

Striking a balance between investment liberalisation and national security in China-U.S. relations



The Chinese and U.S. markets present opportunities for each country. Tatman R. Savio, Stephen S. Kho, Cynthia Y. Liu, and Lucy (Qiong) Lu discuss the ongoing bilateral investment treaty ('BIT') negotiations against the backdrop of national security concerns.

For decades, foreign direct investment ('FDI') between the United States and China was characterised by American multinational companies investing in labour-intensive manufacturing and consumer-oriented operations in China.¹ In the past several years, however, China's FDI in the U.S. market has increased dramatically, moving beyond significant purchases of Treasury bonds and other securities by sovereign investors to investments by Chinese companies in a myriad of advanced technologies, brands, and real estate in the United States.² The Chinese and U.S. markets present a wealth of opportunities for each other, and current and upcoming regulatory and political priorities in both countries will shape the trajectory and dynamics of their economic relationship well into the future. This article explores the potential for continued economic liberalisation between the two countries with the ongoing bilateral investment treaty

('BIT') negotiations, against the backdrop of national security concerns and related developments that may threaten to undermine a more expansive economic future.

Current and proposed restrictions on foreign investment

Based on traditionally accepted principles of international law, countries have the sovereign power to exclude foreign persons and property, and to prescribe the terms and conditions on which foreigners may enter their territory.³ Notwithstanding these powers of exclusion, most countries are able to participate in cross-border trade and investment through various international trade agreements and BITs. However, even under these agreements, countries maintain the right to regulate foreign investments and trade in order to protect their national security interests.⁴ As a result, despite trends towards greater economic and

investment liberalisation, many countries, including the United States and China, maintain laws that proscribe foreign investment in particular sectors and require government review and prior approval of certain other foreign investments.

The U.S. foreign investment review process

Under the Exon-Florio amendment to the Defense Production Act (the 'Exon-Florio law'), the inter-agency Committee on Foreign Investment in the United States ('CFIUS') has the authority to conduct national security reviews and investigations of transactions that could result in foreign control of a U.S. business.⁵ The Exon-Florio law authorises the President to block such a transaction (or order divestment of a completed transaction) if there is credible evidence that foreign control of the U.S. entity 'threatens to impair' U.S. national security, and existing legal provisions do not provide adequate protection. Although



notifying CFIUS of a proposed foreign investment transaction remains voluntary, many parties proactively seek CFIUS clearance to eliminate potential future liability under the Exon-Florio law.

In 2007, the U.S. government enacted the Foreign Investment and National Security Act ('FINSA') in response to U.S. public and political criticism of several high-profile transactions that raised concerns about the sufficiency and effectiveness of CFIUS to protect U.S. national security. Among other changes, FINSA expanded the scope of national security reviews, created a presumption for investigations of certain transactions (e.g., those involving critical infrastructure), and increased Congressional oversight of proceedings. It also required the consideration of additional factors in assessing the national security implications of a proposed transaction, and increased the number of agencies involved in CFIUS reviews and investigations.

In the years following FINSA's enactment, Chinese investors voiced concerns that the U.S. government unfairly targeted Chinese companies in the CFIUS process. Notwithstanding these concerns, Chinese investors have actively engaged the U.S. market in recent years, with China accounting for the most CFIUS notices filed (21) by a foreign country in FY2013, and representing 22% of the total notices reviewed in that period.⁶ Of course, the data does not capture the full complexity or nuances of Chinese investment in the U.S. market, including investors who back off from U.S. deals, restructure them to mitigate Chinese majority ownership or control, or abandon transactions all together, as a result of actual or perceived pressure from the CFIUS process.

China's foreign investment review process and national security initiatives

Current process

China regulates foreign investment through various mechanisms under disparate legal regimes. For foreign investment purposes, China characterises industries as 'encouraged', 'restricted', or 'prohibited' under the *Foreign Investment Guidance Catalogue*.⁷ Any industry not listed in this catalogue falls under the

News: Sino-U.S. cybersecurity agreement

Following President Xi's recent visit to the United States, the Chinese and U.S. governments have entered into a cybersecurity agreement, in which they agreed, among other commitments, not to conduct or support cyber-enabled theft of intellectual property. For now, this development appears to have preempted U.S. consideration of sanctions against certain Chinese companies for alleged cyber-attacks against U.S. companies. If imposed in the future, cybersecurity sanctions would likely create additional challenges for Chinese companies seeking to invest in the United States, particularly in the technology sector. Moreover, the issuance of such sanctions could impact China's consideration of several pending national security measures.

'permitted' category. Except for such activity in China's four free trade zones ('FTZs') (Shanghai, Guangdong, Tianjin, and Fujian – the latter three were established earlier this year), the Chinese government approves foreign investment on a case-by-case basis in what is often a time-consuming process, regardless of which industry category is involved. Moreover, since March 2011, China has subjected foreign acquisitions in specified industries (e.g., defence, agriculture, natural resources, infrastructure, transportation) to a separate national security review process pursuant to a State Council circular,⁸ and implementing rules issued by the Ministry of Commerce ('MOFCOM') ('2011 NSR Rules').⁹

Proposed national foreign investment law and negative list

On 19 January 2015, MOFCOM issued the draft Foreign Investment Law ('FIL'), which promises to streamline the existing Chinese foreign investment regime by replacing various laws currently in place (e.g., the Wholly Foreign-Owned Enterprise Law, Sino-Foreign Equity Joint Venture Enterprise Law, and the Sino-Foreign Cooperative Joint Venture Enterprise Law).¹⁰ The FIL significantly alters the structure and process of foreign investment review in China, including by adopting a 'negative list' approach to foreign investment, which is currently employed in all four FTZs in China. Under the proposed approach, foreign investments falling outside the negative list will no longer require approval, although the establishment of a foreign investment enterprise ('FIE') in an industry outside the negative list will remain subject to certain registration requirements and industry-specific licensing regimes as a domestic Chinese company.

For foreign investment in sectors on the negative list or exceeding the prescribed investment amount thresholds (which have not yet been clarified in the FIL), foreign investors will still be required to obtain a 'market entry permit' from the authority responsible for reviewing the foreign investment. While it is uncertain when or whether the FIL will be promulgated, the Chinese government reportedly passed in late September the *Opinion on Implementing the Negative List for Market Entry*. The opinion states that the State Council will formally implement a negative list for the entire country in 2018, after applying it in select regions in trial versions from 2015-2017.

The FIL also provides the basis for a more extensive national security review for foreign investment. As a counterpoint to the general relaxation of foreign investment restrictions and approval requirements described above, the FIL provides that any foreign investments that 'harm or may harm national security' must undergo a national security review, without limiting the industries involved. Similar to the U.S. regime, the FIL establishes a joint committee and gives it broad discretion to assert jurisdiction over a particular transaction, as well as to make national security decisions that are not subject to judicial or administrative review. Unlike the CFIUS process, the FIL does not explicitly address the confidentiality of the national security review process or exclude greenfield investments or certain other types of transactions from the scope of review. Moreover, while the definition of 'national security' captures some factors of the CFIUS process (e.g., critical infrastructure, sensitive technologies, foreign-government controlled transactions), it also allows

for consideration of 'social public interests' and 'public order'.

AmCham China, AmCham Shanghai, and the U.S. Chamber of Commerce have cautiously welcomed components of the FIL, including its grant of national treatment to foreign investments not on the negative list. However, they have expressed concern about the potential breadth of China's national security review powers, emphasising that the review process should not extend to areas beyond national security, such as national interest, social stability, economic security, or industrial security. In addition, AmCham China and other groups have voiced concern regarding the lack of guarantees with respect to confidentiality and the bifurcation of the market entry and national security review processes, which could result in duplication of the national security review process.

Separately, on 8 May 2015, the State Council issued *Tentative Measures for the National Security Review of Foreign Investment in the Free Trade Zones* (the 'FTZ NSR Circular')¹¹ to apply to foreign investments in all four FTZs. According to the FTZ NSR Circular, a committee comprised of representatives from the National Development Reform Commission ('NDRC'), MOFCOM, and other relevant agencies will also conduct national security reviews of foreign investment in the FTZs. The new regime in the FTZs expands on the current 2011 NSR Rules by requiring a national security review of foreign investments in the following industries: defence, agricultural products, energy and natural resources, infrastructure, transportation services, important culture (newly added), important information technology products and services (newly added), and equipment manufacturing enterprises.

Other national security initiatives

China's recent consideration of a series of national security-related laws, including the National Security Law,¹² the Cybersecurity Law,¹³ the Counterterrorism Law,¹⁴ and the Administration of Foreign Non-Governmental Organizations Law ('NGO Law'),¹⁵ has enhanced concerns about proclaimed national security issues impeding foreign investment. The National Security Law, which

became effective on 1 July 2015, states that its purpose is to '...defend the people's democratic and political power and the socialist system with Chinese characteristics, protect the fundamental interests of the people,

The bilateral investment treaty can be a tool for assuring U.S. investors that China's recently renewed national security focus will not foreclose foreign investment.

ensure the smooth process of reform and opening up to the outside world and the modernisation of socialism, and achieve the great rejuvenation of the Chinese nation'. The law defines 'national security' broadly as 'ensuring that the country's political authority, sovereignty, national unification, territorial integrity, people's welfare, the sustainable development of the economy and society, and other significant national interests are not subject to danger, internal or external threats, and can be guaranteed continued security'. Of particular concern to many is the law's promotion of 'indigenous innovation', as well as its stated goal of maintaining 'secure and controllable' information networks, infrastructure, and systems, which could be interpreted as renewed efforts to block foreign investment, especially in the information technology sector.

Furthermore, China released a draft Cybersecurity Law on 6 July 2015, which, among other objectives, seeks to 'safeguard cybersecurity and maintain cyberspace sovereignty, national security and the social public interests'. The draft law explicitly allows Chinese authorities to cut Internet access during public security emergencies, and requires government agencies to set up cybersecurity monitoring and alert systems and emergency-response measures. Foreign businesses have expressed concern about the impact of this law, especially in the context of other national security-related laws being considered in China.

In addition, China is considering the draft NGO Law, which would require foreign NGOs to register in China and

be sponsored by a government organisation. The draft law's broad definition of 'a foreign NGO' ('social organisations that are non-profit and non-governmental, which are established abroad') could potentially capture the activities of trade associations, overseas chambers of commerce, and professional associations. In June, over 40 U.S. business and professional groups signed a letter to the Chinese government expressing concerns that the law would restrict their activities and damage U.S.-China relations. The European Chamber of Commerce in China also expressed concern regarding the administrative burden of the proposed law and its impact.

In early 2015, due to widespread criticism, the China Banking Regulatory Commission ('CBRC') suspended previously-issued guidance requiring Chinese financial institutions to ensure at least 75% of their information technology infrastructure used 'safe and controllable' products and services by the end of 2019. Many interpreted this provision, in conjunction with other requirements, to mandate the use of Chinese-developed products and services. China has also reportedly pledged to remove discriminatory provisions against foreign firms from the banking regulations, as part of the commitments made at the 2015 U.S.-China Strategic and Economic Dialogue ('S&ED').¹⁶

In March 2015, in the face of strong opposition and direct criticism from President Obama, the Chinese government put on hold its draft Counterterrorism Law, which would have required foreign technology firms to provide Chinese authorities with access to computers and information networks, as well as encryption keys and source code, among other requirements.

Potential for the U.S.-China BIT to improve prospects for foreign investment

Against the backdrop of China's FIL and national security initiatives are a number of recent political and economic events, including instability in China's financial markets, the devaluation of the renminbi, the recent cybersecurity agreement between the United States and China, and the even more recent Trans-Pacific Partnership ('TPP') deal. In relation to these events,

Links and notes

¹ Daniel H. Rosen and Thilo Hanemann, *New Realities in the US-China Investment Relations*, Rhodium Group-US Chamber of Commerce (April 2014), available at https://www.uschamber.com/sites/default/files/documents/files/RHG_New%20Realities_29April2014.pdf.

² Id.

³ Michael V. Seitzinger, *Foreign Investment in the United States: Major Federal Statutory Restrictions*, Cong. Research Serv., June 17, 2013, available at <https://www.fas.org/sgp/crs/misc/RL33103.pdf>.

⁴ See, e.g., *General Agreement on Tariffs and Trade (GATT)*, Art. XXI; *General Agreement on Trade in Services (GATS)*, Art. XIVbis; 2012 U.S. Model Bilateral Investment Treaty, Art. 18.

⁵ 50 U.S.C. App. 2170 (d)(1).

⁶ CFIUS, *Annual Report to Congress CY 2013*, issued Feb. 2015, <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2014%20CFIUS%20Annual%20Report%20for%20Public%20Release.pdf>

⁷ For a copy of the most updated Foreign Investment Guidance Catalogue issued in March 2015, see <http://www.sdp.gov.cn/zcfb/zcfbl/201503/W021501402620481787669.pdf>.

⁸ State Council, *Circular on the Establishment of a Security Review Process for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, March 2011, available at http://www.gov.cn/zwqg/2011-02/12/content_1802467.htm.

⁹ Ministry of Commerce (MOFCOM), *Implementing Rules Regarding the Security Review Process for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, Sept. 2011, available at <http://www.mofcom.gov.cn/aarticle/b/c/201108/20110807713530.html>.

¹⁰ For a copy of the Chinese language version of the draft FIL issued on January 19, 2015, see <http://www.mofcom.gov.cn/article/ae/ag/201501/20150100871007.shtm>.

¹¹ State Council, *Tentative Measures for the National Security Review of Foreign Investment in the Free Trade Zones*, May 2015, available at <http://www.china-shftz.gov.cn/PublicInformation.aspx?GID=26c11407-27be-4ee2-88de-2976aff0e251&CID=953a259a-1544-4d72-be6a-264677089690&MenuType=1>.

¹² National Security Law, available at

http://www.npc.gov.cn/npc/xinwen/2015-07/07/content_1941161.htm

¹³ Cybersecurity Law (reading draft), available at http://www.npc.gov.cn/npc/xinwen/fgz/fica/2015-07/06/content_1940614.htm

¹⁴ Counterterrorism Law (Second Reading Draft), available at: http://www.npc.gov.cn/npc/xinwen/2015-02/27/content_1906005.htm.

¹⁵ Administration of Foreign Non-Governmental Organizations (Second Reading Draft), available at http://www.npc.gov.cn/npc/xinwen/fgz/fica/2015-05/05/content_1935666.htm.

¹⁶ 2015 U.S.-China Strategic and Economic Dialogue U.S. Fact Sheet – Economic Track, June 25, 2015, available at <http://www.treasury.gov/press-center/press-releases/Pages/j10094.aspx>; U.S., *China Agree to Exchange New BIT Negative Lists by September*, Inside U.S. Trade, June 25, 2015.

¹⁷ The 2012 U.S. model BIT is available at: <http://www.state.gov/documents/organization/188371.pdf>.

¹⁸ See Press Release, U.S. Dep't of Treasury, *U.S. and China Breakthrough Announcement on the Bilateral Investment Treaty Negotiations*, 15 July 2013: <http://www.treasury.gov/connect/blog/Pages/U.S.-and-China-Breakthrough-Announcement.aspx>.

¹⁹ U.S., *China Exchange Improved 'Negative-List' Offers at 21st BIT Round*, Inside U.S. Trade, 17 September 2015.

²⁰ Froman Says China's Latest BIT Offer Insufficient; Seeks Progress at Xi Visit, Inside U.S. Trade, 24 September 2015

²¹ China Agrees Not to Engage in Cybertheft of Trade Secrets, Following Xi Visit, Inside U.S. Trade, 1 October, 2015.

²² CFIUS, *Annual Report to Congress CY 2012*, issued Dec. 2013, <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2013%20CFIUS%20Annual%20Report%20PUBLIC.pdf>. See also CFIUS, *Annual Report to Congress CY 2013*, issued Feb. 2015, <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2014%20CFIUS%20Annual%20Report%20for%20Public%20Release.pdf>.

²³ Id.

²⁴ U.S., *China Agree to Exchange New BIT Negative Lists by September*, Inside U.S. Trade, 25 June 2015.

the ongoing negotiations between China and the United States to establish a BIT provide an avenue for engagement between the two countries, both economically and politically. China and the United States have been engaged in BIT negotiations since 2008. The two countries have experienced significant roadblocks along the way, including the election of President Obama, who until recently had prioritised other initiatives. As China moves forward with the FIL and other national security laws, the BIT can be a tool for assuring U.S. investors that China's recently renewed national security focus will not foreclose foreign investment. The BIT can also be an avenue for the U.S. government to assuage Chinese concerns that it is unfairly targeted in the CFIUS process with respect to investment in the U.S. market.

Overview of the substantive disciplines in the BIT

As a general matter, a BIT is a reciprocal, international agreement regarding how nations should treat foreign investment. A country's model BIT is usually the text that forms the starting point for negotiations. However, the BIT negotiation process is dynamic and unique to each trading partner. As a result, the provisions of any given BIT can vary depending on the parties involved.

The United States negotiates BITs on the basis of a 2012 model text ('U.S. Model BIT'),¹⁷ which focuses on protecting U.S. investments abroad. Up until the 1990s, China's BITs were characterised by limited protections for foreign investors. However, recent Chinese BITs contain many of the standard provisions found in global BIT practice, including the foundational disciplines of non-discriminatory and minimum standard of treatment.

The non-discrimination principle is a fundamental component to BITs, providing that the host nation will not discriminate against foreign investment. The standards of non-discriminatory treatment most commonly included in BITs are national treatment and most-favoured-nation ('MFN') treatment. National treatment requires that, in 'like' circumstances, each party treat investors of the other party no less favourably than its own investors. MFN treatment similarly requires that, in

'like' circumstances, each party treats investors of the other party no less favourably than investors from third countries. In addition, BITs usually require that the host nation accord covered foreign investments 'fair and equitable treatment' (e.g., due process protections), as well as 'full protection and security' or equivalent standards (e.g., the level of police protection for foreign investments that is required under customary international law), as the minimum standard of treatment. This minimum standard of treatment is an absolute standard, governing how a host nation must treat foreign investments regardless of how the host nation treats its own nationals or other third-party investments.

In addition, most BITs include provisions on expropriation, free transfers, and investor-state dispute settlement procedures, among other protections. Also relevant to countries' national security interests is the possible inclusion of security and prudential exceptions in the core text of a BIT. Such exceptions allow the parties to apply measures necessary for the protection of its 'essential security interests', as well as measures relating to financial services for 'prudential reasons', such as for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system.

BITs may address market access commitments through the use of a 'negative list' approach or a 'positive list' approach. With a 'negative list' approach, countries specifically carve out sectors for which they will restrict foreign investment. Alternatively, a 'positive list' approach specifies only those sectors for which countries are willing to make investment liberalisation commitments, leaving the remainder closed to foreign investment. In addition, the United States usually favours the 'pre-establishment' model in its BITs, which prevents host countries from discriminating against foreign investment during the stages leading up to the actual investment, such as by imposing an outright quota limiting FDI in covered sectors.

Recent developments in U.S.-China BIT negotiations

While the negotiations are confidential, it is expected that the U.S.-China BIT

core text will include many, if not all, of the substantive disciplines discussed above. Moreover, at the July 2013 S&ED, the U.S. government touted as a significant breakthrough commitments made by China that it would negotiate the U.S.-China BIT using a ‘negative list’ approach, and would commit to protections in all stages of investment pursuant to the ‘pre-establishment’ model.¹⁸

While discussions on the core text are ongoing, the United States and China finally exchanged their initial “negative list” offers during the 19th round (June 8-12, 2015) of negotiations. During the most recent 21st negotiating round in early September 2015, the United States and China exchanged revised negative list offers.¹⁹ Reports in the trade press and reactions from experts familiar with the negotiations have indicated that while China’s negative list improved in the most recent negotiating round, it still contains a long list of industries or sectors that will be excluded from China’s investment liberalisation commitments.²⁰ Both countries agreed to ‘intensify negotiations’ during President Xi’s recent U.S. visit, although many experts predict that negotiations may extend beyond 2016.²¹

Balancing security interests with investment liberalisation

China’s overall record on encouraging and protecting foreign investments has been mixed. On the one hand, it has shown a willingness to adopt a negative list approach to investment, including with respect to the BIT negotiations with the United States. On the other hand, it has still included a significant number of industries, which are either forbidden or restricted to foreign investors, on the negative list applicable to the FTZs. The Chinese

government has not yet released the negative list that will apply under the FIL or the *Opinion on Implementing the Negative List for Market Entry*, nor has it explained how it will align with the negative lists applicable to the FTZs currently in place. Moreover, China may restrict foreign investment through a more extensive national security review process. These factors have resulted in uncertainty and scepticism regarding China’s overall commitment to investment liberalisation.

The United States has similarly drawn criticism from China for the opacity and politicisation of the CFIUS review process. In 2012 and 2013, more investments from China underwent CFIUS review than from any other country.²² For China, the number of CFIUS reviews from 2010 to 2013 has nearly quadrupled, which may be interpreted to represent growing acquiescence among Chinese companies that they must submit to the U.S. national security process.²³ China has also complained that the investment climate in the United States has been quite negative for Chinese firms. In this regard, Chinese government officials have cited U.S. investment restrictions in the infrastructure and financial sectors as one of the main barriers for Chinese investors.²⁴

For the U.S.-China BIT negotiations to conclude successfully, both the United States and China must seek to strike the right balance between their national security interests and commitments to investment liberalisation. First, both countries should present strong negative list offers and limit the sectors that are carved out from the BIT disciplines to only those that are considered critical infrastructure, or truly implicate national security interests (e.g.,

defence, emergency services). In addition, economic interests should not be conflated with security interests, and any security or prudential-related exceptions should be narrowly crafted.

Overall, the BIT offers an opportunity at the highest levels for U.S. and Chinese officials to chart the economic relationship of the two countries for the future. Ongoing dialogue will be especially important as the United States moves forward with finalising the historic TPP trade deal, which includes many countries in Asia, but not China. For the United States, increased Chinese investment will translate, in many cases, into economic growth and job promotion. In China, increased U.S. investment will lead to the development of higher value-added products and services and technical expertise. To achieve their economic goals, both countries must be willing to make commitments to ensure an open, transparent and predictable investment environment. While market access should not translate into an abdication of national security interest, both countries should view circumspectly the efforts of the other to invoke these grounds to foreclose investment, and focus instead on ways to move their relationship forward for reciprocal benefits.

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