalinvestment/investmentpolicy/40408735.pdf>.

¹⁹⁵ OECD, *supra* n. 50, at 5.

¹⁹⁶ OECD, *supra* n. 193, at 4.

¹⁹⁷ OECD, *Guidelines for Recipient Country Investment Policies Relating to National Security*, Recommendation Adopted by the OECD Council on 25 May 2009.

the principles of non-discrimination, transparency of policies and predictability of outcomes, proportionality of measures and accountability of implementing authorities.¹⁹⁸

As Howson pointed out, China's 'Go Global' policy represents a new phase of China's behavior-changing entanglement with foreign and international legal, commercial and governance norms, all with direct effects inside China. The Chinese government, Chinese enterprises and various Chinese commercial instruments were forced for the first time to play by internationally accepted rules not only during the whole acquisition phase but even with respect to internal corporate governance at the firms themselves.¹⁹⁹ In fact, while China's OFDI has witnessed rapid growth, the performance of China's overseas business ventures has reportedly been less than satisfactory, with close to one-third are in the red.²⁰⁰ Clearly, Chinese companies operating overseas face a steep learning curve in making the right OFDI decisions, as well as international management and marketing acumen. Though the learning curve is steep, China's 'Go Global' policy has started a socialization process bringing value to both China and the global economy. It is simply a bad policy choice, both economically and politically, to reject Chinese investments not on legitimate grounds but under the influence of misinformed populism and protectionism.

5.2 IMPLICATIONS FOR CHINA'S ONGOING SOE REFORMS

Though there is a strong suspicion of state capital in some quarters, state capital itself has never become a significant issue in international business transactions. It has long been established that the source of capital itself, without more, should not be a basis for discriminatory treatment by states.²⁰¹ As long as SOEs do not exercise governmental functions, have independent power of decision-making free from government interference and are run on a commercial basis, there is no reason to treat SOEs differently from private enterprises. It should be noted that these are exactly the goals of Chinese SOE reforms announced by the Chinese government. As early as 1993 after Deng Xiaoping's historical southern tour, the goal of Chinese SOE reforms was set to

¹⁹⁸ *Ibid.*, 3–4.

¹⁹⁹ Howson, *supra* n. 174, at 74.

²⁰⁰ First Financial and Economic Daily, *The Total Amount of Chinese OFDI has Increased for Consecutive Ten Years, Close to 30% are Losing Money*, <http://news.sina.com.cn/c/2012-08-31/093025074663.shtml>.

²⁰¹ WTO Appellate Body Report, *United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China*, WT/DS379/AB/R (11 Mar. 2011), para. 318; Recital 22 of EUMR.

require SOEs to be modern enterprises characterized by ‘clear property rights, well-defined power and responsibility, separation of enterprise from government, and scientific management’.²⁰² Moreover, to address the concerns of the Working Party about the integration of China’s ‘socialist market system’ into the World Trade Organization (WTO), China confirmed in the Accession Protocol that ‘the Government of China would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises, including on the quantity, value or country of origin of any goods purchased or sold, except in a manner consistent with the WTO Agreement’.²⁰³ Since the Chinese government and the international community share similar expectation of how Chinese SOEs should be run, the recent attention to Chinese SOEs’ OFDI may be recast in a more positive light, as an external incentive for the Chinese government to accelerate the implementation of the reform strategy that it has already committed to almost two decades ago.

The Chinese government is advised to continue the efforts to reduce governmental interference into SOEs’ decision-making processes; eliminate financial and regulatory benefits conferred on SOEs and upgrade corporate governance standards in SOEs in order to entrench their commercial orientation. These reform measures will not only reduce suspicion and misunderstanding when SOEs ‘Go Global’, but also make SOEs truly competitive global companies. In this regard, several OECD documents provide helpful guidance on internal corporate governance of SOEs as well as when SOEs operate abroad.

The *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (SOE Guidelines) adopted in 2005 is primarily oriented at SOEs using a distinct legal form and having a commercial activity, whether or not they pursue a public policy objective as well.²⁰⁴ The SOE Guidelines constitutes the first international benchmark to help governments improve the corporate governance of SOEs by providing standards and

²⁰² Decision on Issues Regarding the Establishment of a Socialist Market Economic System, para. 1 (2), <http://finance.ifeng.com/opinion/jjsh/20090906/1199906.shtml>.

²⁰³ Report of the Working Party on the Accession of China, WT/ACC/CHN/49 (1 Oct. 2001) para. 46.

²⁰⁴ OECD, *OECD Guidelines on Corporate Governance of State-owned Enterprises* (OECD Publishing 2005), at 10.

good practices, as well as guidance on implementation.²⁰⁵ Grounded in principles of transparency and the separation of function, its objective is to neutralize the sovereign in the operation and control of these enterprises.²⁰⁶ Thus neutralized, the SOE Guidelines expects to create a level playing field in markets where SOEs and private sector companies compete in order to avoid market distortion.²⁰⁷ For that purpose, the SOE Guidelines specifically requires that SOEs face competitive conditions regarding access to finance and avoid indirect market distortions and avoid indirect subsidies through cross-ownership of state enterprises.²⁰⁸ Realizing that SOEs face some distinct governance challenges, the SOE Guidelines treat transparency as a key factor in governing SOEs. Applying the SOE Guidelines to SOEs operating abroad, the OECD document highlighted the importance of separating SOEs' commercial and other objectives, and the governance arrangements in place to lend credibility to the objectives as well as mechanisms for transparency and accountability.²⁰⁹ Undoubtedly, the implementation of these principles would go a long way towards addressing competitive issues associated with SOEs as well as alleviating host country concerns about SOEs' uncertain corporate objectives.²¹⁰ Currently, the OECD 2005 SOE Guidelines are under revision and the 2014 revised SOE Guidelines will be submitted to the OECD Corporate Governance Committee for approval in November 2014.²¹¹ The 2014 Guidelines will take into account developments since the Guidelines were first adopted in 2005 and the experiences of the growing number of countries that have taken steps to implement their recommendations.²¹²

²⁰⁵ P Kowalski et al., *State-owned Enterprises: Trade Effects and Policy Implications*, OECD Trade Policy Papers No. 147 (OECD Publishing, 2013), at 38.

²⁰⁶ OECD, *supra* n. 203, at 13.

²⁰⁷ *Ibid.*, at 18.

²⁰⁸ *Ibid.*, at 12.

²⁰⁹ OECD, *SOEs Operating Abroad: An Application of the OECD Guidelines on Corporate Governance of State-Owned Enterprises to the Cross-border Operations of SOEs* (2010), 4–5.

²¹⁰ Antonio Capobianco and Hans Christiansen, *Competitive Neutrality and State-owned Enterprises: Challenges and Policy Options*, OECD Corporate Governance Working Papers No. 1 (OECD Publishing, 2011).

²¹¹ OECD, *2014 Revision of the OECD Guidelines on Corporate Governance of State-owned Enterprises*, <http://www.oecd.org/corporate/ca/revisionoftheoecdguidelinesoncorporategovernanceofstate-ownedenterprises.htm>

²¹² *Ibid.*

In May 2008, the International Working Group (IWG) of Sovereign Wealth Funds created under the International Monetary Fund drafted the ‘Santiago Principles’.²¹³ The purpose of the Santiago Principles is to identify a framework of generally accepted principles and practices that properly reflect appropriate governance, accountability, and arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis.²¹⁴ The Santiago Principles cover practices and principles in three key areas and they are grounded in four guiding objectives. Three key areas are: (i) legal framework, objectives coordination with macroeconomic policies; (ii) institutional framework and governance structure; and (iii) investment and risk management framework. Four guiding principles are: (i) the maintenance of financial stability and free capital flows, (ii) compliance with applicable laws of host countries, (iii) an idealized private investor strategy for investments, focusing on investments on the basis of economic and financial risk and return-related considerations and (iv) adhering SWFs ought to have in place systems of transparency and a sound governance structure that provide for adequate operational controls, risk management and accountability.²¹⁵ By enacting the principles, the IMG aimed to assure host countries of the absence of threatening political agendas affected through sovereign investment activity. Thus convinced, the hope is to avoid host country lawmaking that would inhibit sovereign investing.²¹⁶

Granted, in view of the very special political economy context in China, there will be doubts as to whether the Chinese government will ever be able to run its SOEs on a commercial manner without changing the current Chinese political system.²¹⁷ Such pessimism should be tempered. To begin with, China is not alone in controlling a substantial number of strong SOEs. Other countries such as Singapore, Norway and

²¹³ *Sovereign Wealth Funds: Santiago Principles* (October 2008), <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>.

²¹⁴ *Ibid.*

²¹⁵ *Ibid.*

²¹⁶ Larry Cata Backer, *Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State-owned Enterprises, and the Chinese Experience*, 19 (3) *Transnat'l L. & Contemp. Probs* 3, 95 (2010).

²¹⁷ Umesh Desai and Vikram Subhedar, *China's Talk of Reform Leave Investors Cool toward State Giants*, <http://uk.reuters.com/article/2013/10/30/uk-china-enterprises-investors-idUKBRE99T1E520131030>.

France also have a large state sector.²¹⁸ The SOEs in these countries do not seem to be a big concern for other countries. Moreover, the new Chinese leadership has brought unprecedented momentum to reform Chinese SOEs at the Third Plenary Session of the 18th CCP Central Committee in November 2013.²¹⁹ The CCP vowed to make the market play a decisive role in allocating resources so as to deepen economic structural reform. As one of the fifteen key reform areas, a ‘mixed ownership economy’ in which both the public sector and non-public sector economy are important components will be developed. This objective requires further consolidation of the state-owned sector and the perfection of the modern corporate system for SOEs.²²⁰ More detailed SOE reform measures include organization of state-owned capital investment and operation companies, more public disclosure of SOE finances, perfection of the enterprise bankruptcy system; increase of dividend pay-out ratio for SOEs from the current 5–15% to 30% by 2020, and promotion of ‘interlocking shareholding’ by encouraging non-public sector stakes in SOEs.²²¹ It is clear that China is in the midst of the biggest attempt in more than a decade to reform the SOEs.²²³

5.3 EMERGING REGULATION OF SOES IN INTERNATIONAL TREATIES

Even though states bear few international legal obligations with regard to the regulation of SOEs, voluntary codes of conduct have been introduced to systematize approaches to the regulation of government-controlled entities and their overseas investments. These voluntary codes of conduct are soft law principles intended to develop both a foundation for customs to form around benchmarked practices and an international consensus in conceptualizing the government-controlled entities in the global markets.²²⁴ They usually encourage home states to take steps to strengthen transparency and governance of SOEs and at the same time urge host states to avoid protectionist responses that could

²¹⁸ Hans Christiansen, *The Size and Composition of the SOE Sector in OECD Countries*, OECD Corporate Governance Working Paper No. 5 (OECD Publishing, 2011), at 1.

²¹⁹ Nargiza Salidjanova and Iacob Koch-Weser, *Third Plenum Economic Reform Proposals: A Scorecard*, US-China Economic and Security Review Commission Staff Research Backgrounder (19 Nov. 2013).

²²⁰ *Communiqué of the Third Plenum of the 18th Chinese Communist Party Congress* (November 2013).

²²¹ *Decision on Certain Major Issues Concerning the Comprehensive Deepening of Reform* (15 Nov. 2013).

²²³ *Fixing China Inc: Reform of State Companies is back on the Agenda*, *The Economist* (30 Aug 2014).

²²⁴ Backer, *supra* n. 216, at 86.

undermine economic growth and development. The OECD SOE Guidelines and Santiago Principles mentioned above are typical examples.

More recently, there have been considerable efforts to impose binding legal obligations on states to regulate SOEs in bilateral investment treaties (BITs) and regional trade agreements (RTAs). These new-generation BITs and RTAs oblige the parties to ensure that SOEs act in a manner that is consistent with the parties' obligations under these RTAs or BITs when they exercise the delegated government authority; act solely in accordance with commercial considerations in their purchase of goods or services; provide non-discriminatory treatment to covered investments; not to enter into anti-competitive agreements among competitors or engage in exclusionary practices; and that the parties shall not influence or direct decisions of the SOEs.²²⁵

As an outcome of the Strategic and Economic Dialogue in May 2012, China and the US agreed to intensify negotiation for a US – China BIT on the basis of the 2012 US Model BIT.²²⁶ It is hoped that the BIT would allow the US to address many of the broader issues posed by Chinese SOEs' OFDI.²²⁷ The SOE problem is also being addressed in the Trans-Pacific Partnership (TPP) negotiations.²²⁸ Some people in the US see the TPP as a means of managing the ability of states, principally China, to blend state and private power through SOEs.²²⁹ Current proposals that seek commitments from TPP members would (1) require that SOEs investing or operating in the markets of other signatories act on commercial considerations; (2) ensure that SOEs do not receive subsidies or financing or other benefits from their governments that unfairly advantage them with respect to investment abroad; (3) include a reporting/monitoring and

²²⁵ For instance, Art. 16.3 of the US – Korea Free Trade Agreement; Art. 11.4 of the EU-Korea Free Trade Agreement; 2012 US Model Bilateral Investment Treaty; Art. 12.3 of the US –Singapore Free Trade Agreement.

²²⁶ US Department of Treasury, *Joint U.S. – China Economic Track Fact Sheet- Fourth Meeting of the U.S. China Strategic and Economic Dialogue*, <http://www.treasury.gov/press-center/press-releases/Pages/tg1567.aspx>.

²²⁷ Fagan, *supra* n. 52, at 7–8.

²²⁸ Bradley Gardner, *Trans-Pacific Partnership Meets to Focus on Rules for SOEs*, <http://www.newsbase.com/newsbasearchive/cotw.jsp?pub=chinaoil&issue=409>.

²²⁹ Derek Scissors, *What a Good Trans-Pacific Partnership Looks Like*, <http://www.heritage.org/research/reports/2013/03/what-a-good-trans-pacific-partnership-looks-like>.

information request mechanism; and (4) provide for a dispute settlement mechanism.²³⁰ China is not yet a party in TPP negotiations. However, if the TPP were successfully concluded, the SOE provisions in the TPP Agreement would set a precedent for future BITs and RTAs, including agreements that China may seek to join or negotiate. Indeed, the SOE problem tops the agenda of the new round of RTA talks between China and other countries. Australia's Trade Minister Craig Emerson admitted in April 2013 that: '... talks on a free-trade deal with China have stalled because of a dispute over restrictions on investment in Australia by Chinese state-owned enterprises'.²³¹

6 CONCLUSION

For decades, FDI means investment from developed countries to developing countries. More recently, a new trend of FDI from developing countries to developed countries has started. In 2012, developed economies saw their FDI outflows fell close to the trough of 2009. By contrast, FDI flows from developing countries rose slightly.²³² In 2013, FDI flows from developed countries continued to stagnate whilst flows from developing countries remained resilient, rising by 3%.²³³ In total, FDI by transnational corporations from developing countries reached \$454 billion in 2013 – another record high. Together with transitional economies, they accounted for 39% of global FDI outflows, compared with only 12% at the beginning of the 2000s.²³⁴ The global OFDI has become a two-way street and this is an integral part of the globalization process.

The Chinese government's embrace of 'Go Global' policy is a logical consequence of the country's success in attracting inbound FDI and promoting exports in previous decades. It is also consistent with the overall framework of continuing reform and liberalization of the Chinese economy.²³⁵ However, there has been a backlash against Chinese SOE investments in some Western countries. This article takes a close look at

²³⁰ Nova J. Daly, Statements before the US- China Economic and Security Review Commission Hearing on 'The Evolving U.S. – China Trade and Investment Relationship' (14 Jun. 2012), at 6.

²³¹ George Gilligan, *A Chilly Breeze for Inward Investment*, <http://www.cimr.unsw.edu.au/article/risk/state-capitalism/chilly-breeze-inward-investment>.

²³² UNCTAD, *supra* n. 5, at 4.

²³³ UNCTAD, *World Investment Report 2014* (New York and Geneva, 2014), at 5-6.

²³⁴ 4. *Ibid*, at xiv.

²³⁵ OECD, *supra* n. 14, at 84.

the underlying drivers of the Chinese OFDI as well as regulatory responses of some Western countries. This article argues that China's OFDI has become increasingly driven by Chinese SOEs' own commercial motivations. Chinese SOEs need a clear, predictable and reliable legal environment for their outbound investments. This article also urges the Chinese government to push forward SOE reforms in China. In this respect, several international voluntary codes of conduct and the new-generation BITs and RTAs offer some helpful guidance. The implementation of these internationally recognized principles would help alleviate concerns when Chinese SOEs 'Go Global'.

The Chinese government has recently launched a new round of far-reaching economic reforms. The decision to reform Chinese SOEs was announced and the implementation rules are being drafted and unveiled.²³⁶ It is also reported that there is a decline of state capital in China's OFDI and outbound investments made by Chinese private enterprises have surged since Spring 2012.²³⁷ It seems that it will not be long when the world comes to realize that there is nothing to fear about Chinese SOEs but fear itself.

²³⁶ Xinhua, *China Ventures into SOE Mixed Ownership Reform* (11 July 2014), http://europe.chinadaily.com.cn/business/2014-07/11/content_17732995.htm

²³⁷ Derek Scissors, *China's Steady Global Investment: American Choices*, The Heritage Foundation Report (6 Jul. 2013); Eve Cary, *SOEs Declining Role in China's Foreign Investment*, The Diplomat, <http://thediplomat.com/china-power/soes-declining-role-in-chinas-foreign-investment/>.