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Dilemma and Countermeasures to National Security Review in M&A by Chinese Companies in the US

Wenbo Zhao[1,a,*]

[1]*University of Leeds, Leeds LS2 9JT, UK*
a. Lw21wz@leeds.ac.uk
**corresponding author*

Abstract: The national security review is an inescapable area for foreign investors to invest in the US. In recent years, the number of CFIUS reviews of cross-border mergers and acquisitions has been on the rise, as well as the number of vetoes, reflecting concerns that the US may lose its global leadership. At a time when competition between the US, and China is intensifying, CFIUS has shown a natural hostility towards Chinese investors, and the situation for Chinese companies in the US is not promising, with a higher rate of failed M&A than in other countries. This has seriously impacted Chinese direct investment in the US. This paper suggests that the reasons for this problem are twofold. On the one hand, there is the deviant treatment of Chinese companies by CFIUS. On the other hand, Chinese companies have their reasons for failing to enter the US including the fact that most of their acquisitions occur in sensitive areas involving national security and ignoring the CFIUS review process. Based on this, this paper argues that Chinese companies should not only formulate a clear M&A strategy before the M&A process but also take the initiative to negotiate with CFIUS and seek judicial remedies when necessary.

Keywords: national security, Chinese enterprises, CFIUS

1. Introduction

The United States is a major country for Chinese companies to implement overseas mergers and acquisitions. As the country with the highest level of economic development and the highest degree of economic openness in the world, it has an open and free competitive market environment, a sound legal system, sound infrastructure conditions, and relatively lax economic regulations. The US has been the largest recipient of foreign investment. However, out of concern for its global leadership, the US has established a strict national security review system. China is the second largest outward investor in the world. Investment in the US involves nearly 20 industries, with the financial sector, manufacturing, information transmission/software, and information technology services ranking in the top three, accounting for 60% of direct investment in the US. As a result, China has received additional attention from CFIUS, and the latest FIRRMA legislation lists China as a special country requiring special scrutiny for China-related mergers and acquisitions. Scholars have different views on the debate on this issue. Some scholars see it as more of a reflection of US political concerns and the use of CFIUS as a tool to achieve political goals. The unilateral expansion of the national security review could ultimately undermine the US's ability to attract foreign investment [1-2]. Some scholars argue that Chinese companies - especially state-owned enterprises - have too many political factors

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and are unduly subsidized by the government and that such companies are prone to unfair competition in mergers and acquisitions [3]. In addition, some scholars argue that although CUIFS imposes severe restrictions on China, Chinese companies are able to enter the US market through appropriate methods [4]. Given this, this paper prefers the last view. The first part of this paper will briefly describe the US regulations on national security and the particular tendencies towards Chinese companies. The second part summarizes the problems for three reasons, the first of which is the misuse of national security by CFIUS to marginalize Chinese companies. The second reason is that Chinese companies lack a clear M&A strategy and habitually invest in projects that are related to national security areas. The third is the lack of proper understanding by Chinese companies of the CFIUS review process. The third part gives the corresponding countermeasures according to the reasons why the problems arise.

2. The M&A Dilemma for Chinese Companies Entering the US Market

The United States introduced a national security assessment mechanism for foreign investment as the first nation in the world. President Ford established the Committee on Foreign Investment in the United States (CFIUS), a special agency for national security review, in 1975 by signing Executive Order No. 11858. CFIUS was directly appointed by the President to evaluate and review foreign investment in the United States. To better implement the national security review system, the US passed the Exon-Florio Amendment. The Act gives the President of the United States the power to look into foreign takeovers of US companies and mergers from the standpoint of national security and, if necessary, to halt such transactions. Subsequently, the FINSA Amendment was passed on the basis of the Exon-Florio Amendment. The national security clearance process for foreign acquisitions in the US has gotten more demanding as a result of new trade protectionist policies. With the gradual increase of CFIUS on the number of national security reviews. Investors from China have already felt the most profound negative impact. According to CFIUS statistics, from 2015 to 2017, CFIUS reviewed 552 cases in the name of national security, including 143 cases from China, which is almost twice as many as Canada, which is in second place [5]. Due to mounting worries about Chinese investment in the US, Congress enacted the FIRRMA Amendment on August 13, 2018. It has been argued that the main purpose of the Act is to restrict Chinese companies' access to U.S. high technology through mergers and acquisitions, and as a response to the Made in China 2025 initiative. Since the passage of the FIRRMA, Chinese investment activity in the U.S. has declined significantly, with the U.S.-China Investment Project reporting that, following the FIRRMA, Venture capital from China falls by almost half in 2019 [6]. Clearly, the number one obstacle to Chinese companies going to the U.S. for M&A is the national security review from CFIUS.

3. Reasons for the High Failure Rate of Chinese Companies in M&A

3.1. CFIUS Abuses the Name of National Security to Boycott Chinese Companies

Concerns about the potential national security implications of foreign government-controlled enterprises date back to the 1992 Byrd Amendment. The amendment subjected all foreign transactions involving foreign government-owned or controlled entities that could jeopardize national security to a more stringent review process. This vague provision was carried over into the subsequent FISNA and FIRRMA Acts [7]. However, the legislator did not give a clear criterion as to the extent to which an enterprise constitutes control by a foreign government. Chinese SOEs have typically been regarded as being under the control of or operating on behalf of the Chinese government by CFIUS and the US President. They contend that rather than being driven by economic interests, SOEs are frequently motivated by acquisitions to further the strategic goals of the Chinese government. [8]. For example, in the case of CNOOC's acquisition of Unocal. CNOOC's national

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background raised concerns with CFIUS. Congress and senators believe that the Chinese government owns 70% of the shares of CNOOC's parent company, and a large part of the acquisition will be funded by banks owned by the Chinese government. Unocal's strategic assets will therefore be allocated to China by the Chinese government as a matter of priority. [9]. Along with this skepticism, CFIUS deemed the merger to jeopardize the national energy security of the United States and as a result, CNOOC was forced to withdraw from the deal. The problem is that Unocal is a relatively small role in the world oil and gas field, and it is difficult to be regarded as a part of strategic assets. Even if this merger and acquisition are successfully completed, CNOOC Unocal after the merger will not be able to shake the position of other energy giants. The natural gas output of the new company will account for about 1% of the US consumption, and the oil output will be equivalent to 0.3% of the US domestic consumption, which seems insufficient to threaten national security. [9] However, in the name of national security, the administration neither provides an explanation process nor gives the affected investors an opportunity to rebut [4]. In the absence of regulation and countermeasures, CFIUS can exercise its powers without restriction as long as it relies on the banner of national security.

In addition, the CFIUS determination of SOEs is not limited to traditional SOEs. In practice, the appointment of SOE management by the Chinese government, the close relationship between the head of the company and the government, and the government's financial support to the SOE are all considered evidence that the company is "controlled" by the government [3]. As a result, the US believes that large private enterprises in China are likely to be influenced by political party organizations and state intervention. In May 2010, Huawei wanted to invest in the acquisition of the core assets of 3Leaf in the United States. The Department of Commerce's Bureau of Industry and Security first gave permission for Huawei to buy and export 3Leaf technologies, assuring Huawei that no license was needed for this transaction. But after the merger closed, CFIUS made the decision to step in and investigate the deal's potential effects on national security. In this case, CFIUS is convinced that Huawei has strong ties to the Chinese government. Even more, CFIUS believes Huawei may be controlled by the government, as the military background of Huawei's founder leads CFIUS to believe that the company has close ties to the military [1]. The result of the case is that CFIUS overturned the license from the Ministry of Commerce and forced Huawei to divest its previously purchased assets. This shows that although the transaction has been approved by the relevant authorities, CFIUS can still conduct post-review in the name of national security. There is no doubt that this will increase the uncertainty of Chinese enterprises in the process of M&A.

3.2. Chinese Companies Mostly Acquire Sensitive Sectors

Early acquisitions by Chinese companies in the US were mainly focused on some infrastructure sectors such as energy. The Exon-Florio Amendment first designated these two industries as national security ones, and soon after that, FINSA broadened the definition of national security to include more industries. The concept of national security was deemed to include homeland security and the introduction of the concepts of critical infrastructure and critical technology further restricted the areas of investment in the US and strengthened the regulation of foreign investment in the US. The latest FIRRMA amendment also expands CFIUS's authority to review transactions involving critical technology [10]. The first is to bring mergers and acquisitions with companies with critical technologies within the scope of review. Transactions involving the control of critical technology businesses are subject to stricter regulation under FINSA. However, under the FIRRMA, collaborations with other companies are subject to CFIUS review even if they do not meet the control standard. FIRRMA includes all technologies and related items that are important to national security or are considered important by the U.S. to be subject to jurisdictional transactions. At the same time, FIRRMA links emerging technologies to countries of special interest. As long as an M&A transaction

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can enable countries with special concerns to maintain or expand other emerging technologies that are critical to their technological advantages, or gain advantages in areas where such countries do not yet have technological advantages. CFIUS has the right to prevent this transaction, which may be deemed to damage the advantages of the United States in this technology or industry [11]. However, the general concept of "technology deemed important by the United States" signifies that CFIUS may review any transaction involving that technology. Even products or technologies that are not subject to export or transfer restrictions under current laws are included in the jurisdiction of CFIUS [2]. According to the U.S. Treasury Department's 2021 CFIUS Annual Report. The Finance, Information, and Services sector accounted for 40% of the 726 cases subject to CFIUS review from 2012 to 2021, while the Manufacturing sector accounted for 38% of the 691 cases. The Mining, Utilities Construction sectors and the Wholesale Trade, Retail Trade, and Transportation sectors have 257 (14%) and 149 (8%) numbers and percentages respectively [12]. The largest share of Chinese investment in the US in 2020 will be in manufacturing and Finance, Information and Services, with 29,3% and 27.2% respectively [13]. This shows that there is a high degree of overlap between the areas of Chinese M&A investment in the US and sectors that the US fears could endanger national security. Many of the Chinese transactions investigated or blocked by CFIUS are related to the high-tech or energy sectors. The previously mentioned CNOOC acquisition of Unocal involved the oil-related energy sector and Unocal's possession of critical technologies for deep-sea exploration and drilling. Similarly, in the Huawei acquisition of the 3Leaf case, which was deemed to potentially jeopardize US cyber security. President Trump's 2017 ban on Canyon Bridge, which has Chinese capital, from merging with US-based Lattice was over concerns about the transfer of semiconductor technology. In 2018 President Trump moved to block Broadcom's acquisition of Qualcomm, which, if completed, would have been the largest semiconductor technology acquisition ever [2]. Chinese investment in the US is disproportionately concentrated in critical technologies and energy sectors, causing the US to fear losing its technological edge. To maintain US world leadership in high technology, Chinese companies investing in critical US technologies will inevitably be targeted by CFIUS. To maintain the world-leading position of the United States in the field of high and new technology. Chinese enterprises' investment in critical technology fields will inevitably cause CFIUS to target.

In addition to the traditional review in the area of national security, the FIRRMA amendments expand the jurisdiction of CFIUS by adding a new provision on real estate transactions. The purchase or lease by foreigners of personal or state-owned government equipment or assets located close to military facilities or related to national security and other real estate as defined by CFIUS is subject to national security review [14]. Concerns about real estate transactions near military facilities have been reflected in the case of Ralls' acquisition of the Terna US wind power project [15]. In August 2010, Sany Group incorporated Ralls in the United States, which is an affiliated enterprise of Sany Group to carry out wind power investment and construction in the United States. Ralls acquired four wind farm projects in Oregon near a naval base from the Greek firm Terna US in March 2012 and secured all necessary permits and clearances for the project's construction. However, in August 2012, CFIUS asked Ralls to suspend all construction and construction projects because the four wind farms were located close to the US military restricted zone and were suspected of threatening national security. If it is only from the perspective that foreign governments may control transactions, CFIUS' decision has set up a solid barrier to US national security, but in this case, Terna has been acquired by a listed company in Greece. The problem lies in why Greek companies can acquire Terna unimpeded, while Ralls was reviewed by CFIUS and even became the first merger rejected by presidential decree. In addition to citing widespread concerns about "national security", the US government refused to disclose the basis of its concerns.

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CFIUS' strict restrictions on information disclosure also raised concerns about the objectivity of its judgment. With a cash value of $15.1 billion, CFIUS authorized CNOOC's acquisition of Canadian oil producer Nexen in July 2012. One of the oil fields was less than 50 miles from the Navy reserve base and submarine cable, but it still passed the CFIUS review [4]. These two transactions show a high degree of similarity, but one has passed the review of CFIUS and the other has not. This conflict has not been resolved in FIRRMA. FIRRMA does not clearly define the concept of nearly close but leaves the right to define the concept to CFIUS. CFIUS may deem it sensitive to buy or rent undeveloped land or non-military facilities adjacent to military bases. It is difficult to regard CNOOC's M&A as a success when CFIUS has extensive discretion. The only thing that can be understood is that the new provisions on real estate transactions in the FIRRMA amendment will make future transactions related to critical infrastructure more difficult.

3.3. Lack of Awareness of CFIUS Review Process among Chinese Companies

The CFIUS review process can be initiated by the acquirer's voluntary declaration or CFIUS's notification to the acquirer. Although foreign investors are not obliged to report to CFIUS when initiating mergers and acquisitions, it is clear that voluntary declaration helps reduce the concerns of CFIUS and members of Congress. If the parties concerned fail to make a declaration, the chairman of CFIUS has the right to ask both parties of the merger and acquisition case to provide relevant documents. In addition, as long as any one of the institutions constituting CFIUS raises doubts that the transaction case may cause potential national security risks, or thinks that it should be reviewed by CFIUS, the institution can request CFIUS to review the transactions that have not been voluntarily declared. CFIUS review traditionally lasts 90 days, including 30 days of the preliminary review, 45 days of investment, and 15 days of a presidential decision. FIRRMA extended the review time limit to 120 days for the first time, including 45 days of the preliminary review, 60 days of investigation, and 15 days of a presidential decision [14]. FIRRMA extended the time limit for national security review because cross-border M&A transactions are too complex. The 120-day period can enable CFIUS to conduct a more detailed review to ensure national security to the greatest extent. The 120-day period is a double-edged sword for enterprises. The advantage is that enterprises have more time to dispel CFIUS' doubts during the investigation process. The disadvantage is that longer time will increase the investment cost of enterprises and make them more prone to passivity. In addition, FIRRMA has added a mandatory declaration procedure. For transactions that foreign governments may obtain substantial benefits or involve critical technologies, they should submit a mandatory declaration 30 days before the transaction completion date, otherwise, they may face a maximum penalty equal to the proposed transaction amount [16]. Among them, "substantial interests" is defined as the direct or indirect voting rights of 25% or more in the US TID (technology, infrastructure, data) enterprise that the foreign investment entity can obtain through this transaction. The "foreign government" holds 49% or more direct or indirect voting rights in the foreign investment entity. However, the critical technology has not made a clear concept but is simply summarized by listing 27 related industries. CFIUS still reserves the discretion on the concept of critical technology.

When conducting overseas M&A cases, some Chinese enterprises think that their business activities will not threaten the security of the United States, so they also think that they will not be examined by the CFIUS agency of the United States. This kind of blind arrogance is a misunderstanding. Ralls is a typical case where the transaction is reviewed after the transaction is completed due to the failure to actively declare. After receiving the report from the US Department of Defense, CFIUS reminded Rolls Royce and asked the latter to declare its transaction. After that, Ralls submitted materials related to the transaction, which led to CFIUS's bad impression of it, and Ralls was in a passive position at the beginning of the review. In addition, in Huawei's acquisition of 3leaf, Huawei also did not report the acquisition to CFIUS in advance, which led CFIUS to think that

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Huawei had the motivation to bypass the review, so it increased the security review of the acquisition [3]. To sum up, CFIUS holds the initiative in the face of national security review. Under FIRRMA, mergers and acquisitions in almost all fields may be challenged by CFIUS, and it is difficult for the reviewed objects to realize whether they are involved in the field of national security before mergers and acquisitions - CFIUS does not provide a clear feedback channel. In addition, a longer review cycle will add a greater burden to enterprises in terms of capital and reputation. Therefore, for Chinese enterprises going to the United States for M&A, it is very necessary to negotiate with CFIUS in advance.

4. Suggestions for Companies to Get Out of Dilemmas

4.1. Make a Clear Strategy Before M & A

Mergers and acquisitions by Chinese enterprises in the United States are often subject to strict scrutiny. These M&A transactions are considered not to be based on commercial interests, but to achieve the strategic objectives of the Chinese government [9]. The U.S. Congress is more determined than ever to take action against Chinese businesses. In November 2016, one of the recommendations in the report issued by an expert group in charge of security and trade relations is that Chinese state-owned enterprises should be prohibited from making any investment in the United States [17]. This report shows the resistance of Congress to state-owned enterprises. Therefore, for state-owned enterprises, it is necessary to reconsider how to reduce the proportion of state-owned shares to meet the requirements of CFIUS. For state-owned enterprises, it is a good way to gain the trust of CFIUS to improve the transparency of enterprises through public listing, hiring recognized auditors, and improving the level of enterprise information disclosure. This method can narrow the gap with non-state-owned enterprises in the success rate of mergers and acquisitions, and reduce the disadvantages of state-owned enterprises in solving the opacity [18]. In addition, State-owned enterprises can cooperate with private enterprises to establish mixed ownership enterprises, or cooperate with enterprises in the Excepted Foreign States in the FIRRMA Act to dilute the state-owned background by establishing joint ventures. For nonstate-owned enterprises, they should take the initiative to express their position and reject non-standard subsidies from the government. For example, in the case of Shuanghui's acquisition of Smithfield, the government did not give excessive substantive preferences, only the bank of China provided a syndicated loan worth 4 billion dollars to Shuanghui. with a syndicated loan worth $4 billion [19]. The interest rate of this loan is determined according to the market-oriented standard, and there is no possibility that it is suspected to be a low-interest loan by the United States, which not only provides financing facilities for Chinese enterprises but also avoids additional legal risks for Chinese enterprises.

When choosing projects, enterprises should not blindly look at the resources and technological advantages of the United States. Foreign investors can infer the list of industries that may involve national security factors by relying on relevant cases in CFIUS' National Security Review Practice for many years. According to the annual report of CFIUS, in the cases of national security review, finance, information, manufacturing, and minerals are the focus of CFIUS' attention [12]. These industries or businesses are sensitive to a certain extent and are vulnerable to special attention and strict review by CFIUS and the president. If the target company that a Chinese enterprise is trying to acquire involves the above industries, the possibility of the merger being reviewed and rejected is high. The failure of Ant financial acquisition of MoneyGram in 2017 is a typical case. The merger involves both the financial and information industries. CFIUS is worried that the personal data of American financial consumers will be used by Chinese companies and the Chinese government, endangering the financial security and information security of the United States. One of the major reasons for Shuanghui's successful acquisition of Smithfield is that Shuanghui chose the food

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processing field instead of the high-tech field. CFIUS does not consider food safety as a part of national security but considers it as economic security. At the same time, when acquiring real estate near critical infrastructure. Chinese enterprises should try their best to avoid acquiring such critical infrastructure or acquiring projects adjacent to critical infrastructure, otherwise, such mergers and acquisitions will cause CFIUS to focus on the review.

4.2. Using the Remedies in CFIUS

FIRRMA Act stipulates the mandatory declaration requirements for foreign governments to obtain "substantial benefits" transactions or transactions involving critical technologies. Almost all M&A fields may be turned into national security fields. Meanwhile, the review cycle of up to 120 days is also a new burden on enterprises. Therefore, after the Chinese enterprises have preliminarily negotiated with the target company and reached a consensus on M&A, both parties should fully consider whether the industry or field involved in M&A will cause national security risks. Even if the possibility of the risk is low, it should actively report to CFIUS and submit the required relevant materials. In addition, FIRRMA has created a new "declarations" procedure, which is a simple declaration with a wider scope, shorter (no more than 5 pages in length), lasting for 30 days, and not triggering the national security review [14]. It creates a "two-tier" declaration system for national security review along with the formal declaration procedure outlined under FINSA. If it passes the CFIUS review in the declaration procedure, a safe harbor will be formed, and the transaction will not be infected by CFIUS in the subsequent procedures. Even if it does not pass the declarations procedure, it will not directly trigger the formal review process. Before the formal declaration. The enterprise still has the opportunity to negotiate with CFIUS, to have a mental expectation of whether the transaction can be successfully realized. Enterprises should make full use of this procedure to dispel CFIUS' doubts before formal review or change their merger and acquisition plans as required to avoid falling into the formal review that lasts longer [20]. For example, TikTok acquired musical.ly did not report to CFIUS, and suffered a serious economic blow when it was sentenced to compulsory divestiture. If the declaration was made at that time, TikTok could continue to operate in the United States even if it did not pass the review, to avoid being reviewed afterward.

In addition to the above methods, entering into a mitigation agreement with CFIUS is also a possible way. Mitigation agreements refer to the addition of restrictions to the transaction prior to the finalization of the acquisition that further reduces the national security risk posed by the transaction. For example, the enterprise can divest the part related to national security or sign a contract to ensure that the information related to national security will not be disclosed. This agreement is usually signed within the 30-day preliminary review period, but it can also be signed within the 45-day formal investigation period. According to the annual report of CFIUS, A total of 31 transactions reviewed in 2021 involve mitigation agreements, accounting for about 11% of the total notifications in 2021. This data shows that companies conducting M&A in the United States lack awareness of the importance of mitigating agreements. A positive example is that Wanxiang, a Chinese auto parts company, reached a mitigation agreement with CFIUS when it acquired A123 systems, a US battery manufacturer, and sold the contract between A123 and the US military to Navitas systems, thus passing the review on national security [21]. If Wanxiang does not reach a mitigation agreement with CFIUS, the merge will likely be stopped by CFIUS because it involves military contracts.

4.3. Actively Seek Judicial Relief

Chinese enterprises' M&A transactions in the United States are often vetoed by CFIUS or the president, or they voluntarily terminate the transactions under various pressures. However, these enterprises seldom consider fighting back against the misconduct of the U.S. government and

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safeguarding their legitimate rights and interests through litigation or arbitration. The reason may be that the substantive review results of CFIUS and the presidential decisions made on the basis of CFIUS are exempt from judicial review [22]. This provision further restricts the investors' national security review relief channels. However, in addition to directly challenging the decisions made by CFIUS and the president, enterprises can request to protect their rights and interests through procedural review. In the Ralls case, Ralls was ruled unsuccessful in the first instance lawsuit, and the court held that the presidential decree was not subject to judicial review. In this regard, during the second trial, Ralls did not directly challenge President Obama's decision but focused on the company's due process interests [10]. Finally, the court ruled that because CFIUS did not share the non-confidential information that it relied on when it proposed to the president to block the transaction, Ralls' due process interests were infringed and the president and CFIUS were ruled unconstitutional.

5. Conclusion

This paper makes a brief analysis of the problem that Chinese enterprises are easy to be rejected by CFIUS in their M&A in the United States, and gives three possible solutions. The first is that Chinese enterprises should formulate a clear M&A strategy. First of all, they should recognize the rationality of CFIUS' bias against state-owned enterprises and reduce the proportion of state-owned equity using system reform or refuse nonstandard subsidies from the government. The second is to pay attention to the pre-procedure in the CFIUS review process and consult with CFIUS in advance, to eliminate the behavior of evading the review. The third is that even if they fail to pass the national security review, they should make full use of judicial relief procedures to safeguard their rights and interests. The purpose of this article is to summarize the failure and success factors of Chinese enterprises in M&A in the United States and to provide solutions to the national security problems in cross-border M&A.

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