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Foreign Direct Investment from China: Sense and Sensibility

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Foreign Direct Investment from China: Sense and Sensibility

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Abstract: Inspired by psychological studies on human judgment, this Article represents the first attempt to provide a systematic account of how various heuristics and cognitive biases can influence public perception as well as regulatory response to foreign direct investment. In particular, it catalogues the main social and cognitive mechanisms through which various well-organized interest groups can exploit public fear of foreign direct investment from China. By closely studying two examples—the U.S. Congress' hostile response to CNOOC's attempted acquisition of Unocal and the European Commission's increased antitrust scrutiny of Chinese state-owned enterprises' acquisitions in Europe—this Article shows how undue fear of Chinese investment can lead to counterproductive regulatory response. Contrary to the popular perception that Chinese state-owned enterprises are mere puppets of the government, this Article draws attention to the pervasive but neglected agency problems that have powered the surge of Chinese outward investment. It calls for more effortful thinking by Western policymakers and cautions against extreme precautionary measures for investment from China. At the same time, however, it questions the wisdom of overseas investment by Chinese state-owned enterprises. Empire building incentives, exacerbated by weak corporate governance structures and the lack of financial disclosure, make it highly likely that state assets are squandered in overseas acquisitions.

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I. INTRODUCTION

The meteoric rise of China has astonished the world. By any standard, China's economic performance over the past three decades has been impressive. Gross domestic product (GDP) has grown at an average of ten percent each year and hundreds of millions of people have been lifted out of poverty.[1] China is now the largest manufacturer, the largest exporter, and the second largest economy in the world.[2] Even if China grows a third as slowly in the future compared with its past, economists estimate that it will still surpass the United States in economic size by 2030.[3] In 2012, China boasted seventy-three companies on the Fortune 500 list, surpassing

[1] *See* WORLD BANK, CHINA 2030: BUILDING A MODERN, HARMONIOUS, AND CREATIVE HIGH-INCOME SOCIETY xv (2013), *available at* http://www.worldbank.org/en/news/feature/2012/02/27/china-2030-executive-summary.

[2] *Id.*

[3] *Id.*

Japan in number of multinational companies; it now ranks second on the global list, immediately behind the United States.[4]

While the West has described China as a "rising power," China sees itself as a "returning power."[5] As Henry Kissinger acutely observes, from the perspective of the Chinese, "[T]he prospect of a powerful China exercising influence in economic, cultural, political and military affairs" is only "a return to the normal state of affairs."[6] Indeed, China was one of the most advanced and powerful countries in the world before the modern era, but its influence declined precipitately with the ascendency of the West during the Industrial Revolution.[7] It is thus no surprise that the new Chinese leader Xi Jinping is now trumpeting a "great renaissance of the Chinese nation" to appeal to popular nationalistic sentiments.[8]

But this is not the way the West sees China. Indeed, the rise of China has inspired a mix of awe, fear, and skepticism. As observed by China expert Peter Nolan: "The over-riding sentiment in both Europe and the USA is fear."[9] The fear of China is pervasive and comprehensive: there is fear of its growing military clout,[10] fear of Chinese espionage and penetration,[11] fear that its trade dominance will weaken domestic manufacturing sectors and cause widespread unemployment,[12] fear of the secretive Chinese communist party,[13] fear of poor enforcement of product quality and safety standards for Chinese products,[14] and fear of the lack of protection for intellectual property rights.[15] The list goes on.

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[4] *Global 500,* FORTUNE, http://money.cnn.com/magazines/fortune/global500/ (last visited Apr. 13, 2014).

[5] HENRY KISSINGER, ON CHINA 546 (2012).

[6] *Id.*

[7] JUSTIN YIFU LIN, DEMYSTIFYING THE CHINESE ECONOMY 1 (2012).

[8] Jane Cai & Verna Yu, *Xi Jinping Outlines His Vision of 'Dream and Renaissance,'* S. CHINA MORNING POST (Mar. 18, 2013), http://www.scmp.com/news/china/article/1193273/xi-jinping-outlines-his-vision-chinas-dream-and-renaissance.

[9] PETER NOLAN, IS CHINA BUYING THE WORLD? 3 (2012).

[10] *See, e.g.*, OFFICE OF THE SEC'Y OF DEF., ANNUAL REPORT TO CONGRESS: MILITARY AND SECURITY DEVELOPMENTS INVOLVING THE PEOPLE'S REPUBLIC OF CHINA 2013 (2013), *available at* http://www.defense.gov/pubs/2013_china_report_final.pdf.

[11] *See, e.g.*, STEVE DEWEESE ET AL., CAPABILITY OF THE PEOPLE'S REPUBLIC OF CHINA TO CONDUCT CYBER WARFARE AND COMPUTER NETWORK EXPLOITATION (2009); *see also* OFFICE OF THE NAT'L COUNTERINTELLIGENCE EXEC., FOREIGN SPIES STEALING US ECONOMIC SECRETS IN CYBERSPACE: REPORT TO CONGRESS ON FOREIGN ECONOMIC COLLECTION AND INDUSTRIAL ESPIONAGE, 2009–2011 (2011).

[12] *See, e.g.*, ROBERT E. SCOTT, ECON. POLICY INST., THE CHINA TOLL (2012), *available at* http://www.epi.org/publication/bp345-china-growing-trade-deficit-cost/.

[13] *See, e.g.*, RICHARD MCGREGOR, THE PARTY: THE SECRET WORLD OF CHINA'S COMMUNIST RULERS (1st ed. 2010).

[14] *See, e.g.*, U.S.-CHINA ECON. & SEC. REVIEW COMM'N, THE NATIONAL SECURITY IMPLICATIONS OF INVESTMENTS AND PRODUCTS FROM THE PEOPLE'S REPUBLIC OF CHINA IN THE TELECOMMUNICATIONS SECTOR (2011).

[15] U.S. INT'L TRADE COMM'N, CHINA: INTELLECTUAL PROPERTY INFRINGEMENT, INDIGENOUS

Yet one of the biggest fears about China that has emerged in recent years is one of being "owned by China."[16] Since the financial crisis in 2008, the growing prowess of Chinese firms and their rapid expansion in mature markets has inflamed global fears that China is "taking over" the world. Such fear is amplified by the fact that foreign direct investment (FDI)[17] from China is dominated by state-owned or state-controlled enterprises (SOEs).[18] As Chinese SOEs are often perceived as mere puppets of their state master, speculation about the political motives of Chinese outward investment abounds. Accordingly, Western regulators are becoming increasingly concerned that Chinese investment constitutes a disruptive force in host economies.[19]

But the controversy about Chinese FDI hardly marks the first time that anxiety and opposition have been directed toward a foreign nation's investment activity. Indeed, FDI has been controversial from the start. Economists have debated its costs and benefits to host countries, politicians have wrangled over the economic and national security implications of foreign powers controlling domestic economies, and lawmakers have disagreed on how to optimally regulate FDI. While the literature on FDI is voluminous, this Article represents the first attempt to apply psychology in order to provide a systematic account of how various heuristics and cognitive biases can influence public perception as well as regulatory responses to FDI. It first traces the sources of undue fear of FDI and

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INNOVATION POLICIES, AND FRAMEWORKS FOR MEASURING THE EFFECTS ON THE U.S. ECONOMY (2010), *available* at http://www.usitc.gov/publications/332/pub4199.pdf.

[16] NOLAN, *supra* note 9, at 10.

[17] The concept of FDI is elusive. Traditionally it has been defined as the "ownership of assets in one country by residents of another for purposes of controlling the use of those assets." *See* EDWARD M. GRAHAM & PAUL R. KRUGMAN, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES 8 (3rd ed. 1995). In practice, however, the nationality of a firm is difficult to identify and the concept of what constitutes "control" is controversial. *See id.* at 8–10. For the purposes of this Article, FDI from China is defined generally as outward investment made by companies residing in China (excluding wholly foreign-owned enterprises) and their overseas subsidiaries. These Chinese investments can take the form of greenfield investment or acquisitions of more than 10% ownership interest in existing foreign companies. *See* discussion *infra* Part II.C.

[18] According to the official data by Chinese Ministry of Commerce (MOFCOM), SOEs accounted for more than 55% of total Chinese outward investment in the non-financial sector in 2011. *See* MOFCOM, NAT'L BUREAU OF STATISTICS OF PEOPLE'S REPUBLIC OF CHINA & STATE ADMIN. OF FOREIGN EXCH., 2011 STATISTICAL BULLETIN OF CHINA'S OUTWARD FOREIGN DIRECT INVESTMENT 11 (2012) [hereinafter 2011 STATISTICAL BULLETIN OF CHINA'S OUTWARD FDI].

[19] *See, e.g.*, ANDREW SZAMOSSZEGI, U.S.-CHINA ECON. & SEC. REVIEW COMM'N, AN ANALYSIS OF CHINESE INVESTMENTS IN THE U.S. ECONOMY 118 (2012), *available at* http://origin.www.uscc.gov/sites/default/files/Research/11-7-12_An_Analysis_of_Chinese_Investments_in_the_U.S._Economy(CTI).pdf ("These entities [SOEs] are potentially disruptive because they frequently respond to policies of the Chinese government, which is the ultimate beneficial owner of U.S. affiliates of China's SOEs. Likewise, the government behaves like an owner, providing overall direction to SOE investments, including encouragement on where to invest, in which industries, and to what ends.").

explores people's difficulties in assessing its risks, and then connects those difficulties to FDI regulations.

This methodology is by no means country specific. However, Chinese FDI provides a particularly intriguing context to study how heuristics and cognitive biases can lead to irrational policy response. For the past century, FDI has flowed almost exclusively from developed countries to developing countries. The influx of Chinese FDI to the Western world represents the first reversal of such a trend, a new phenomenon that neither the Western public nor regulators are familiar with. Unfamiliarity also entails much uncertainty as to the nature of the potential harm of Chinese investment and the likelihood of such harm occurring. When information is scarce, there is a tendency for people to rely on their intuition to make judgments. But overreliance on intuition can lead people astray in forming misconceived judgments.[20]

This Article does not argue that none of the fears about Chinese FDI are justified or that all Western response to Chinese FDI is irrational. In fact, it is perfectly rational for the Western public and regulators to have doubts about Chinese FDI. Even after several rounds of privatization reform, the Chinese government still retains a significant interest in a large portion of the Chinese economy. According to the latest estimate from a U.S. congressional report, SOEs account for more than 40% of China's non-agricultural GDP.[21] Although many of these Chinese SOEs have adopted a modern corporate governance structure and are listed on domestic and international stock exchanges, the Chinese Communist Party (CCP) continues to exercise control over the appointments of their leadership.[22] The political control over personnel, coupled with opaque governance structures (especially at the holding company level, where corporations are wholly owned by the government and thus not subject to public listing rules), cast a long shadow over the independence of Chinese SOEs.[23] Moreover, the Chinese government's recent campaign to actively encourage its domestic companies to "go global" further invites suspicion about the motivations of those Chinese SOEs pursuing overseas investment.[24]

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[20] CASS R. SUNSTEIN, RISK AND REASON: SAFETY, LAW AND THE ENVIRONMENT 49 (2004) [hereinafter SUNSTEIN, RISK AND REASON].

[21] *See* ANDREW SZAMOSSZEGI & COLE KYLE, U.S.-CHINA ECON. & SEC. REVIEW COMM'N, AN ANALYSIS OF STATE-OWNED ENTERPRISES AND STATE CAPITALISM IN CHINA (2011).

[22] Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 737 (2013); *see also* Hon S. Chan, *Cadre Personnel Management in China: The* Nomenklatura *System, 1990–1998*, 179 CHINA Q. 703 (2004).

[23] *See* Angela Huyue Zhang, *The Single-Entity Theory: An Antitrust Time Bomb for Chinese State-Owned Enterprises?*, 8 J. COMPETITION L. & ECON. 805, 815 (2012).

[24] In a recent speech to Chinese diplomats, former Prime Minister Wen Jiabao stated the following: "We should hasten the implementation of our 'going-out' strategy and combine the utilization of

But what skeptics often fail to realize is that no FDI is free of risk—any investment from foreign countries can pose potential political and economic risks to the host country. The crucial task is not only the identification of the possible risks, but also the evaluation of the magnitude of such risks and the likelihood that such risks will materialize. Regulators must consider both the benefits that Chinese FDI could bring and the potential costs of blocking such investment. Unfortunately, intuitive and emotional responses often trump careful cost and benefit analysis during policy debates. For Western regulators to make informed decisions about Chinese FDI, it is extremely important that they consider the typical scenarios where people overreact to Chinese FDI, as well as circumstances where undue fear of Chinese FDI is exploited by various social forces that ultimately lead to ineffective or even counterproductive regulatory responses.

The Article proceeds as follows. Part II identifies anomalies in perception about FDI and explores how various heuristics and biases can lead to undue fear of investment from China. Part III describes the social mechanisms through which various well-organized interest groups can promote, amplify, and exploit public fear of Chinese FDI to advance their own agendas. Part IV surveys FDI regulations in both the United States and Europe and explores how irrational thinking about Chinese FDI can lead to a counterproductive regulatory response. This part focuses on two representative examples: the U.S. Congress' hostile response to CNOOC's attempted acquisition of Unocal in 2005 and the recent European Commission's (the Commission) increased antitrust scrutiny of Chinese SOEs' acquisitions in Europe. Part V studies how agency problems at Chinese SOEs—which tend to be neglected or even ignored by Western regulators—have powered the surge of Chinese FDI. Part VI concludes with policy implications and final thoughts.

II. COGNITIVE BIAS, EMOTION, AND FDI

This Article was inspired by the work of Daniel Kahneman and Amos Tversky, two leading psychologists on human judgment. In 1974, Kahneman and Tversky published a path-breaking article in Science Magazine entitled *Judgment Under Uncertainty: Heuristics and Biases.*[25]

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foreign exchange reserves with the 'going out' of our enterprises." *See* Jamil Anderlini, *China to Deploy Foreign Reserves*, FIN. TIMES (July 21, 2009, 7:09 PM), http://www.ft.com/cms/s/0/b576ec86-761e-11de-9e59-00144feabdc0.html; *see also* Org. for Econ. Co-operation & Dev., *State Owned Enterprise in China: Reviewing the Evidence* (Occasional Paper, Jan. 26, 2009) (noting that the main goals of the "go global" strategy include enlarging global markets, exploiting natural resources abroad, attaining higher technologies, and enhancing the corporate brand values of Chinese enterprises).

[25] Daniel Kahneman & Amos Tversky, *Judgment Under Uncertainty: Heuristics and Biases*, 185

Their article shows that people often make decisions on the basis of heuristic devices (the simplifying shortcuts of intuitive thinking), which may work well in many circumstances but can also lead to systematic errors. The article was an instant success and has inspired scholars in many fields, including finance, law, statistics, and philosophy. Indeed, the past decade has seen increasing enthusiasm for the behavioral analysis of law in the United States.[26] One of the leading thinkers in this field is Cass Sunstein, who has made significant contributions in applying studies on heuristics and biases to the analysis of risk, regulation, and public policy.[27] Sunstein believes that biased reactions to risks are an important source of erratic and misplaced priorities in public policy.[28] In particular, he introduces a general framework for thinking about the precautionary measures adopted by regulators in reaction to irrational responses to risks.[29] He argues that such a framework is necessary as regulators can be prone to the same cognitive biases that affect wider publics, and because they may want to exploit public fear to advance political agendas.[30] Although Sunstein's work focuses on environmental, food, and security regulation, a similar framework of analysis can be applied to the study of FDI regulation and public policy. The fundamental task of FDI regulation for any country is to decide how to deal with the risks posed by FDI—essentially a matter of judgment under uncertainties.

Building on a vast body of literature on psychology, law, political science, and economics, this Article explores the underlying dynamics of fear of FDI. From time to time the rapid rise of FDI hits a nerve in host countries, triggering fear that foreign countries are taking over the economy. But too often, the public panic about the threat of FDI is based on rapid intuitive thinking, guided directly by people's impressions and feelings. This can lead them to form misconceived judgments about FDI. Moreover, when people are fearful of FDI, governments are likely to respond by tightening regulations. Furthermore, regulators themselves can also resort to intuitive thinking and overreact to FDI, especially when they

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SCIENCE 1124 (1974).

[26] *See, e.g.*, Christine M. Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); BEHAVIORAL LAW AND ECONOMICS (Cass R. Sunstein ed., 2000); CHRISTINE M. JOLLS, BEHAVIORAL ECONOMICS AND THE LAW (2010); *see also* Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1054 (2012). The authors compiled statistics documenting this phenomenon of increased legal academic interest in behavioral law and economics. *Id.*

[27] *See, e.g.*, CASS R. SUNSTEIN, LAWS OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE (2005) [hereinafter SUNSTEIN, LAWS OF FEAR]; CASS R. SUNSTEIN, WORST-CASE SCENARIOS (2007) [hereinafter SUNSTEIN, WORST-CASE SCENARIOS]; SUNSTEIN, RISK AND REASON, *supra* note 20.

[28] *See generally* SUNSTEIN, LAWS OF FEAR, *supra* note 27, at 13–106.

[29] *Id.* at 109–48.

[30] *Id.*

are confronted with a novel situation where the risks of FDI are difficult to assess. What the public and regulators often fail to realize, however, is that regulation can come at a dear cost, and can itself pose risks to economic health and national security. To avoid the self-defeating tendencies of undue fear, it is extremely important to identify how people's thinking about FDI can go wrong and how such errors can lead to ineffective and even counterproductive law and policy.

A. Dual Process of Mind

Abundant research in psychology has identified the existence of a dual process of mind.[31] Referring to processes similar to those traditionally called "intuition" and "reason," psychologists Keith Stanovich and Richard West label them as "System 1" and "System 2," respectively.[32] System 1 is rapid, automatic, and intuitive; it operates quickly and without much effort at self-control.[33] It is thus often prone to error.[34] System 2 is slow, deliberative, and calculative; it allocates attention to the effortful mental activities that demand it and is less prone to errors.[35] While System 1 proposes quick answers to problems of judgment, System 2 operates as a monitor that confirms or overrides those judgments.[36]

According to Kahneman, the core of System 1 thinking lies in associative memory, which continually constructs a coherent interpretation of the things that happen in our world.[37] Therefore, System 1 can operate as an associative machine—one that allows people to jump to conclusions. Kahneman's formula for this phenomenon is "what you see is all there is."[38] Moreover, because people are more sensitive to the strength of evidence than its weight, confidence is often determined by the coherence of the story rather than the quality or quantity of the evidence.[39] As such, people are far too willing to believe findings based on inadequate evidence

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[31] *See, e.g.*, Shelly Chaiken, *Heuristic Versus Systematic Information Processing and the Use of Source Versus Message Cues in Persuasion*, 39 J. PERSONALITY & SOC. PSYCHOL. 752 (1980); Daniel Kahneman & Shane Frederick, *Representatives Revisited: Attribute Substitution in Intuitive Judgment*, *in* HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 49, 51 (Thomas Gilovich, Dale Griffin & Daniel Kahneman eds., 2002).

[32] Keith E. Stanovich & Richard F. West, *Individual Differences in Reasoning: Implications for the Rationality Debate?*, 23 BEHAV. & BRAIN SCI. 645, 658–59 (2000).

[33] *Id.* at 658.

[34] *Id.* at 659.

[35] *See* SUNSTEIN, LAWS OF FEAR, *supra* note 27, at 68.

[36] *See* Kahneman & Frederick, *supra* note 31.

[37] DANIEL KAHNEMAN, THINKING, FAST AND SLOW 13 (2011).

[38] *Id.* at 86.

[39] *See generally* Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411 (1992).

and are prone to collect too few observations in making decisions. Furthermore, people tend to seek data and analyses that are likely to be compatible with their intuitive thinking and beliefs, which can contribute to confirmation basis.[40] This contrasts with System 2 thinking, which is in charge of doubting and disbelieving.[41]

One salient manifestation of System 1 thinking is the difficulty people have with statistical thought. People tend to solve inductive problems by the use of a variety of intuitive heuristics. Statistics, however, require people to make summary judgments of complex information. Accordingly, they tend to make errors when these heuristics diverge from the correct statistical approach.[42] In the context of FDI, public alarm is often caused by the impression of a sudden surge of foreign capital flowing into the domestic economy.[43] Such impressions are mostly formed on the basis of widespread media reports, particularly those reports that cite vivid examples of high-profile foreign takeovers and that warn of the dire consequences of a takeover of the domestic economy by foreign companies. System 1 thinking can thus operate as a mechanism for people to jump to the conclusion that FDI poses a threat to the host economy. Indeed, few would go the extra mile to conduct a statistical study in order to get the full picture of the FDI phenomenon. Such impulsive thinking dominated the American public perception of Japanese FDI three decades ago.

In the 1980s, a sudden surge of FDI into the United States was the subject of concern in Congress, the media, and academic circles. The public debate targeted Japan, which was accused of seeking global dominance. Japanese purchases of iconic American companies and luxury real estate, such as Columbia Pictures, the Empire State Building, Rockefeller Centre, and Pebble Beach Golf Course generated sensational headlines and evoked economic, socio-cultural, and political fears among the American public and regulators.[44] Americans began to fear that the Japanese were "taking over" the U.S. economy.[45] According to a 1988 public opinion survey conducted by the polling firm of Smick-Medley and

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[40] KAHNEMAN, *supra* note 37, at 81.

[41] *Id.*

[42] *See, e.g.*, Daniel Kahneman & Amos Tversky, *Subjective Probability: A Judgment of Representativeness*, 3 COGNITIVE PSYCHOL. 430 (1972); Daniel Kahneman & Amos Tversky, *On the Psychology of Prediction*, 80 PSYCHOL. REV. 237 (1973); Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207 (1973).

[43] EDWARD M. GRAHAM & DAVID M. MARCHICK, U.S. NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT 95 (2006).

[44] Wei He & Marjorie A. Lyles, *China's Outward Foreign Direct Investment*, 51 BUS. HORIZON 485, 486 (2008).

[45] C.S. Eliot Kang, *U.S. Politics and Greater Regulation of Inward Foreign Direct Investment*, 51 INT'L ORG. 301, 317 (1997).

Associates, 73% of respondents believed the Japanese invested the most in the United States, while only 3% believed the British did.[46] This fear of Japanese expansion into the United States was epitomized by public furor against Fujitsu's 1986 bid for Fairchild Semiconductor, a leading American computer chip firm. U.S. regulators viewed this acquisition as an attempt by Japanese companies to dominate the world semiconductor market, which would not only affect U.S. market share in the semiconductor industry, but also affect national security.[47] Confronted with the overwhelming negative political response, Fujitsu decided to withdraw its bid.

But these common perceptions about Japanese investment in the United States were not borne out by data. During this period, the United Kingdom was the top investor whereas Japan only ranked third in terms of assets invested in the United States.[48] Second, the growing foreign investment into the United States was not primarily a U.S.–Japan issue. According to leading FDI experts Edward Graham and Paul Krugman, Japanese firms accounted for only a small fraction of both the level of foreign presence and its growth in the United States (except for the banking sector), even though they had increased considerably in relative importance.[49] In fact, various data sources indicate that foreign investment (including that from Japan) in U.S. real estate was very tiny.[50]

Importantly, few realized that the increased foreign presence in the United States, including the increased FDI from Japan, was only part of a globalization trend rather than a phenomenon unique to the United States.[51] From 1985 to 1990, FDI in the United States grew from approximately $185 billion to $395 billion, representing an annual growth rate of 16%.[52] While this seems to be a massive increase, the total worldwide inward FDI stock also grew from $972.2 billion to $1,950.3 billion, representing an annual growth rate of 15%, closely similar to the growth rate of the United

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[46] NORMAN J. GLICKMAN & DOUGLAS P. WOODWARD, THE NEW COMPETITORS: HOW FOREIGN INVESTORS ARE CHANGING THE U.S. ECONOMY 32 (1989) (citing Smick-Medley & Assoc., *Foreign Investment: A Smick-Medley and Associates Public Opinion Survey of U.S. Attitudes* 12 (Smick-Medley White Paper, 1988)).

[47] Barry K. Robinson, *Practical Comments on the Exon-Florio Provisions and Proposed Regulations*, *in* THE COMMERCE DEPARTMENT SPEAKS 1990: THE LEGAL ASPECTS OF INTERNATIONAL TRADE 173, 182 (1989); *see also* Paul I. Djurisic, Comment, *The Exon-Florio Amendment: National Security Legislation Hampered by Political and Economic Forces*, 3 DEPAUL BUS. L.J. 179, 184 (1990).

[48] *See* GLICKMAN & WOODWARD, *supra* note 46, at 35.

[49] GRAHAM & KRUGMAN, *supra* note 17, at 22–23.

[50] *Id.* at 31.

[51] GRAHAM & MARCHICK, *supra* note 43, at 22–23.

[52] TDBOR, *World Investment Report 2004: The Shift Toward Services*, Annex tbl.B.3, UNCTAD/WIR/2004 (2004).

States.[53] Indeed, foreign-controlled firms had already played a significant role in many other advanced countries, such as the United Kingdom and France in the 1980s, and, therefore, much of the rise of inward FDI in the United States could be viewed as a shift to the more typical position of these developed countries.[54] According to the 1993 UN World Investment Report, from 1986 to 1991, the United States ranked only tenth out of twenty-three industrialized countries in average FDI inflows as a share of GDP.[55] Unfortunately, this fact was largely missed during the policy debate on Japanese FDI.[56] As the level of Japanese direct investment reached record highs in the late 1980s, members of Congress remade the long dormant rules and regulations targeting foreign acquisitions, ultimately leading to the passage of the Exon-Florio Amendments of the Omnibus Trade and Competitiveness Act of 1988 (Exon-Florio), a piece of legislation that has had far reaching implications for FDI regulations in the United States.[57]

The current hot debate over Chinese FDI could be "a case of déjà vu for the United States."[58] Indeed, the political backdrop against which Chinese FDI takes place today also bears striking similarity to that of Japanese FDI three decades ago—rising trade friction, continuing dispute over currency manipulation, heated debates over state subsidies, and perceptions of China's increasing economic rise and the West's relative decline.[59] Today media reports on Chinese FDI have mostly focused on its rapid growth, as evidenced by recent examples of Chinese companies snapping up well-known international brands such as IBM, Volvo, Chateau de Viaud vineyard, Ferretti luxury yachts, and AMC Theatres. These transactions make sensational headlines, as it is only a very recent phenomenon that companies from emerging countries such as China have started to venture overseas to make acquisitions in advanced countries. The avalanche of such news reports could therefore provoke worries that

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[53] *Id*.

[54] *See* GRAHAM & KRUGMAN, *supra* note 17, at 32–33.

[55] *See* TDBOR, *World Investment Report 1993: Transnational Corporations and Integrated International Production*, Annex tbl.3 (1993).

[56] GRAHAM & MARCHICK, *supra* note 43, at 22.

[57] Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 502, 102 Stat. 1107 (1988).

[58] Curtis J. Milhaupt, *Chinese Investment: A Case of Déjà Vu for the United States*, 4 E. ASIAN F.Q. 1, 34 (2012).

[59] *See, e.g.*, Sophie Meunier, *Political Impact of Chinese Foreign Direct Investment in the European Union on Transatlantic Relations* 5 (European Parliament Briefing Paper, May 4, 2012); *see also* Curtis Milhaupt, *Is the U.S. Ready for FDI from China? Lessons from Japan in the 1980s*, *in* INVESTING IN THE UNITED STATES: A REFERENCE SERIES FOR CHINESE INVESTORS 2 (2008). To be sure, Chinese FDI also has important features that can be distinguished from Japanese FDI. *See infra* Part IV.

Chinese firms are buying up the world.[60]

But such concerns are exaggerated. To be sure, Chinese FDI has been increasing rapidly. Since China officially announced the "Go Global" policy in 2000, FDI outflows jumped from a mere $1 billion in 2000 to more than $74 billion in 2011, representing an average compound growth rate of almost 50% annually.[61] But the base of China's FDI is very small. The most recent official figures show that in 2011 China's FDI stock accounts for just $425 billion—a mere 2% of the global total.[62] While China had the sixth largest FDI outflows in 2011, it ranked thirteenth in terms of FDI stock.[63] In comparison, Japan's FDI stock was more than twice that of China's, while the United States held more than ten times that of China.[64] Indeed, Chinese outward investment as a percentage of overall GDP is much lower than most developed countries. In 2011, China's outward FDI stock to GDP ratio was only 6%, far below the global average of 31% and the transitional economy average of 17%.[65] China's FDI stock in both the United States and Europe remains trivial compared to the aggregate. Based on statistics from China's Ministry of Commerce and the United Nations, in 2011 FDI inflows from China accounted for only 0.8% of the total FDI inflows into the United States and less than 2% in Europe.[66] The weight of total Chinese FDI stock in these economies is even more trivial, accounting for approximately 0.3% of the total in both the United States and Europe in 2011.[67]

But even these figures can be deceiving, as the absolute number of Chinese FDI flows is only a very crude estimate. The vast majority of Chinese FDI goes to offshore tax havens. For instance, the top three destinations for Chinese FDI flows in 2011 were Hong Kong, the British Virgin Islands, and the Cayman Islands.[68] In particular, Hong Kong alone accounted for 53% of Chinese total outward investment flows. The top

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[60] *See, e.g.*, FRANÇOIS GODEMENT, JONAS PARELLO-PLESNER & ALICE RICHARD, EUROPEAN COUNCIL ON FOREIGN RELATIONS, THE SCRAMBLE FOR EUROPE (2011) ("China is buying up Europe. Its automobile manufacturers have bought MG and Volvo and taken a life-saving stake in Saab. Its transportation firms are acquiring, leasing or managing harbours, airports, and logistical and assembly bases across the continent. Its development bank is financing projects in Europe's periphery much like it does in Africa."); *see also* various news reports about Chinese outbound acquisitions *infra* notes 137–38.

[61] *See* 2011 STATISTICAL BULLETIN OF CHINA'S OUTWARD FDI, *supra* note 18, at 5.

[62] *Id.* at 4.

[63] *Id.*

[64] *Id.*

[65] *See* TDBOR, *World Investment Report 2012: Towards a New Generation of Investment Policies*, Annex tbl.7, http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=171.

[66] *Id.* Annex tbl.1.1; 2011 STATISTICAL BULLETIN OF CHINA'S OUTWARD FDI, *supra* note 18, at 9–10.

[67] *See* TDBOR, *supra* note 65, Annex tbl.1.2; 2011 STATISTICAL BULLETIN OF CHINA'S OUTWARD FDI, *supra* note 18, at 15.

[68] *See* 2011 STATISTICAL BULLETIN OF CHINA'S OUTWARD FDI, *supra* note 18, at 9.

three destinations together accounted for 69% of the total, whereas only less than 3% of Chinese FDI went to the United States.[69] Due to the inherent secrecy of these tax havens, the ultimate destinations of Chinese FDI flows are difficult to reveal. These countries are gateways for FDI because they offer professional services and institutional support unavailable in China and can give Chinese investors the cover of another nationality.[70] Some of these investments in fact reflect the phenomenon of "round-tripping," whereby funds are moved abroad and then reinvested in China to benefit from the advantageous terms that the Chinese government provides for foreign investors.[71] While some of the financial advantages provided by the Chinese government, such as favorable tax treatments, have been phased out in recent years, some advantages still remain in many circumstances.[72] Therefore, if a large portion of Chinese FDI flows to Hong Kong is ultimately reinvested back into mainland China, then the absolute number of Chinese FDI flows probably overstates its true amount. On the other hand, if some of the funds invested in tax havens are redirected to other countries such as those in Europe or the United States, then the value of Chinese investment in those regions should be higher than the current figures suggest. Recognizing the shortcomings of the official data, Daniel Rosen and Thilo Hanemann from the Rhodium Group compiled their own dataset to monitor Chinese FDI.[73] While their figures are higher than official data, they are still small by any standard. For instance, they estimated that China's outward investment would account for a mere 4% of total EU FDI inflows in 2010.[74] Thus it seems that even if the Chinese FDI figures are adjusted upwards, it would still have a miniscule presence in Western countries.

The above analysis illustrates the important role that statistics can play in informing FDI policy making, but unfortunately its importance is often overlooked during policy debate. Instead, people rely on intuition and resort to various mental shortcuts when making judgments about FDI. As discussed in detail below, various heuristics and biases could be the major source of misconceptions about FDI.

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[69] *Id.*

[70] *See* Randall Morck et al., *Perspectives on China's Outward Foreign Direct Investment*, 39 J. INT'L BUSINESS STUDIES 337, 339–40 (2008); *see also* Ivar Kolstad & Arne Wigg, *What Determines Chinese Outward FDI*, 47 J. WORLD BUSINESS 26, 28 (2012).

[71] Morck et al.*, supra* note 70, at 340.

[72] DANIEL H. ROSEN & THILO HANEMANN, PETERSON INST. FOR INT'L ECON., CHINA'S CHANGING OUTBOUND FOREIGN DIRECT INVESTMENT PROFILE: DRIVERS AND POLICY IMPLICATIONS 3 n.10 (2009), *available at* http://www.iie.com/publications/pb/pb09-14.pdf.

[73] THILO HANEMANN & DANIEL H. ROSEN, RHODIUM GRP., CHINA INVESTS IN EUROPE: PATTERNS, IMPACTS AND POLICY IMPLICATIONS 35–36 (2012).

[74] *Id.* at 35.

B. Loss Aversion

People tend to be loss averse.[75] They have the tendency to strongly prefer avoiding losses rather than accruing gains. Consider the following experiment. If you are offered a gamble where there is a 50% chance of winning $110 and 50% chance of losing $100, will you take this gamble? The rational response is yes, as the expected gain ($55) clearly exceeds the expected loss ($50). However, like most people, you probably will choose not to play this game because the psychological cost of losing $100 outweighs the benefit of winning $110. It should be noted that loss aversion is a deeply ingrained human trait that can be traced to evolutionary history.[76] Indeed, studies have found that organisms that treat threats as more urgent have a better chance to survive and reproduce.[77]

Loss aversion has been applied to explain many anomalies in life. One particularly interesting phenomenon is the "endowment effect," that is, the human tendency to demand more to give up a good than one would be willing to pay to acquire it.[78] But the endowment effect is not universal. Merchants who trade goods for a living or financial traders who trade stocks as their daily business activities do not suffer from the endowment effect because they view their goods as carriers of value for future exchanges.[79] Another implication of loss aversion is that individuals have a strong tendency to remain at the status quo, a phenomenon known as status quo bias.[80] In addition, loss aversion can influence people's judgment about fairness. Studies show that people's perception of fairness strongly depends on whether the question is framed as reduction in a gain or as a loss.[81]

These psychological findings on loss aversion have important implications for the study of risk regulation. Sunstein observed that people

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[75] *See, e.g.*, Richard H. Thaler, *The Psychology of Choice and Assumptions of Economics*, *in* QUASI RATIONAL ECONOMICS 137, 143 (1991); Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1328 (1990).

[76] *See* Arne Ohman, *Fear and Anxiety as Emotional Phenomena: Clinical Phenomenology, Evolutionary Perspectives, and Information-Processing Mechanisms*, *in* HANDBOOK OF EMOTIONS 511, 520 (Michael Lewis et al. eds., 1993).

[77] *Id.*

[78] Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependent Model*, 106 Q.J. ECON. 1039 (1991); *see also* Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSPECTIVES 193, 196 (1991).

[79] KAHNEMAN, *supra* note 37, at 294; *see also* John A. List, *Does Market Experience Eliminate Market Anomaly?*, 118 Q.J. ECON. 41 (2003).

[80] Kahneman, Knetsch & Thaler, *supra* note 78, at 196.

[81] Daniel Kahneman, Jack L. Knetsch & Richard Thaler, *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728, 731 (1986).

are closely attuned to losses produced by newly introduced risks or any aggravating risks, but are far less concerned with the benefits that are foregone as a result of regulation.[82] In the context of FDI, loss aversion and the endowment effect could explain some anomalies in people's thinking about the economic consequences of FDI. All around the world, governments and national publics tend to be friendlier to greenfield investments than to foreign acquisitions.[83] For example, greenfield investors "are usually offered generous incentives" by local governments, but foreign takeovers are often viewed with skepticism and "are sometimes thwarted" for economic or political reasons, particularly when they involve "strategic" industries.[84] For instance, a national survey conducted by the Pew Research Center in March 2006 found that 53% of Americans held a negative view of foreign investors "owning" U.S. companies (foreign acquisitions), whereas only 36% of Americans viewed foreign companies "investing" in the United States (greenfield investment) as bad.[85]

From an economic standpoint, however, there seems to be little sense in distinguishing greenfield investment and investment via acquisitions. In fact, economic theory on FDI usually does not distinguish between different modes of entry at all.[86] Indeed, it has been generally recognized that the primary expected economic benefits of inward FDI are productivity gains—gains that can arise from either greenfield investments or acquisitions.[87] For instance, Krugman and Graham argue that the main benefits of FDI in the United States—the facilitation of trade in goods, services, and knowledge—generally apply regardless of investors' mode of entry; moreover, they argue that FDI only has an indirect and limited effect on aggregate employment and net trade in the United States.[88] Empirical evidence also "suggests that the supposed advantages of greenfield investment over" foreign acquisitions—"such as net job creation and the building of export capacities—do not figure among the main benefits of FDI."[89]

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[82] SUNSTEIN, LAWS OF FEAR, *supra* note 27, at 42.

[83] OECD, INTERNATIONAL INVESTMENT PERSPECTIVES: FREEDOM OF INVESTMENT IN A CHANGING WORLD 68 (2007). Generally speaking, Greenfield investment refers to a form of FDI where foreign investors establish new operational facilities from the ground up in the host country.

[84] *Id.* at 71.

[85] News Release, Pew Research Ctr. for the People & the Press, Bush Approval Falls to 33%, Congress Earns Rare Praise 2 (Mar. 15, 2006), *available at* http://www.people-press.org/files/legacy-pdf/271.pdf.

[86] *See* GRAHAM & KRUGMAN, *supra* note 17, at 57–67.

[87] *See* Magnus Blomstrom, Ari Kokko & Mario Zejan, FOREIGN DIRECT INVESTMENT: FIRM AND HOST COUNTRIES STRATEGIES 101–221 (2000); *see also* OECD, FOREIGN DIRECT INVESTMENT FOR DEVELOPMENT: MAXIMISING BENEFITS, MINIMISING COSTS 9 (2002).

[88] *See* GRAHAM & KRUGMAN, note 17, at 59–65.

[89] *See* OECD, *supra* note 83, at 86.

So why do people tend to be more friendly to greenfield investment than to foreign acquisitions? This in part may have to do with loss aversion and status quo bias. Greenfield projects are new investments that are perceived to create job opportunities and, if the project generates exports, to have a potentially positive impact on the trade balance. Thus there appears to be obvious "gain" from greenfield investment but no obvious "loss." In contrast, foreign takeovers of domestic assets mean the host country is ceding control of the domestic assets to foreign investors. Host countries may be concerned that foreign acquisitions of domestic enterprises could lead to workforce reductions and increased unemployment. There may also be concern that foreign acquisitions could lead to declining exports, as a parent company may decide that export markets could best be served by affiliates elsewhere.[90] Other concerns include the loss of technological capabilities or loss of competitive advantages if technology is actually transferred out of the host economy.[91] People tend to fixate on the potential losses brought about by foreign acquisitions, without investigating whether such concerns are legitimate, whether the probable occurrence of such losses is high, or whether foreign acquisitions may actually benefit the host economy. Indeed, these potential "costs" loom large in people's minds, and their aversion to loss could therefore distort perception of the benefits of foreign takeovers, especially when a particular public understands itself to be "endowed" with the strategic assets of acquired firms. As such, they tend to resort to mental shortcuts and jump to the conclusion that the cost of ceding control of domestic assets outweighs the benefits gained from foreign acquisitions.

Endowment effects also affect people's sense of fairness in terms of FDI regulation. When people think they are endowed with their country's strategic assets, they tend to believe that it is fair for regulators to introduce harsh measures to block foreigners from taking away those assets. One good example is the French people's overwhelming opposition to Pepsi's attempted acquisition of Danone in 2005.[92] Danone is a leading French food company and a source of enormous pride in France. As a "national business champion," Danone occupied a "special place in French hearts," whereas PepsiCo was viewed as "the ugly face of American capitalism."[93] The French people are so emotionally attached to Danone that no payoff from PepsiCo was deemed sufficient to compensate for the psychological cost of ceding control of a leading French business to an American firm. Although Pepsi ultimately denied its intention to acquire Danone, the case

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[90] *Id*. at 85.

[91] *Id.* at 86.

[92] Franck Riboud, *France Flouts the Pepsi Challenge*, TELEGRAPH (July 24, 2005), http://www.telegraph.co.uk/finance/2919479/France-flouts-the-Pepsi-challenge.html.

[93] *Id.*

prompted the French government to take preemptive action to introduce laws protecting companies in strategic industries such as Danone.[94]

C. Availability Heuristic

The "availability heuristics" refers to the process through which people judge the frequency of an event by the ease with which instances can be brought to mind.[95] If a salient event is highly publicized by the media, people tend to think an event is more probable as they can recall an occurrence more easily. For instance, immediately after the terrorist attacks on September 11, 2001, many people were scared of flying and chose to drive instead without being aware that driving is a more dangerous form of transportation.[96] On the other hand, when the risks are not easily accessible and available, people tend to ignore them.[97] As psychologist Paul Slovic asserts: "What is out of sight is effectively out of mind."[98] Availability heuristics do not exist in a social vacuum, as suggested by Tim Kuran and Cass Sunstein, who have studied the social mechanisms that govern the availability of information.[99] They observe that availability heuristics interact with social processes, particularly informational and reputational forces. According to the authors, when people communicate their opinions to others, it creates an information externality. Thus, an availability cascade is formed whenever individual uses of the availability heuristic increase public availability of data pointing to a particular interpretation or conclusion, and this increase in availability then triggers reinforcing individual response.[100]

In the context of FDI, public sentiment regarding foreign investment could also be swayed by availability heuristics. Consider a dramatic incident such as the terrorist attacks on the United States on September 11, 2001. Commentators observed that this event fundamentally changed the perception of FDI held by many U.S. policymakers, many of whom have called for greater consideration of the impact of FDI on national security.[101] Congress' fierce opposition to the attempted takeover by Dubai Customs

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[94] Inst. for Econ. & Soc. Research, *New Legislation Aimed at Regulating Takeover Bids*, EIRONLINE (Sept. 1, 2006), http://www.eurofound.europa.eu/eiro/2006/04/articles/fr0604039i.htm.

[95] Kahneman & Tversky, *supra* note 25, at 1127.

[96] Robert W. Hahn, *The Economics of Airline Safety and Security: An Analysis of the White House Commission's Recommendations*, 20 HARV. J.L. & PUB. POL'Y 791, 804 (1997).

[97] *See generally* Sarah Lichtenstein, Paul Slovic, Baruch Fischhoff, Mark Layman & Barbara Combs, *Judged Frequency of Lethal Events: Human Learning and Memory*, 4 J. EXPERIMENTAL PSYCH. 551 (1978).

[98] *See* PAUL SLOVIC, THE PERCEPTION OF RISK 107–09 (2000).

[99] Timur Kuran & Cass Sustein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999).

[100] *Id.* at 712.

[101] JAMES K. JACKSON, CONG. RESEARCH SERV., RL34561, FOREIGN INVESTMENT AND NATIONAL SECURITY: ECONOMIC CONSIDERATIONS (2013).

and Free Zone Corporation (Dubai Ports World) is a case in point. In 2006, Dubai Ports World, a company based in United Arab Emirate (UAE), proposed to purchase the Peninsular and Oriental Steam Navigation Company (P&O), a London-based company. P&O operates a number of facilities worldwide including six ports in the United States. In January 2006, President Bush approved the transaction after Dubai Ports World provided an assurance letter providing guarantees for certain security standards to be met at the U.S. ports.[102] However, because Dubai Ports World is an investor based in a Middle Eastern nation, the deal attracted overwhelmingly negative media attention and spurred impassioned debates over the national security implications of allowing a Middle Eastern company to assume control over important U.S. port facilities.[103] Americans' fresh memories of the tragedies of September 11, a component of the associative machine of System 1, dominated public judgment about the transaction. Undue fears were propounded by gripping news headlines such as "Dubai Ports Company in Al-Qaida Heartland."[104] The UAE was depicted in the media as an "operational and financial base for the hijackers who carried out the attacks of Sep. 11, 2001."[105]

But the public debate about the risks posed by the Dubai Ports World transaction was marked by great exaggeration. First of all, the UAE has been an ally and friend of the United States post-September 11.[106] Second, it is the U.S. Coast Guard and customs authorities, not the port operators, who are ultimately responsible for port security.[107] Importantly, Dubai Ports World had already given assurance that it would meet certain security standards to address U.S. concern about national security risks.[108] Unfortunately, U.S. politicians did not emphasize these facts. Instead they pointed to the "worst-case scenario," suggesting that there could be dire consequences of UAE control of U.S. ports.[109] Indeed, for many Americans, the idea of terrorists conjures up intense images of disaster and suffering. Even if the risks were really remote, Americans' extreme repulsion to terrorism after September 11 made it impossible for them to

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[102] Press Release, Dep't of the Treasury, CFIUS and the Protection of the National Security in the Dubai Ports World Bid for Port Operations (Feb. 24, 2006).

[103] JAMES K. JACKSON, CONG. RESEARCH SERV., RL33388, THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) (2014).

[104] Stellar Dendrite, *Peter King: Dubai Ports Company in "Al-Qaida Heartland*,*"* NEWSMAX.COM (Feb. 20, 2006), http://www.freerepublic.com/focus/f-news/1582224/posts.

[105] Associated Press, *More Objections to Port Takeover By Arab Entity*, N.Y. TIMES, Feb. 20, 2006, at A9.

[106] GRAHAM & MARCHICK, *supra* note 43, at 139.

[107] David D. Kirkpatrick & Patrick McGeehan, *Pataki Joins Opposition to Takeover of Ports*, N.Y. TIMES, Feb. 21, 2006, at B3.

[108] GRAHAM & MARCHICK, *supra* note 43, at 138.

[109] *Id.* at 140.

tolerate any risk posed by an acquisition by a Middle Eastern company.

Availability heuristics could similarly affect American attitudes toward Chinese FDI today. For instance, the row against espionage activities conducted by the Chinese government recently intensified in the United States. In February 2013, Mandiant, a private security firm, released a report that documents systematic cyber attacks originating from a building in Shanghai.[110] The Chinese military is suspected to be involved in this attack, although there is no conclusive evidence to prove this. The incident has received heightened attention from the U.S. government. In response to mounting anger over Chinese cyber espionage, Congress recently introduced a provision barring federal government purchases of high-tech equipment produced by Chinese suppliers.[111] It is not clear whether Congress has considered introducing any mitigating measures that would reduce the risks inherent in allowing Chinese suppliers to participate in U.S. networks (rather than blocking Chinese suppliers outright). Given this new dynamic, FDI experts have warned that continuing allegations of state-sponsored cyber attacks could create additional mistrust and suspicion of Chinese companies seeking to invest in the United States.[112]

D. Affect Heuristic

"Feelings" play an important role in how people make judgments about risk. Paul Slovic, a leading psychologist among scholars on risk, has identified the inextricable link between availability heuristics and people's emotional reactions to risks.[113] Slovic proposed that "affect," a general positive or negative feeling people may experience about a certain object, can operate as a heuristic that affects people's judgment about both benefits and dangers.[114] If a certain risk invokes strong feelings, people will tend to resort to a mental shortcut by asking how they feel about the risk, instead of making thoughtful deliberation in their evaluation of it.[115] Moreover, people's reactions to risks are often based on whether they can easily imagine or visualize the "worst-case scenario."[116] If the outcome is vivid and bad, it can evoke strong emotions. And when strong emotions are

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[110] MANDIANT, AP1: EXPOSING ONE OF CHINA'S CYBER ESPIONAGE UNITS (2013), *available at* http://intelreport.mandiant.com/Mandiant_APT1_Report.pdf.

[111] Consolidated and Further Continuing Appropriations Act, 2013, H.R. 993, 113th Cong., § 516.

[112] *See* Thilo Hanemann, *Chinese FDI in the United States: Q1 2013 Update*, RHODIUM GROUP (Apr. 30, 2013).

[113] Paul Slovic, Melissa Finucane, Ellen Peters & Donald G. MacGregor, *The Affect Heuristic*, *in* HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 397 (Thomas Gilovich, Dale Griffin & Daniel Kahneman eds., 2002).

[114] *Id.*

[115] SLOVIC, *supra* note 98, at 413–28.

[116] SUNSTEIN, RISK AND REASON, *supra* note 20, at 45.

present, people will tend to ignore the probability that the outcome will occur.[117] Indeed, research suggests that sometimes people favor regulation of certain risks because they focus on the harms, which are effectively on-screen while ignoring the compensating benefits which are off-screen.[118]

Affect heuristics have important implications for risk regulation. In the context of FDI, the question the public faces is difficult (Is FDI beneficial to our society?), whereas the answer to an easier and related question (Do I like FDI?) comes readily to mind. Therefore, the public will tend to answer the easier question, usually without noticing the substitution. This is especially true when a foreign acquisition poses risks to economic or national security. These sensitive sectors can readily invoke negative feelings, which can in turn distort people's perception of benefits and thus produce irrational judgment of the merits of a potential FDI transaction. Recent surveys of public opinion on FDI demonstrate that people's perceptions of FDI are influenced by their feelings toward the country of origin: if they like a particular country, they tend to view FDI from that country more favorably; if they dislike a certain country, they tend to view FDI from that country more negatively.[119]

When affect heuristics are at work, negative public representations of the Chinese government or Chinese companies could influence public perception of Chinese FDI. If there is overwhelming anti-China sentiment in a host country, Chinese FDI is not likely to be welcome, as people will tend to judge Chinese FDI as bearing high risks and low benefits. Indeed, many of the challenges posed to Chinese companies investing abroad may have to do with a simple lack of trust in the Chinese government. This could eventually contribute to a poisoned environment—one in which it would be very difficult to conduct a policy debate about Chinese FDI.

For instance, U.S. regulators have thwarted Huawei's several attempts to acquire U.S. technology companies in recent years. In 2007, Huawei and its partner investor Bain Capital Partners were forced to withdraw their proposed joint acquisition of network equipment maker 3Com following their failure to reach a mitigation agreement that adequately addressed the U.S. government's concern.[120] Even though Huawei was only taking a

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[117] Yuval Rottenstreich & Christopher Hsee, *Money, Kisses, and Electric Shocks: On the Affective Psychology of Risk*, 12 PSYCHOLOGICAL SCI. 185, 188 (2001).

[118] SUNSTEIN, RISK AND REASON, *supra* note 20, at 41 (citing HOWARD MARGOLIS, DEALING WITH RISK 75–92 (1997)).

[119] Nathan M. Jensen & René Lindstädt, *Globalization with Whom: Context-Dependent Foreign Direct Investment Preferences* (July 2013), http://pages.wustl.edu/files/pages/imce/nathanjensen/globalization_with_whom_working_paper.pdf (The authors cited a Gallup poll finding that 77% of Americans had a favorable view of Japanese FDI in comparison to a 42% favorability rating for Chinese FDI. The authors' own survey found two times the support for Japanese FDI versus Chinese FDI into the United States.).

[120] Press Release, 3Com, 3Com and Bain Capital Partners Announce Mutual Withdrawal of CFIUS Application (Feb. 20, 2008).

minority interest of 16.5% in 3Com, some Congressional members called for blocking the transaction, reciting a litany of alleged espionage related activities attributed to China, Huawei's alleged ties to the Chinese Liberation Army, and other publicly reported concerns over Huawei's business.[121] In 2011, Huawei chose to divest the assets it acquired from 3Leaf, a bankrupt California technology company, after CFIUS made a negative recommendation against this deal.[122] In a recent report on the national security issues posed by Huawei and ZTE (another leading Chinese telecommunications firm), the U.S. House Permanent Select Committee on Intelligence recommended that the United States view with suspicion the continued penetration of the U.S. telecommunications market by these Chinese companies and that it should block their investment in any form.[123]

E. Some Reflections

To be sure, the vast majority of Chinese overseas investments are not subject to national security review by the host governments, and most that are reviewed are approved without any delay. So why are Western governments able to overcome fear about Chinese FDI so often?[124]

First, partly due to loss aversion, greenfield investment tends to be viewed more favorably by the host countries than acquisition and, accordingly, is subject to much less regulatory review. For instance, data collected by Rhodium Group indicates that almost 70 percent of Chinese investment in the United States (in terms of numbers of deals) was greenfield from 2000 to 2012.[125] As Exon-Florio applies solely to foreign acquisitions, greenfield investment by Chinese firms is not subject to national security review.

Second, Chinese acquisitions of companies in nonstrategic sectors tend to avoid controversy as dynamics—such as loss aversion, availability heuristics, and affect heuristics—are more pronounced when the assets involved are deemed indispensable and important for the host countries.

Third, Chinese companies that are looking to invest abroad are

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[121] *Bain Capital Drops Its Bid for 3Com*, WALL ST. J. (Mar. 21, 2008), http://online.wsj.com/article/SB120603627253952409.html.

[122] Shayndi Raice & Andrew Dowell, *Haiwei Drops U.S. Deal Amid Opposition*, WALL ST. J. (Feb. 22, 2011), http://online.wsj.com/article/SB10001424052748703407304576154121951088478.html.

[123] U.S. HOUSE PERMANENT SELECT COMM. ON INTELLIGENCE, 112TH CONG., INVESTIGATIVE REPORT ON THE U.S. NATIONAL SECURITY ISSUES POSED BY CHINESE TELECOMMUNICATIONS COMPANIES HUAWEI AND ZTE (Oct. 8, 2012).

[124] I thank Scott Kennedy for suggesting this question.

[125] *China Investment Monitor*, RHODIUM GROUP, http://rhg.com/interactive/china-investment-monitor (last visited Mar. 1, 2014).

typically assisted by legal advisors who can conduct careful assessment of the regulatory risks in the host country. If a Chinese bid is likely to face high regulatory hurdles in the host country, Chinese investors will probably be advised against proceeding with the bid.[126] Hence, it is not surprising that the vast majority of deals that are subject to regulatory review are approved because Chinese investors will probably not make a bid in the first place if the deal is likely to be rejected.

This also suggests that Western regulators not only need to assess whether they have made a proper decision with regard to those Chinese acquisitions that have been made but that they also need to evaluate the costs of deterring Chinese companies from investing in the first place. For instance, the failed attempts of Chinese companies such as Huawei to invest in the United States have sent a bad signal to many Chinese companies that, partly influenced by availability heuristics, wrongly believe that the U.S. government is hostile toward Chinese investors.[127] As a result, these companies decide to look elsewhere to invest.

III. EXPLOITING FEAR

Well-organized interest groups—including the media, the government, and business rivals—can exploit and manipulate undue public fear of foreign investment in order to advance their own personal agendas. In fact, fears of foreign investment are likely to be generated endogenously by special interests seeking a regulatory response. This aspect, however, is often neglected during heated public debates on foreign investment.

A. Private Interest Groups

Self-interested private groups have incentives to exploit people's fear. They can advance their personal goals through publicizing vivid examples of bad consequences of policies they contest and by encouraging deliberation among like-minded people.[128] A typical tactic includes the exaggeration of risk and over stressing the worst-case scenario. In the context of FDI, private interest groups include competing bidders, business rivals, and other stakeholders who can utilize foreign investment review processes to obtain leverage over other parties or to impact the timing and certainty of the transaction.

For instance, there is an overwhelming consensus among FDI experts

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[126] I thank Thilo Hanemann for suggesting this point.

[127] Anthony Lin, *Can China Change CFIUS?*, LAW.COM (May 13, 2013), http://www.alm.law.com/jsp/article.jsp?id=1202599753882&thepage=1.

[128] *See* SUNSTEIN, RISK AND REASON, *supra* note 20, at 91.

that the Dubai Ports World case was highly politicized.[129] In particular, a disgruntled supplier to the target company was believed to be the driving force behind the political controversy in this case.[130] The supplier was Eller & Co., a small stevedoring firm in the United States that has had a long-standing commercial dispute with the target American firm P&O. By taking advantage of the post-September 11th anti-Arab sentiment, Eller & Co. successfully stoked the flame in Washington to block the deal in order to increase its leverage.[131] Similarly, Huawei's perennial political and legal troubles in the United States seem to have been rooted in its patent disputes with rival Cisco. Officials from Huawei point out that Cisco resorted to lobbying U.S. politicians in response to the competition from Huawei, which has become a more formidable competitor.[132] As discussed in further detail in Part IV, Chevron, a rival bidder to CNOOC, played a key role in Congress' hostile actions toward CNOOC's attempted acquisition of Unocal. It has been reported that Chevron spent tremendous resources enlisting supporters and lobbying Congress in order to block the CNOOC acquisition.[133]

B. The Media

The media's role in promoting a public discourse of fear is well studied.[134] Similar to private interest groups, mass media has the power to influence underlying dynamics and amplify the salience of consequences. There are two forces at work here. The first is the media's incentive to respond to people's negativity bias.[135] As people are loss averse, they tend to pay more attention to and give more weight to negative rather than positive experiences or information. In order to increase ratings and viewership, the media will respond asymmetrically to information by selectively choosing gripping instances to attract attention.[136] As the saying goes: "If it bleeds, it leads." The second force at work here is availability heuristics. Kahneman has long observed that media coverage

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[129] GRAHAM & MARCHICK, *supra* note 43, at 140.
[130] *Id.* at 139.
[131] *Id.*
[132] *See* Cecelia Kang, *Huawei's U.S. Competitors Among Those Pushing for Scrutiny of Chinese Tech Firms*, WASH. POST (Oct. 10, 2012), http://articles.washingtonpost.com/2012-10-10/business/35500591_1_huawei-and-zte-chinese-government-cisco-systems.
[133] *See* Jonathan Weisman, *In Washington, Chevron Works to Scuttle Chinese Bid*, WASH. POST (July 16, 2005), http://www.washingtonpost.com/wp-dyn/content/article/2005/07/15/AR2005071501889.html.
[134] David L. Altheide, *The News Media, the Problem Frame, and the Production of Fear*, 38 SOC. Q. 647 (1997).
[135] Richard Lau, *Negativity in Political Perception*, 4 POL. BEHAV. 353 (1982).
[136] Stuart N. Soroka, *Good News and Bad News: Asymmetric Responses to Economic Information*, 68 J. POL. 372, 381 (2006).

can warp people's perception of risks: "The world in our heads is not a precise replica of reality; our expectations about the frequency of events are distorted by the prevalence and emotional intensity of the messages to which we are exposed."[137] As a consequence, the media's asymmetric response to bad news can in turn amplify public fear of bad news, thus leading to a vicious cycle in which availability heuristics and media incentives aggravate each other.[138]

The media's reaction to the influx of foreign capital into the United States in the 1980s offers a good example. The growing foreign presence in the United States sparked a flood of popular news articles and books at that time, most of them expressing concern, but few media pieces defended FDI. For instance, Time magazine ran a cover story in 1987 entitled *The Selling of America: Foreign Investors Buy, Buy, Buy*. Others, however, ran sensational headlines such as *Foreign Investors: Allies or Aggressors?*, *Foreigners Buy America*, and *A Nation Hooked on Foreign Funds*.[139] Books on Japanese global dominance also mushroomed during this period. These suggested that takeovers of U.S. firms by Japanese firms had reached a dangerous level and that FDI would diminish U.S. technological capabilities, threaten the U.S. tax base, and reduce the quality and quantity of U.S. jobs.[140] For instance, in *Selling Out: How We Are Letting Japan Buy Our Land, Our Industries, Our Financial Institutions, and Our Future*, published in 1990, the authors tell an alarming story of the transfer of American companies and wealth into Japanese hands and characterize FDI as an economic "war" in which America is dangerously defenseless.[141] In 1992, Martin Tolchin and Susan Tolchin released their popular book *Selling Our Security: The Erosion of America's Assets*.[142] In this book, the authors presented a shocking picture of American manufacturers of critical technologies being taken over by foreign investors and an America in grave danger of losing its technological edge and becoming dependent on overseas suppliers. They also warned that foreign investment threatened America's economic and political security and called for a stronger government role in protecting critical industries. Similarly, Clyde Prestowtiz's 1992 *Trading Places: How We Are Giving Our Future to*

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[137] *See* KAHNEMAN, *supra* note 37, at 138.

[138] SUNSTEIN, LAWS OF FEAR, *supra* note 27, at 102.

[139] GLICKMAN & WOODWARD, *supra* note 46, at 10.

[140] *See, e.g.*, DANIEL BENSTEIN, YEN! JAPAN'S NEW FINANCIAL EMPIRE AND ITS THREAT TO AMERICA (1988); MARK MASON, EUROPE AND THE JAPANESE CHALLENGE (1998); DOUGLAS FRANTZ & CATHERINE COLLINS, SELLING OUT: HOW WE ARE LETTING JAPAN BUY OUR LAND, OUR INDUSTRIES, OUR FINANCIAL INSTITUTIONS, AND OUR FUTURE (1990); MARTIN TOLCHIN & SUSAN TOLCHIN, SELLING OUR SECURITY: THE EROSION OF AMERICA'S ASSETS (1992); CLYDE PRESTOWITZ, TRADING PLACES: HOW WE ARE GIVING OUR FUTURE TO JAPAN (1992).

[141] *See* FRANTZ & COLLINS, *supra* note 140.

[142] *See* TOLCHIN & TOLCHIN, *supra* note 140.

Japan elicited great anxiety and inflamed fear among the American public that the Japanese were on the verge of dominating America.[143] Yet these dire predictions about the threat of Japanese investment simply never came to pass. Rather than decline relative to Japan in the 1990s, U.S. technological capabilities rose in large part because of the expansion of information technology-based industries in the United States.[144] As Graham and Marchick commented: "In hindsight, much of the furor over Japanese FDI in the United States now seems exaggerated or even downright silly."[145]

Similar to the situation with Japan two decades ago, China is now at the center of the media spotlight. In November 2010, the Economist declared on its cover that "China Buys Up the World."[146] Other magazines like Forbes and the Independent have run similar cover stories about the Chinese shopping spree abroad.[147] Books on China's growing dominance have become highly popular in recent years, with lurid titles including: *When China Rules the World: The Rise of the Middle Kingdom and the End of the Western World*; *Beijing Consensus: How China's Authoritarian Model Will Dominate the Twenty-First Century*; *Eclipse: Living in the Shadow of China's Economic Dominance*; and *China, Inc.: How the Rise of the Next Superpower Challenges America and the World*.[148] These news headlines and books can therefore become a source of fear that China is dominating the world and poses a threat to the West.

C. Governments

Driven by their own interests in re-election or promotion, government officials in democratic societies respond to the public's concern about risk even if a particular fear is groundless. Kent Weaver, a political scientist, has called this phenomenon "the politics of blame avoidance."[149] This is rooted in the loss aversion of human beings, as voters tend to be more sensitive to real or potential losses than to gains. As Weaver puts it:

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[143] *See* PRESTOWTIZ, *supra* note 140.

[144] *See* GRAHAM & MARCHICK, *supra* note 43, at 24.

[145] *Id.* at 95.

[146] *See Buying Up the World: The Coming Wave of Chinese Takeovers,* ECONOMIST (Nov. 13, 2010).

[147] *See, e.g.*, *China Buys the World*, FORTUNE (Oct. 26, 2009); *The Great Haul of China: As Beijing's Spending Spree Extends to Brazil, What Does It Mean for the World?*, INDEPENDENT (Oct. 2010).

[148] *See* MARTIN JACQUES, WHEN CHINA RULES THE WORLD: THE RISE OF THE MIDDLE KINGDOM AND THE END OF THE WESTERN WORLD (2009); STEPHEN HALPER, BEIJING CONSENSUS: HOW CHINA'S AUTHORITARIAN MODEL WILL DOMINATE THE TWENTY-FIRST CENTURY (2010); ARVIND SUBRAMANIAM, ECLIPSE: LIVING IN THE SHADOW OF CHINA'S ECONOMIC DOMINANCE (2011); TED FISHMAN, CHINA, INC.: HOW THE RISE OF THE NEXT SUPERPOWER CHALLENGES AMERICA AND THE WORLD (2006).

[149] R. Kent Weaver, *The Politics of Blame Avoidance*, 6 J. PUB. POL'Y 371 (1986).

"Voters are more sensitive to what has been done to them than what has been done for them."[150] In response to public demand, politicians are more motivated to avoid blame for unpopular actions rather than to claim credit for popular ones.[151] As a result, governments tend to react in response to temporary fear without investigating the facts and consequences—a tendency that can come at a dear cost and impose risks of its own. For instance, critics suggest that President George W. Bush's administration exaggerated the need for a "war on terrorism" in part because the exaggeration served his political interests.[152]

In the context of FDI, it has been observed that those who were most eager to revamp foreign investment policy in the United States in the 1970s were members of Congress from districts and states receiving the bulk of new investments rather than "members of some aggrieved interest group or vigilant guardians of national security."[153] Reacting strongly to complaints "in their voting districts about the invasion of the country by rich foreign" multinationals, these congressional members introduced "bills ranging from the prudent to the xenophobic."[154] While they "did not have access to the accurate information needed to take sound policy positions, they had little to lose" in arguing against foreign investment.[155] Needing to appease the popular demand for anti-foreigner policies, they had great incentive to appear responsive, "to draw further attention to the issue and to grandstand."[156]

Another illustrative case is Dubai Ports World's rebuffed attempt to acquire six U.S. ports in 2006. When the public furor against this deal rose, some members of Congress decided that they had to "do something."[157] For instance, the congressional leaders denounced the deal as "transfer[ing] title to the Devil."[158] Representative Peter King of New York also warned against this deal, alleging that the UAE had been involved with terrorists in the past: "This was only 4 1/2, five years ago that they were very close to Bin Laden, they were supporting Taliban . . . [a]nd unless there's been a complete transformation, I have real

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[150] *Id.* at 373.

[151] *Id.*

[152] SUNSTEIN, LAWS OF FEAR, *supra* note 27, at 83.

[153] Kang, *supra* note 45, at 312; *see also* Judith Miller, *Foreign Investment in the U.S. Economy Arouses Congressional Concern: The Buying of America*, 38 PROGRESSIVE 42 (1974).

[154] Kang, *supra* note 45, at 312–13.

[155] *Id.* at 313.

[156] *Id.*

[157] Editorial, *The Don't Invest in America Act*, WALL ST. J., July 19, 2006, at A12.

[158] John Cranford, *Defining 'Ours' in a New World*, CQ WEEKLY, Mar. 3, 2006, at 592 (Senator Frank Lautenberg warns: "Don't let them tell you this is just the transfer of title. Baloney. We wouldn't transfer title to the Devil; we're not going to transfer title to Dubai.").

concerns."[159] The Committee on Foreign Investment in the United States (CFIUS), an inter-agency responsible for national security review, was "excoriated . . . for their supposed lapse in judgment," and "many in Congress [] argue[d] for greater transparency in the CFIUS process."[160] To appear tough on terrorism, some members of Congress threatened "to pass legislation forcing [Dubai Ports] World to divest itself of its U.S. holdings."[161] Prominent Senators Clinton and Menendez also introduced legislation that would prohibit the sale of terminal operations to foreign governments.[162] To placate these concerns, Dubai Ports World was forced to sell its interest in the six U.S. ports.

Today, sensational reports in tabloids, TV, and radio can quickly build heat around a particular takeover transaction from a Chinese company. Western politicians worried about their public image are naturally afraid of being accused by the media of selling invaluable domestic assets to the Chinese or of failing to protect national interests. For this reason, politicians can be reluctant to defend Chinese foreign investments and are more prone to taking a hardline approach to placate angry voters.

More alarmingly, fear in such scenarios is contagious. Although each of the various interest groups is working alone to advance their own agendas, they share a unifying goal of amplifying public fear. Their individual endeavors can therefore feed on each other, with the consequence that their joint efforts become a formidable force for disrupting foreign investment. Indeed, there exists a positive feedback loop among various interest groups. Public fear about FDI incentivizes the media to respond more strongly to negative news rather than positive news of FDI, which further amplifies public fear. Private interest groups exploit public fear about foreign investment and lobby for regulatory response. As fear of FDI heightens, politicians take action to respond, as doing so can increase their popularity, even if they do not have sufficient grounds to respond. Tough regulatory responses, such as blockage of foreign investment, produce sensational headlines. This results in a vicious cycle by further contributing to fear about FDI.

IV. RESPONSE TO FEAR

When people are fearful, the government is likely to react, even if the

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[159] Jonathan Weisman, *Port Deal to Have Broader Review; Dubai Firm Sought U.S. Security Probe*, WASH. POST, Feb. 27, 2006, at A1.

[160] *See* GRAHAM & MARCHICK, *supra* note 43, at 140.

[161] Greg Hitt, *Lawmakers Keep Up Pressure on Dubai Ports Firm*, WALL ST. J., Mar. 16, 2006, at A4.

[162] David D. Kirkpatrick & Patrick McGeehan, *Pataki Joins Opposition to Takeover of Ports*, N.Y. TIMES, Feb. 21, 2006, at B3.

fears are baseless.[163] Moreover, regulators themselves can be susceptible to various cognitive biases and thus may overreact to risks. In the face of uncertainty, regulators will often find it more attractive to take precautionary measures to avoid blame. This is especially true when people can easily imagine or visualize a "worst-case scenario," as their reactions are often based mostly on the badness and the vividness of the outcome rather than on the probability of its occurrence.[164] Better safe than sorry. Consequently, governments tend to enthusiastically embrace the Precautionary Principle.[165] There are many different forms of Precautionary Principles. Precautionary Principle in its weak form means that a lack of decisive evidence of harm should not be a ground for refusing to regulate.[166] Sunstein agrees that this is perfectly sensible.[167] However, he has severely criticized a strong version of the principle, which suggests that regulation is required whenever there is a possible risk of harm.[168] He argues that such overreaction to risks can itself produce potential risks and lead to significant loss for societies.[169] As he eloquently argues: "The Precautionary Principle turns out to be flawed, not because it is vague (though it is), and not because it threatens to impede desirable economic development (though it does), but because it is paralyzing, forbidding the very steps that it requires."[170]

Indeed, the influx of foreign investment from an emerging economy such as China represents a novel situation for many Western regulators with which they have never dealt before. Although some of these concerns are reminiscent of the anxieties about Japanese FDI two decades ago, there are also important distinguishing features. First, unlike Japan, China is the only large economy that is not an ally of Europe or the United States. Second, while China is an emerging power with a rapidly modernizing economy, "it is also a state with nondemocratic values and an economy with a high degree of leverage" and intervention from the state.[171] Third, "China has a negative track record in industrial and political espionage" and a reputation as a proliferator "of sensitive technologies to rogue

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163 SUNSTEIN, RISK AND REASON: SAFETY, *supra* note 20, at viii.
164 *Id.* at 41.
165 *See* SUNSTEIN, LAWS OF FEAR, *supra* note 27, at 18.
166 *Id.* at 18–20.
167 *Id.*
168 *Id.* at 24.
169 *Id.* at 103.
170 SUNSTEIN, WORST-CASE SCENARIOS, *supra* note 27, at 279.
171 Thilo Hanemann, *Chinese FDI in the United States and Europe: Implications and Opportunities for Transatlantic Cooperation*, STOCKHOLM CHINA FORUM (June 2011), *available at* http://www.gmfus.org/archives/chinese-fdi-in-the-united-states-and-europe-implications-and-opportunities-for-transatlantic-cooperation.

regimes."[172] When information about Chinese FDI is limited, Western regulators tend to rely on intuition when thinking about the risks posed by Chinese FDI. Fearing a "worst-case scenario" in which Chinese control of domestic economies causes dire political and economic consequences, they may be tempted to embrace a strong form of the Precautionary Principle. As such, they appeal to the alarmist bias against China and take extreme precautionary measures, as revealed in the two examples below—the U.S. Congress' hostile response to CNOOC's attempted acquisition of Unocal and the Commission's increased antitrust scrutiny of Chinese SOEs' acquisitions in Europe.

A. U.S. Response to Chinese FDI

As Graham and Marchick observe: "The debate over investments from China is not the first time that anxiety and opposition have been directed toward a single nation."[173] During World War I, the United States' concern regarding German investment in the chemical industry prompted the passage of the Trading with the Enemy Act in 1917, which provided the President with the power to seize foreign-owned assets in the United States in either time of declared war or in any "international emergency."[174] In the 1970s, the influx of investment from the Organization of Petroleum Exporting Countries following a politically motivated oil embargo caused a near panic among the American public and its policy makers.[175] CFIUS was consequently established to oversee foreign investment and placate Congress' concern.[176] In the 1980s, the emergence of Japan as a large direct investor in the United States caused consternation, which ultimately propelled Congress to approve the Exon-Florio Amendment, the first body of law to establish an investment review regime in the United States.[177]

1. The Legal Mechanism[178]

Under Exon-Florio, the President has the authority to block a foreign acquisition if "there is credible evidence that leads the President to believe

[172] *Id.*
[173] *See* GRAHAM & MARCHICK, *supra* note 43, at 96.
[174] Trading with the Enemy Act ch. 106, 40 Stat. 411 (1917).
[175] GRAHAM & MARCHICK, *supra* note 43, at 20.
[176] Exec. Order No. 11,858(b), 40 Fed. Reg. 20263 (May 7, 1975).
[177] GRAHAM & MARCHICK, *supra* note 43, at 29.
[178] In addition to national security regulations, other laws and regulations such as the Hart Scott-Rodino Antitrust Improvement Act of 1976, the Foreign Corrupt Practices Act of 1977, the Export Administration Regulations, and the International Traffic in Arms Regulations can be applicable to foreign investment but they are not the focus of this Article.

that the foreign interest exercising control might take action that threatens to impair the national security," and if other laws, excepting the International Emergency Economic Powers Act, "do not in the President's judgment provide adequate and appropriate authority for the President to protect the national security in the matter before the President."[179] As such, the passage of Exon-Florio made it possible for the federal government to intervene in virtually any foreign acquisition in any industry for reasons of "national security," a nebulous term that Congress intentionally did not define in the amendment.[180]

In the wake of the controversies over the CNOOC-Unocal and Dubai Ports World deals, Congress passed the Foreign Investment and National Security Act of 2007 (FINSA) on July 27, 2007, amending Exon-Florio.[181] Among other things, FINSA increases congressional oversight throughout the process by requiring CFIUS to adhere to a system of congressional briefings and annual reporting.[182] Upon completion of each investigation, CFIUS must provide Congress with notice of the transaction, the actions taken, and certifications of conclusion by CFIUS officials.[183] Critics note that the increased congressional reporting requirements, together with the allowance of access to confidential information pertaining to foreign investment by the Congress and state senators, may allow special interest groups to gain influence and to politicize the FDI review process.[184] As observed by one commentator: "With increased congressional involvement in the CFIUS review process, there is an increased likelihood of pressure from both domestic competitors and target managers to propel, delay, or prevent certain proposed foreign acquisitions."[185]

Notably, the U.S. Congress has already taken an active interest in Chinese FDI. In 2007, Congress created a bipartisan committee, the United States–China Economic and Security Review Commission (USCC), specifically "to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship" between the United States and China.[186] In 2012, the USCC published an influential report specifically analyzing the economic and policy implications of rising Chinese investment in the U.S. economy. While the

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[179] Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107 (1988).

[180] *See* Kang, *supra* note 45, at 303.

[181] Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007).

[182] *Id.* § 7.

[183] *Id.* § 2.

[184] Jonathan C. Stagg, *Scrutinizing Foreign Investment: How Much Congressional Involvement Is Too Much?*, 93 IOWA L. REV. 325, 329 (2007).

[185] Joanna Rubin Travalini, *Foreign Direct Investment in the United States: Achieving a Balance Between National Economy Benefits and National Security Interests*, 29 NW. J. INT'L L. & BUS. 779, 795 (2009).

[186] Floyd D. Spence National Defense Authorization Act for 2001 § 1238, 22 U.S.C. § 7002 (2001).

report recognizes the welcome, though still modest, economic benefits of Chinese FDI, it also warns that such benefits are counterbalanced by the policy challenges tied to Chinese FDI.[187] With the increased congressional involvement with Chinese FDI, commentators note that the potential for a Chinese acquisition to become highly politicized is significant.[188] Indeed, the public reaction, in conjunction with the fiercely negative Congressional response to CNOOC's bid for Unocal, offers a prime example of how cognitive biases and emotions can be exploited by various interest groups to interfere with the national security review process.

2. CNOOC's Proposed Acquisition of Unocal

On June 23, 2005, CNOOC proposed a bid of $18.5 billion for Unocal, a California-based oil and gas company with significant assets and operations in Asia. CNOOC's announcement immediately spurred a heated debate among the public and touched off a firestorm in Washington.[189] Indeed, when CNOOC announced its bid for Unocal, the timing could not have been worse. In 2005, the global demand for oil and gas was at the highest level in history and the global excess capacity of oil production was at the lowest level in the past decade.[190] As the world's oil prices reached historic highs, gasoline prices steadily rose in the United States.[191] While such hikes can at least partially be explained by American consumers' increased demand for oil, American politicians attributed the increase mostly to China's rising energy demand.[192] Only two years earlier, China surpassed Japan and became the world's second largest oil consumer, immediately after the United States.[193] Therefore, for many Americans, CNOOC's proposed purchase of major U.S. energy resources was akin to a hostile force "intruding on our territory and snatching away that which was vital for our own long-term survival."[194]

These strong reactions show that the American public and U.S.

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[187] SZAMOSSZEGI, *supra* note 19, at ix.

[188] David N. Fagan, *The U.S. Regulatory and Institutional Framework for FDI*, *in* 2 INVESTING IN THE U.S.: A REFERENCE SERIES FOR CHINESE INVESTORS 17 (2009).

[189] *See, e.g.*, Stephanie Kirchgaessner, *Chinese Case Puts Secretive Panel in Spotlight: US Vetting of Foreign Takeovers is Hot Topic*, FIN. TIMES, Aug. 4, 2005, at 22.

[190] H.R. Res. 344, 109th Cong. (2005).

[191] U.S. DEP'T OF ENERGY, A PRIMER ON GASOLINE PRICES (May 2006), *available at* http://www.neo.ne.gov/reports/primerongasoline.pdf.

[192] EDWARD S. STEINFELD, PLAYING OUR GAME, WHY CHINA'S ECONOMIC RISE DOESN'T THREATEN THE WEST 177 (2010).

[193] Pablo Bustelo, *China and Oil in the Asian Pacific Region: Rising Demand for Oil*, 21 NEW ENGLAND J. PUB. POL'Y 171, 172 (2007).

[194] STEINFELD, *supra* note 192, at 178 (Steinfeld provides a detailed discussion of CNOOC's operation and its proposed acquisition of Unocal).

politicians have suffered from "endowment effects," an anomaly originating in loss aversion. Because Unocal is a U.S. based company, the American public and policymakers have a natural emotional attachment to its domestic oil and gas assets. The adamant response from the regulators shows that they were extremely confident about their judgment, which seems to derive from a simple logic: (1) oil is a scarce commodity that is indispensable to the effective and normal functioning of the U.S. economy; (2) oil prices have been rising and the demand for oil is increasing in the United States; (3) therefore it does not make sense to sell these domestic resources to foreign companies. But such thinking misses two important pieces of information. First, oil is a highly fungible commodity. There is no doubt that oil is a scarce resource and that America needs to import much oil. However, the oil market operates on a global scale and it matters little where oil supplies originate.[195] Fungibility also means that if certain oil supplies are artificially channeled to one destination, other oil suppliers will be redirected, filling any market that previously relied on the channeled supplies. Indeed, energy experts point out that America's vulnerability to oil supply disruptions is primarily related to how much oil it consumes, not where the oil it consumes happens to originate.[196] Second, the American public seems to have completely ignored the compensating benefits of the transaction. CNOOC was, in fact, the higher of the two bidders for Unocal, and Unocal's shareholders would have been better off financially if the deal had gone through.

In addition to loss aversion, affect heuristics also played an important role in shaping the public reaction to the CNOOC bid. CNOOC is a publicly listed company based in Hong Kong, and it is 70% owned by China National Offshore Oil Company, one of the largest state-owned oil companies in China. For many Americans, CNOOC is the commercial face of the Chinese communist government. The CNOOC bid also coincided with growing uneasiness in the United States over the rise of China's economic and political power, the large bilateral trade deficit with China, rising concern about China's manipulation of its currency, and inadequate protection of intellectual property rights.[197] As such, System 1 dominated public thought processes: instead of answering the question of whether the CNOOC acquisition was good for America, the American public took a shortcut, instead answering the question of whether it "liked" the acquisition or even whether it "liked" China in general.

Availability heuristics further amplified people's fear of a rising

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[195] BERNARD A. GELB, CONG. RESEARCH SERV., RS22182, UNOCAL CORPORATION'S OIL AND GAS (2005).

[196] Jerry Taylor, *CNOOC Bid for Unocal No Threat to Energy Security*, CATO INST. (July 19, 2005), *available at* http://www.cato.org/publications/free-trade-bulletin/cnooc-bid-unocal-no-threat-energy-security.

[197] DICK K. NANTO, JAMES K. JACKSON, WAYNE M. MORRISON & LAWRENCE KUMINS, CONG. RESEARCH SERV., RL33093, CHINA AND THE CNOOC BID FOR UNOCAL: ISSUES FOR CONGRESS (2005).

China. Immediately before the CNOOC bid, there had been at least two headline transactions involving large Chinese companies' takeovers in America.[198] A few months before CNOOC's announcement, Chinese computer maker Lenovo's acquisition of IBM's legendary personal computer business caused a stir among the U.S. public and American politicians, many of whom expressed concern over the national security implications of the deal. Lenovo's footsteps were quickly followed by Haier Group, one of China's biggest consumer electronics companies, who led a consortium investor group to acquire the Maytag Corporation, an American appliance icon. Three high profile acquisitions occurring in such a short period of time came as a shock to the American public, leaving them with the impression that Chinese companies were ferociously acquiring dazzling American corporate icons and, in the process, taking over America.[199] Indeed, given nominal oil prices at record levels, strong anti-China sentiment in Washington, and recent high profile acquisitions signifying China's growing economic clout, CNOOC's attempt to acquire Unocal produced a "perfect storm" in Congress for a debate on the national security implications of Chinese investment in the United States.

CNOOC was competing with American-owned Chevron, who had already made an offer to acquire Unocal for $16.4 billion in cash and stock.[200] To supplant Chevron's bid, CNOOC made a more attractive offer of $18.5 billion, all in cash.[201] Both Chevron and CNOOC hired lobbyists to sway public opinion and political leaders. But Chevron had a "home advantage" in its efforts in Washington. According to the *Washington Post*, Chevron lined up a formidable team of heavyweights in Washington to lobby against the CNOOC bid.[202] Its main strategy was to convince Unocal's shareholders that CNOOC's higher all-cash offer was not worth the risk of an extensive regulatory and security review.[203]

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[198] David Barboza & Andrew Ross Sorkin, *Chinese Oil Company Offers $18.5 Billion for Unocal*, N.Y. TIMES, June 22, 2005, *available at* http://www.nytimes.com/2005/06/22/business/worldbusiness/22WIRE-CNOOC.html?pagewanted=print&_r=0.

[199] *Id.*

[200] *Id.*

[201] *Id.*

[202] *See* Weisman, *supra* note 133 (Chevron's team of heavyweights include: Wayne L. Berman, a top fundraiser for President Bush whose wife is the White House social secretary; Drew Maloney, a former legislative director of House Majority Leader Tom DeLay (R-Tex.); Kenneth J. Kies, a prominent tax lobbyist; former commerce secretary Mickey Kantor; Democratic trade experts Claude G.B. Fontheim and Kenneth I. Levinson; and David M. Marchick, a senior trade official in the Clinton administration who specializes in national security reviews by the high-level Committee on Foreign Investment in the United States).

[203] David O'Reilly, *Chevron's Pitch*, WALL ST. J., July 12, 2005, *available at* http://online.wsj.com/article/0,,SB112113139861482996,00.html (As announced by David O'Reilly, the then chairman and chief executive officer of Chevron: "For Unocal shareholders, the most important issue is clear. It is a choice between a definitive merger agreement with Chevron, which can close in the next four weeks,

In addition to lobbying from Chevron, politicians in the United States also used the CNOOC transaction as an opportunity to exploit people's fear of rising Chinese FDI in order to advance their own political agendas. On June 24, 2005, Representative William Jefferson, together with forty fellow members of Congress, sent a letter to Treasury Secretary John Snow.[204] In the letter, they characterized the transaction as a symbol of an aggressive China taking over scarce energy resources, which would make it "increasingly difficult for U.S.-based companies to compete for scarce energy resources on the world market against China's state-owned and/or controlled energy companies."[205] They asked that the transaction "be reviewed immediately to investigate the implications of the acquisition of U.S. energy companies and assets by CNOOC and other government controlled Chinese energy companies."[206]

On June 30, 2005, the House of Representatives passed H.R. 344. Introduced by Congressman Richard Pombo, the resolution expressed the concern that a Chinese state-owned energy company exercising control of critical American energy infrastructure and energy production capacity could threaten American national security. It called on the President to make a thorough review if the deal went forward.[207] On July 13, 2005, the House Armed Services Committee held a hearing on the CNOOC transaction. Jim Woolsey, a former Central Intelligence Agency Director, declared "China is pursuing a national strategy of domination of the energy markets and strategic dominance of the West Pacific."[208] He called CNOOC "an organ, effectively, of the world's largest Communist dictatorship," which should be blocked from acquiring American assets.[209] During the same hearing, Frank Gaffney Jr., President of the Center for Security Policy, warned that the sale of Unocal Corp. to CNOOC "would have adverse effects on the economic and national security interests of the United States," pointing to "the folly of abetting Communist China's effort to acquire more of the world's relatively finite energy resources."[210]

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versus an uncertain and highly contingent proposal from CNOOC, which cannot be executed unless and until Unocal shareholders reject the Chevron agreement, or Chevron opts out.").

[204] *Letter to Treasury Secretary John W. Snow from Representative William J. Jefferson et al*., 151 CON. REC. H5570-77 (daily ed. June 30, 2005).

[205] *Id.* H5574.

[206] *Id.*

[207] H.R. Res. 344, 109th Cong. (2005).

[208] Steve Lohr, *Unocal Bid Denounced at Hearing*, N.Y. TIMES, July 14, 2005, *available at* http://www.nytimes.com/2005/07/14/business/worldbusiness/14unocal.html?adxnnl=1&adxnnlx=1373447060-/Q2cKsZf3kJ8xlYJvQ1JDg.

[209] *Id*.

[210] *"CNOOCERED": The Adverse National Security Implications of the Proposed Acquisition of Unocal by the China National Offshore Oil Corporation: Hearing Before the House Armed Servs. Comm.*, 109th Cong. (2005) (statement of Frank J. Gaffney, Jr., President, Ctr. for Sec. Policy).

On July 29, 2005, the Senate and House representatives agreed to adopt the amendment of the Energy Policy Act of 2005 authored by Congressman Pombo. It required that the secretaries of energy, defense, and homeland security conduct a study of China's growing energy requirements and the implications of "such growth on the political, strategic, economic, or national security . . . of the United States."[211] The Amendment prohibited CFIUS from concluding its national security review of an "investment in the energy assets of a United States domestic corporation by an entity owned or controlled by the government of the People's Republic of China" until after a period of 141 days.[212] That meant that CFIUS could not complete its review of a potential CNOOC-Unocal transaction for 141 days, or fifty-one days longer than the maximum of ninety days established under Exon-Florio. Notably, Chevron is located in the congressional district represented by the chairman of the House Committee on Resources, Richard Pombo, the very person introducing H.R. 344 and proposing amendment of the energy bill. On August 2, 2005, CNOOC withdrew its offer, ensuring Chevron's success. In response to the new law, CNOOC released a press release citing "unprecedented political opposition . . . creating a level of uncertainty that present[ed] an unacceptable risk to our ability to secure this transaction."[213]

There is an overwhelming consensus among FDI and energy experts that Congress overreacted to CNOOC's bid.[214] The Congressional Research Service reports that Unocal is an insignificant player in the U.S. energy market, accounting for only 0.8% of U.S. production of crude oil, condensate, and national gas liquids.[215] If the CNOOC-Unocal deal had gone through, the combined natural gas production would have amounted to about 1% of U.S. consumption, and combined oil production would have been equivalent to 0.3% of domestic U.S. consumption.[216] Given the relatively small size of Unocal's global oil and gas holdings, a CNOOC acquisition would have had a negligible impact on global energy markets. Moreover, the majority of Unocal's reserves are located in Asia and are already committed under long-term contracts to serve the Asian regions.[217]

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[211] Energy Policy Act, H.R. 6, 109th Cong. § 1837 (2005).

[212] *Id.*

[213] Press Release, CNOOC, CNOOC Limited to Withdraw Unocal Bid (Aug. 2, 2005).

[214] *See, e.g.*, JAMES A. DORN, CATO INST., U.S.-CHINA RELATIONS IN THE WAKE OF CNOOC (2005); Edward M. Graham, *No Reason to Block the Deal*, 168 FAR E. ECON. REV. 25 (July 2005); GRAHAM & MARCHICK, *supra* note 43, at 128–36.

[215] BERNARD A. GELB, CONG. RESEARCH. SERV., RS22182, UNOCAL CORPORATION'S OIL AND GAS 2 (2005).

[216] DICK K. NANTO, JAMES K. JACKSON, WAYNE M. MORRISON & LAWRENCE KUMINS, CONG. RESEARCH SERV., RL33093, CHINA AND THE CNOOC BID FOR UNOCAL: ISSUES FOR CONGRESS 11 (2005).

[217] Patrick Barta & Matt Pottinger, *Why CNOOC May Not Be Such a Big Threat*, WALL ST. J. (June 30, 2005), http://online.wsj.com/news/articles/SB112007624176673219.

In 2006, a study undertaken by the U.S. Department of Energy at the request of Congressman Pombo also concluded that foreign investments by China's national oil companies pose no economic threat to the United States.[218]

As noted earlier, oil is a fungible commodity and it matters little where oil supplies originate. Therefore, if CNOOC acquired Unocal and directly shipped oil to China, instead of buying it on the open market, the United States would not be "crowded out"; the Unocal production would simply replace other imports that would have gone to China otherwise.[219] Since overall global supply would remain the same, the price of oil would not be affected. CNOOC might absorb a financial loss by selling below world price to Chinese customers, but there would be little impact on the rest of the world.

There is also no indication that Unocal possessed any proprietary technology that was not already available to CNOOC through private vendors, contractors, and other sources. While Unocal's knowledge of deep water drilling off the Gulf of Mexico is of great value, spreading such expertise could result in greater oil production worldwide, benefiting all consumers. Furthermore, CNOOC was willing to relinquish the Gulf of Mexico assets if that step would have secured U.S. approval of that transaction.[220] In fact, CNOOC had agreed not to divert Unocal's U.S. production of oil and gas to other markets and it planned to retain virtually all of Unocal's employees.[221] While there was also concern about subsidized finance, that was not a sufficient legal reason to block CNOOC's acquisition. Indeed, U.S. officials have confirmed that CFIUS remains focused on the national security implications of inward FDI. Expanding the mandate to cover debates over investment subsidies would take CFIUS into terrain far better covered by expertise in other agencies.[222]

Unfortunately, these facts were largely downplayed or ignored during the policy debate about CNOOC's bid. Instead, many U.S. Congress members favored precautionary measures and adamantly opposed the CNOOC-Unocal deal. What they may have failed to realize, however, were the consequences potentially resulting from their actions—the political and economic repercussions of blocking CNOOC's acquisition.

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[218] ERICA S. DOWN & PETER C. EVANS, BROOKING INST., UNTANGLING CHINA'S QUEST FOR OIL THROUGH STATE-BACKED FINANCIAL DEALS 154 (2006).

[219] DORN, *supra* note 214.

[220] Dennis K. Berman et al., *China Still Has to Prove It Can Close the Deal*, WALL ST. J., July 21, 2005, *available at* http://online.wsj.com/article/SB112190262333391544.html.

[221] Press Release, CNOOC, Statement by FU Chengyu, Chairman and CEO of CNOOC Ltd. (June 24, 2005).

[222] Gary Hufbauer et al., *Investment Subsidies for Cross-Border M&A: Trends and Policy Implications* (U.S. Council Found., Occasional Paper No. 2, 2008).

As the country with the largest outward investment in the world, the United States has a strong interest in maintaining open markets and encouraging open investment policies; blocking the CNOOC-Unocal transaction could have led to protectionism and ultimately hurt U.S. interests. If the United States prevents Chinese firms from acquiring U.S.-based companies such as Unocal, the Chinese will look elsewhere—to friendly states such as Canada as well as to rogue states such as Sudan and Iran.[223] This could actually lead to a worse outcome than what most opponents were worried about in the first place.

Another important aspect that tends to be ignored by U.S. regulators is the benefits of globalization. One of the major benefits of Chinese FDI is that the Chinese firms' venture overseas could help them to learn Western games (i.e., the rules in Western institutions).[224] This is particularly true for Chinese SOEs, who have enjoyed advanced and superior status in China and are shielded from competition and regulations. However, once they venture overseas, they will need to play the same games as their Western counterparts: they will not only need to comply with local laws and regulations but will also be subject to the jurisdiction of U.S. courts and litigation. The exposure to foreign regulations could create a positive feedback effect into China, pushing the Chinese government to realize its current legal and administrative system may be hindering the chances of these companies operating successfully overseas.[225]

In fact, the increasing Chinese investment in the United States should be viewed as "a hopeful sign" for the future of Chinese–American relationships. As commented by Judge Posner: "[The CNOOC acquisition] suggests that China envisages [a] peaceful, constructive commercial relationship with the United States. Otherwise it would not spend billions of dollars to acquire assets that ultimately are under the control of our government."[226] Indeed, empirical research has shown that trade has the benefit of reducing the probability of conflict between nations.[227] The more assets China invests in the United States, the more the U.S. government can hold these assets as hostages against China. The United States is one of the largest foreign investors in the Chinese market. Recently Chinese regulators have brought a number of tough regulatory

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[223] DORN, *supra* note 214.

[224] *See generally* STEINFELD, *supra* note 192.

[225] Danil H. Rosen & Thilo Hanemann, *The Rise in Chinese Overseas Investment and What It Means for American Business*, CHINA BUS. REV., July 1, 2012, *available at* http://www.chinabusinessreview.com/the-rise-in-chinese-overseas-investment-and-what-it-means-for-american-businesses/.

[226] Richard A. Posner, *Posner's Comment on Chinese Purchases of American Companies*, BECKER-POSNER BLOG (Aug. 7, 2005), http://www.becker-posner-blog.com/2005/08/posners-comment-on-chinese-purchases-of-american-companies/comments/page/2/.

[227] Solomon W. Polocheck, *Conflict and Trade*, 24 J. CONFLICT RESOL. 55 (1980).

sanctions against foreign companies for corruption and antitrust violations.[228] Foreign companies have complained that they have been unfairly targeted.[229] But the more Chinese companies invest overseas, the more Chinese assets will be subject to regulatory control by Western regulators. This in turn could impose constraints on Chinese regulators (if their actions have indeed unfairly targeted foreign firms), thus reducing friction between the two countries. In cases of national emergency, such as a military conflict, the U.S. government could even nationalize Chinese assets. For example, after the outbreak of the Second World War, subsidiaries of German companies operated in the United States were cut off from their parent companies in Germany.[230] These German subsidiaries operated in the United States came under U.S. control, and there is no evidence that they attempted to act in the interests of Germany against the United States.[231]

B. European Response to Chinese FDI

The EU's response to foreign takeovers has largely been dominated by the drive to create a single internal market. The 1957 Treaty of Rome called for members to "progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in Member States."[232] In 1993, the Maastricht Treaty further expanded Europe's achievements on internal freedom of capital movements to third countries.[233] Article 63 of the Treaty on the Functioning of the European Union (TFEU) stipulates that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited."[234] The legal framework allows very limited exceptions, thus leaving EU member states with the most liberal economies among developed countries in the regulation of FDI.[235]

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[228] Michael Martina & Kazunori Takada, *Rattled by Investigations, Foreign Firms in China Beef Up Compliance*, REUTERS, Sep. 2, 2013, *available at* http://www.reuters.com/article/2013/09/02/us-china-investigations-idUSBRE9810NG20130902.

[229] Victoria Ruan, *EU Group Wants Fairer Policies for Foreign Firms*, S. CHINA MORNING POST (Sept. 6, 2013), http://www.scmp.com/news/china/article/1304205/eu-group-wants-fairer-policies-foreign-firms.

[230] *See* GRAHAM & KRUGMAN, *supra* note 17, at 102.

[231] *Id.*

[232] Treaty of Establishing the European Economic Community ch. 4, art. 67, Mar. 25, 1957, 4300 U.N.T.S. 294.

[233] Treaty on European Union art. 73(b), Feb. 7, 1992, 1992 O.J. (C 191) 1.

[234] Consolidated Version of the Treaty on the Functioning of the European Union art. 63, May 9, 2008, 2008 O.J. (C 115) 70 [hereinafter TFEU].

[235] THILO HANEMANN & DANIEL H. ROSEN, RHODIUM GRP., CHINA INVESTS IN EUROPE: PATTERNS, IMPACTS AND POLICY IMPLICATIONS 64–65 (2012).

1. *The Legal Mechanism*

Currently there is no foreign investment control at the EU level. But such investment control may exist at the national level. Pursuant to the TFEU, EU member states retain the right to impose restrictions on foreign investment based on public security considerations, as long as those restrictions do not result in arbitrary discrimination or a disguised restriction on trade.[236] The EU law does not define national security clearly, leaving the door open to broad interpretation.[237] Indeed, investment security regimes at the member state level vary widely across Europe. Countries such as France and Germany have established investment reviews that are used to address security concerns, whereas those like Belgium, Czech Republic, Hungary, Iceland, Ireland, and the Netherlands do not have any investment measures related to public order and essential security considerations.[238]

As EU member states have a mandate to protect the single market, the Commission has been closely monitoring restrictions imposed by member states on capital movements. As observed by Hanemann & Rosen: "Cases involving economic nationalism against foreign takeovers of local companies . . . were typically met with an ultimatum for compliance and a filing with the European Court of Justice . . . ."[239] For instance, the European Union Merger Regulation (EUMR) recognizes that member states may take appropriate measures to protect certain "legitimate interests" such as public security, plurality of the media, and prudential rules.[240] In practice, however, the Commission has narrowly interpreted the scope of these "legitimate interests."[241] In fact, member states have rarely

[236] TFEU, *supra* note 234, art. 346.

[237] *See generally* OECD, PROPORTIONALITY OF SECURITY-RELATED INVESTMENT INSTRUMENTS: A SURVEY OF PRACTICES (2008), http://www.oecd.org/daf/inv/investment-policy/40699890.pdf; *see also* OECD, TRANSPARENCY AND PREDICTABILITY FOR INVESTMENT POLICIES ADDRESSING NATIONAL SECURITY CONCERNS: A SURVEY OF PRACTICES (2008), http://www.oecd.org/daf/inv/investment-policy/40700254.pdf.

[238] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-320, FOREIGN INVESTMENT: LAWS AND POLICIES REGULATING FOREIGN INVESTMENT IN TEN COUNTRIES (2008); OECD, IDENTIFICATION OF FOREIGN INVESTORS: A FACT FINDING SURVEY OF INVESTMENT REVIEW PROCEDURES (2010), http://www.oecd.org/dataoecd/4/3/45425060.pdf; Robert LaRussa & Lisa Raisner, *Foreign Investment Review: Mergers National Interest & National Security in 26 Jurisdictions Worldwide*, *in* GETTING THE DEAL THROUGH—FOREIGN INVESTMENT REVIEW 2013 (2013).

[239] HANEMANN & ROSEN, *supra* note 73, at 65.

[240] *See* Council Regulation (EC) No. 139/2004 of 20 Jan. 2004 on the Control of Concentrations Between Undertakings, art. 21(4), 2004 O.J. (L 24) 1 [hereinafter EUMR].

[241] *See, e.g.*, Case IV/M.1616, BSCH/Champalimaud, Regulation (EC) No. 4064/89 (July 20, 1999); Commission Press Release IP/00/1338 of November 22, 2000; Commission Press Release IP/06/1265 of September 26, 2006.

been successful in blocking foreign acquisitions on "legitimate interests" grounds.[242]

2. *Recent Chinese SOEs' Acquisitions in Europe*

In general, Europe is perceived as a more welcoming destination for Chinese investment than the United States. This has partly contributed to the surge of capital influx into the EU in recent years, especially after the financial crisis. The Rhodium Group estimated that in 2011, FDI from China tripled from $3 billion to $10 billion, whereas inflows to the United States remained unchanged at $5 billion.[243] Such a large influx of capital into Europe has alarmed European regulators, leading to "a fear of politically and strategically motivated takeovers executed by Chinese SOEs."[244] In 2010, Xinmao, a Chinese cable maker, proposed an acquisition of Draka, a Dutch fiber cable producer. This prompted European Commissioner for Industry and Entrepreneurship Antonio Tajani to call for a EU-wide foreign investment review to protect European know-how and technology from Chinese investors.[245] Tajani and his colleague Michael Barnier later wrote to EU President José Manuel Barroso emphasizing the need for a pan-European investment review regime: "[W]e have to make sure it's not a front for something else, in terms of taking our know-how abroad . . . ."[246] As he stated below: "The time to fireproof your house is before it catches fire . . . we want to be sure we know who is investing in Europe, and why."[247] Echoing such concerns, the European Parliament called for a European body "entrusted with the ex ante evaluation of foreign strategic investment."[248] Politicians in Europe have further expressed concern that the current patchwork of investment rules in different EU member states risks a race to the bottom in which some member state authorities may abandon attempts to screen for security in the

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[242] *See, e.g.*, Case IV/M.567, Lyonnaise des Eaux SA/Northumbrian Water Group, Regulation (EEC) No. 4064/89 (Mar. 29, 1995); Case IV/M.759, Sun Alliance/Royal Insurance, Regulation (EC) No. 4064/89 (June 18, 1996). *See also* RICHARD WHISH & DAVID BAILEY, COMPETITION LAW 852–53 (7th ed. 2012).

[243] HANEMANN & ROSEN, *supra* note 73, at 36.

[244] *See* John W. Miller, *Chinese Companies Embark on Shopping Spree in Europe*, WALL ST. J. (June 6, 2011), http://online.wsj.com/news/articles/SB10001424052748704355304576214683640225122; *see also* Maaike Okano-Heijmans & Frans-Paul van der Putten, *Europe Needs to Screen Chinese Investment*, FIN. TIMES (Aug. 11, 2009).

[245] *See* Miller, *supra* note 244 (citing interview with Industry Commissioner Tajani).

[246] John W. Miller, *Bid Dropped as EU Raises China's Wall*, WALL ST. J. (Jan. 7, 2011), http://online.wsj.com/article/SB10001424052748704415104576065313773996124.html.

[247] Miller, *supra* note 244.

[248] Resolution on "EU and China: Unbalanced Trade?", EUR. PARL. DOC. P7_TA 0218 (2012).

rush to attract Chinese money.[249]

Some scholars suggest that there are two ways to overcome this problem. The first is to create a EU-wide body, similar to CFIUS, to vet foreign investment.[250] However, this is likely to be met with significant opposition from member states, who may have conflicting political and economic interests and thus be reluctant to cede jurisdiction to a EU-wide body. An alternative avenue for response is to strengthen the monitoring of Chinese FDI on grounds of competition policy.[251] This appears to be a more feasible approach since the Commission is already empowered to review cases at the EU level. Indeed, this seems to be exactly what has happened recently.

Since 2011, acquisitions by Chinese SOEs in Europe have been subject to heightened merger review by the Commission. In each of the recently notified cases involving Chinese SOEs, the Commission has considered the "worst-case scenario." That is, operating on the hypothetical assumption that all Chinese SOEs are controlled by the Chinese government and thus should be treated as a single entity, the Commission has considered whether a given transaction will pose any anti-competitive harm.[252]

This "worst-case scenario" approach has introduced significant complications for transactions involving Chinese SOEs. From a procedural standpoint, if all Chinese SOEs are deemed part of the same entity, then presumably the turnover requirement under the EUMR will surely be met for the Chinese party, which would significantly increase the likelihood that a Chinese acquisition would need to be notified to the Commission. In fact, under the "worst-case scenario" considered by the Commission, any acquisition involving any Chinese SOE would definitely require notification to the Commission, as long as the European target's turnover also meets EU thresholds. From a substantive standpoint, if all Chinese SOEs are treated as part of a single entity, then competitive assessments would focus on the target and all the Chinese SOEs in the same sector,

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249 *See* Meunier, *supra* note 59; *see also* GODEMENT, PARELLO-PLESNER & RICHARD, *supra* note 60.

250 *See* Meunier, *supra* note 59; *see also* GODEMENT, PARELLO-PLESNER & RICHARD, *supra* note 60.

251 *See* Meunier, *supra* note 59; *see also* GODEMENT, PARELLO-PLESNER & RICHARD, *supra* note 60.

252 *See, e.g.*, Case COMP/M.6111, Huaneng/Intergen, Regulation (EC) No. 139/2004 (Feb. 2, 2011); Case COMP/M.6082, China National Bluestar/Elkem, Regulation (EC) No. 139/2004 (Mar. 31, 2011); Case COMP/M.6151, Petrochina/Ineos, Regulation (EC) No. 139/2004 (May 13, 2011); Case COMP/M.6113, DSM/Sinochem/JV, Regulation (EC) No. 139/2004 (May 19, 2011); Case COMP/M.6141, China National Agrochemical/Makhteshim Agan, Regulation (EC) No. 139/2004 (Oct. 3, 2011); Case COMP/M.6235, Honeywell/Sinochem/JV, Regulation (EC) No. 139/2004 (Dec. 2, 2011); Case COMP/M.6700, Talisman/ Sinopec/JV, Regulation (EC) No. 139/2004 (Oct. 16, 2012); Case COMP/M.6715, CNOOC/NEXEN, Regulation (EEC) No. 139/2004 (Nov. 12, 2012); Case COMP/M.6807, Mercuria Energy Asset Management/Sinomart KTS Development/Vesta Terminals, Regulation (EC) No. 139/2004 (Mar. 7, 2013).

rather than the target and the acquiring Chinese SOE alone, which could adversely affect transactions.

So far the Commission has unconditionally cleared all the notified cases involving Chinese SOEs because even under the "worst-case scenario," these transactions would not pose any anti-competitive harm. Therefore, the Commission left open this issue of whether Chinese SOEs should be viewed as a single entity in all its published decisions up to date. However, the Commission continued to apply the "worst-case scenario" approach to each notified transaction involving Chinese SOEs, and indeed has taken jurisdiction over at least one case where the turnover of the notifying Chinese SOE clearly did not meet the EU merger notification thresholds.[253] Thus even though the Commission has not openly taken a position on the independence of Chinese SOEs, its review practice to date indicates that it has tacitly reached a conclusion that Chinese SOEs are not independent from each other and should be viewed as a single entity.

It is understandable that the Commission would want to exercise caution in dealing with Chinese FDI, but the "worst-case scenario" approach is precisely the kind of paralyzing precautionary measure that could itself inflict cost and create risks. To begin, the "worst-case scenario" approach significantly increases the regulatory risks and burdens for the transacting parties, which could have the effect of deterring Chinese investors. As the Commission has yet to reach an official conclusion on this issue, transacting parties are left with no guidance as to whether they need to notify their transactions to the Commission when their acquiring Chinese SOE's turnover does not satisfy the EU thresholds. Moreover, once a transaction has been notified, the Commission usually requires the parties to gather market data for all other Chinese SOEs in the same sector—a mission nearly impossible since Chinese SOEs are presumed to be independent. Indeed, unless the other relevant SOEs voluntarily disclose their data, it is almost impossible for the parties to obtain such information.

A more vexing issue is that the single entity theory is a double-edged sword. If Chinese SOEs in the same sector are treated as part of a single entity, agreements as well as mergers between them would arguably be exempted from EU competition law.[254] Therefore, applying the "worst-case scenario" approach to Chinese SOEs is very costly—the Commission risks creating a precedent that will work against itself in the future when it wants to exercise jurisdiction over mergers or cartels between Chinese SOEs. The EU has a potential interest in intervening in those cases

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[253] This is based on the observation of a European competition lawyer representing a Chinese SOE in connection with its acquisition in Europe. The lawyer wishes to stay anonymous.

[254] *See* Zhang, *supra* note 23, at 824–26.

because Chinese SOEs have access to European markets either via their affiliates based in Europe or via exports. In the United States, there have been at least three class action suits against Chinese companies for conducting export cartels.[255] In March 2013, Hebei Welcome Pharmaceutical Co. and its affiliate company North China Pharmaceutical Group Co. were found liable for fixing export prices on vitamin C in the United States and were ordered to pay $162 million in damages.[256] Similarly, although mergers between Chinese SOEs take place in China, they will potentially have effects on European markets as long as they make sales in Europe. But if the Commission treats all Chinese SOEs as part of a single entity, then it will presumably lose jurisdiction over these important mergers.

Moreover, the current approach adopted by the Commission may jeopardize the EU's hard-earned reputation as an open environment for foreign investment. Indeed, the Commission risks the appearance of applying a double standard to Chinese SOEs, as it has not explained in its decision why it has not applied the same evidentiary standard in cases involving Chinese SOEs and cases involving European SOEs.[257] Practitioners have already raised concerns as to whether the Commission has been influenced by political factors in reviewing cases involving Chinese firms.[258] This could tarnish the reputation of the EUMR, a body of antitrust law that should be firmly grounded in economics rather than political concerns.[259]

So why did the Commission fail to see the adverse consequences that

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[255] *In re* Vitamin C Antitrust Litig., 810 F. Supp. 2d 522 (E.D.N.Y. 2011); Resco Prods., Inc. v. Bosai Minerals Grp., No. 06-235, 2010 WL 2331069 (W.D. Pa. June 4, 2010); Animal Sci. Prods., Inc. v. China Nat'l Metals & Minerals Imp. & Exp. Corp., 702 F. Supp. 2d 320 (D.N.J. 2010), *vacated sub nom*. Animal Sci. Prods., Inc. v. China Minmetals Corp., 654 F.3d 462 (3d Cir. 2011); *see also* Dingding Tina Wang, *When Antitrust Met WTO: Why U.S. Courts Should Consider U.S.-China WTO Disputes in Deciding Antitrust Cases Involving Chinese Exports*, 112 COLUM. L. REV. 1096 (2012). It should be noted that these cases only involve Chinese companies that are privately owned.

[256] *In re* Vitamin C Antitrust Litigation [Animal Science Products, Inc., et al. v. Hebei Welcome Pharm. Co. Ltd., et al.], No. 06-md-1738, No. 05-cv-0453 (E.D.N.Y. Mar. 14, 2013).

[257] *See* Zhang, *supra* note 23, at 822–24, 830 ("[C]ontrary to the principle under the EUMR and previous Commission cases involving European SOEs, the Commission has seemed to focus on whether the Chinese State is able to exert influence over the SOEs, rather than whether such influence has been exerted in practice.").

[258] *See, e.g.*, Odd Stemsrud, "*China Inc" Under Merger Regulation Review: The Commission's Approach to Acquisitions by Chinese Public Undertakings*, 32 EUR. COMPETITION L. REV. 481, 486 (2011) ("The practical approach of the Commission to undertake an entire "China Inc" alternative assessment could also be viewed in light of the *de lege ferenda* view of Vice President Tajani, that the Commission needs additional powers to investigate Chinese investments in the EU. In this political environment it is, perhaps, understandable that DG COMP applies the old warning: "Approach with caution.").

[259] Some scholars in Europe have held a contrary view that the EU competition law has and should include other public policy objectives. *See generally* CHRISTOPHER TOWNLEY, ARTICLE 81 EC AND PUBLIC POLICY (2009).

could result from its "worst-case scenario" approach? This Article posits that cognitive biases have led them astray. Because the consequences of a communist Chinese state controlling the Western economy are cognitively available and highly salient, strong emotions are triggered in European publics and regulators and fear of Chinese FDI is heightened. When people have a strong negative affect toward Chinese FDI, they tend not to think much about the probability of harm but focus instead on possible disastrous consequences. As such, European regulators have reacted with extreme caution in dealing with Chinese investment and have focused on "worst-case scenarios"—a salient manifestation of alarmist bias. In fact, European regulators themselves have influenced public perception of the risks associated with Chinese FDI. As evidenced by Antonio Tajani's warning about the potential dire consequences of Chinese investment in Europe, regulators can themselves act as availability entrepreneurs and further amplify European fear of Chinese FDI. Moreover, when the Commission forms the belief that a Chinese SOE has no independent power of decision-making, it tends to seek evidence supporting such a thesis rather than evidence challenging it. To make matters worse, alarmist bias and confirmation bias are worsened by inadequate checks and balances in the EU competition regime. Wouter Wils, a leading scholar on EU competition law, has long observed that antitrust regulators are susceptible to prosecutorial biases and that this problem is particularly acute for the Commission as it combines the prosecutorial function with the adjunctive function.[260]

But how likely is it that the Chinese government still continues to control the decision-making of Chinese SOEs? The Commission's analysis is silent on this point. Indeed, if there is a one percent chance that the Chinese government maintains close control of the decision-making of the SOEs, the action taken by the Commission should differ from a scenario in which there is a ninety-nine percent chance that it does. To resolve this issue, the Commission needs to take a step back and re-examine the historical and contemporary dynamics of SOE governance in China.

Thirty years ago, few would have doubted that the whole Chinese economy was one big firm, and that none of the Chinese SOEs possessed independent power of decision-making. But China has made great strides in reforming its SOE system. In the 1990s, the Chinese government privatized a large number of small and medium size SOEs and conducted extensive restructuring of the remaining larger SOEs.[261] In 2003, the

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[260] *See* WOUTER P. J. WILS, PRINCIPLES OF EUROPEAN ANTITRUST ENFORCEMENT 164–65 (2005).

[261] *See* OECD, OECD REVIEWS OF REGULATORY REFORM: CHINA—DEFINING THE BOUNDARY BETWEEN THE MARKET AND THE STATE (2009) [hereinafter OECD, OECD REVIEWS OF REGULATORY REFORM], http://www.oecd.org/china/42390089.pdf.

Chinese government created the State Asset Supervision and Administration Commission (SASAC), a special commission directly subordinate to the State Council, to act as a fiduciary to manage its ownership interests.[262] One of the primary objectives in establishing the SASAC was to "separate the government's social and public management functions from the role as the investor of the state-owned assets in terms of institutional framework."[263] Pursuant to the Enterprise State-Owned Assets Law promulgated in 2008, SASAC is entitled to rights as a shareholder, including returns on its investment and approval of any major ownership decisions such as mergers, bankruptcy, and the issuance of new securities of the firm.[264] In addition, SASAC has the authority to appoint directors, managers, and supervisors of wholly SOEs, and to nominate directors and supervisors in partially state-owned enterprises.[265] Besides the exercise of such rights, SASAC is not allowed to intervene directly in management or day-to-day operations.[266] Thus it appears that Chinese SOEs enjoy a power of decision-making independent of SASAC, which essentially exercises basic ownership functions on behalf of the Chinese government as a non-managing trustee.

On the other hand, there are also good reasons for the Commission to be skeptical about Chinese SOEs. While the creation of the SASAC has weakened the administrative ties between SOEs and government agencies, the ties have not been completely severed. In particular, the CCP—the single ruling party in China—is omnipresent at all levels of the government and the national economy and still exercises influence over Chinese SOEs through the Soviet-style *nomenklatura* system. As a result, the appointments of senior executives at Chinese SOEs, as well as the future career paths of the top SOE executives, are determined by the CCP, which gives incentives to SOE executives to follow the government's policy guidance.[267] However, due to the secretive nature of the CCP, it is not exactly clear to what extent it still influences the decision-making of senior executives at Chinese SOEs. This poses significant challenges to the staff at the merger unit of the Commission, who are antitrust law experts but

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[262] *See China State-Owned Asset Management System Reform Entering New Stage*, SASAC (May 23, 2003), http://www.sasac.gov.cn/n2963340/n2964727/n2974401/2976097.html.

[263] *Id.* For a detailed discussion on SASAC as a controlling shareholder of Chinese SOEs, see Lin & Milhaupt, *supra* note 22, at 734–46.

[264] *See* Zhonghua Renmin Gongheguo Guoyou Qiye Zichan Fa (中华人民共和国国有企业资产法) [The Law of the People's Republic of China on the State-Owned Assets of Enterprises] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009) arts. 12, 16, 18, 21, 30–38 (China).

[265] *See id.* art. 22.

[266] *See id.* arts. 6, 14.

[267] Nan Lin, *Capitalism in China: A Centrally Managed Capitalism (CMC) and Its Future*, 7 MGM'T & ORG. REV. 63 (2010); *see also* Lin & Milhaupt, *supra* note 22, at 738–39.

may not necessarily understand the corporate governance of SOEs operating in a transitional economy like China.

To be sure, this Article does not argue that the Commission should just sit back and do nothing. Given the opaque governance structure of Chinese SOEs, it is perfectly understandable for European regulators to be vigilant about the potential risks of Chinese SOEs' investment in Europe. But prior to adopting any precautionary measures, European regulators should conduct careful cost and benefit analysis to study the consequences of their regulatory actions. Importantly, when evidence is speculative and the regulatory cost is high, regulators should consider whether there are any less intrusive measures to mitigate the risks. Under the current European legal framework, a more pragmatic approach seems to involve treating Chinese SOEs as independent under EUMR and dealing with any potential economic and political risks under the national security review regimes that exist at the member state level. This, however, is not an ideal position for the Commission as it could have interests in conflict with those of individual member states. Europe is now confronted with a thorny issue: should member states be left with the exclusive power to regulate FDI under national security regimes or should the Commission be empowered to do so as well? Whatever Europe decides in the future, it must ensure that its antitrust review is not swayed by political considerations.

V. WHO IS DRIVING CHINESE FDI?

When information about Chinese FDI is limited, people tend to rely on intuition and feelings in making judgments. In particular, associative memory, the core of System 1, will try to construct a coherent interpretation of the motivation of Chinese FDI. People can feel very confident about their judgment, without realizing that it is in fact based on inadequate evidence. Ironically, knowing little about China may actually make it easier for people to fit everything they know into a coherent pattern. The story is simple: (1) most Chinese FDI is made by companies owned by the Chinese government; (2) the Chinese government actively encourages Chinese SOEs to venture overseas to make foreign investment; and (3) therefore Western governments should be vigilant, as such investments could be "Trojan horses" of the Chinese government.

As a consequence, the public debate on foreign investment from China becomes deeply imbalanced. Most analysis of Chinese FDI policy has placed the central government in the driver's seat. The typical worries are that Chinese SOEs looking for expansion opportunities overseas are not pure market players but are simply puppets that respond to the policies and instructions of the Chinese government.[268] But appearances can be deceptive. The Chinese economy, as China expert Yasheng Huang acutely observes, "is so complicated that what appears to be straightforward and obvious on the surface is not at all so once we dig into the details."[269] Indeed, what the Western news reports and policy debate often fail to address is that the rapid increase of Chinese FDI is in fact predicated on a number of institutional distortions in the Chinese economy. Crucially, they ignore or downplay that agency problems, particularly empire building incentives, exist at the Chinese SOE level. Yet these incentives are one of the most important factors powering the surge of Chinese FDI. It would be difficult to estimate the exact amount these empire building incentives have factored in Chinese FDI, but a close study of outbound investment made in the oil and gas sector reveals that agency problems are pervasive and weigh heavily on the investment decisions of Chinese national oil companies (NOCs).

A. Empire-Building Incentives

Empire building is a manifestation of agency problems existing in firms. Due to the information asymmetry between shareholders and management, the latter may retain private information about the firm and not reveal it to the former. Conflict arises when management maximizes its own interest at the expense of shareholders. Michael Jensen, a leading scholar on corporate finance, has proposed a free cash flow theory suggesting that management has perverse incentives to grow beyond optimal size.[270] Instead of paying free cash flow to shareholders, management has the incentive to spend free cash flow to fund acquisitions—this not only increases the amount of resources under its control, but can also increase its compensation (as compensation is positively linked to the growth of a company). Free cash flow theory therefore predicts that managers of firms with unused borrowing power and large free cash flows are more likely to undertake low-benefit or even value-destroying mergers. To prevent overinvestment, economists have shown that external capital markets such as debt can serve the monitoring role of disciplining managerial use of free cash flow.[271]

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[268] SZAMOSSZEGI, *supra* note 19, at ix.

[269] YASHENG HUANG, CAPITALISM WITH CHINESE CHARACTERISTICS: ENTREPRENEURSHIP AND THE STATE 2 (2008).

[270] *See* Michael C. Jensen, A*gency Costs of Free Cash Flow, Corporate Finance, and Takeovers,* 76 AM. ECON. REV. 323 (1986) (Free cash flow refers to cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital.).

[271] *Id.*; *see also* René M. Stulz, *Managerial Discretion and Optimal Financing Policies*, 26 J. FIN. ECON. 3 (1990).

Jensen's research on empire building has mainly focused on the conflict between management and a diffuse group of shareholders. But empire-building incentives loom even larger for management at SOEs. Janos Kornai, a Hungarian economist, has long posited that SOEs are afflicted with "investment hunger."[272] Due to soft budget constraints, SOEs operating in a socialist system do not need to bear the loss from faulty investment decisions. Moreover, it is difficult to hold management accountable since SOEs have many policy burdens, and profits cannot be used as a sole evaluating factor. Indeed, research has shown that agency costs associated with managerial empire building behavior are more severe when corporate governance is weak[273] and managers are less accountable to their shareholders.[274]

SOEs in China have an insatiable desire to expand: the bigger it is, the more powerful it becomes; the more powerful it is, the easier it becomes to obtain financial resources for overseas expansion. It thus grows even bigger and more powerful, resulting in a vicious cycle. Chinese firms are vying to become leaders in their particular industries so that they will be deemed indispensible to local and central governments. Such incentives have been well documented in Yasheng Huang's *Selling China*, an excellent book about FDI into China.[275] Huang finds that SOEs' obsession with technology drives them to partner with foreign multinational companies to create joint ventures in China. As profits no longer serve as a guiding criterion, SOEs like to use tangible inputs to showcase their competitiveness.[276] This leads to a destructive consequence: SOEs pile up hard assets and the government allocates resources according to the technological capabilities of the SOEs.[277] Worryingly, Huang identifies evidence that SOEs know how to accumulate assets but do not know how to use them efficiently; he points out that Chinese SOEs are more interested in spending money to acquire hard assets than in generating positive return from their assets.[278]

Worse yet, distortions in China's capital markets compound distortions

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[272] JANOS KORNAI, THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM 162 (1992) ("Expansion drive is a fact of life for the bureaucracy. And because this system has only bureaucrats and no real owners, there is almost total lack of internal, self-imposed restraint that might resist this drive. The investment hunger is ubiquitous.").

[273] Pornsit Jiraporn, Yuong Sang Kim, Wallace N. Davidson & Manohar Singh, *Corporate Governance, Shareholder Rights and Firm Diversification: An Empirical Analysis*, 30 J. BANK. & FIN. 947 (2006).

[274] Ole-Kristian Hope & Wayne B. Thomas, *Managerial Empire Building and Firm Disclosure*, 46 J. ACCOUNT. RES. 591 (2008).

[275] YASHENG HUANG, SELLING CHINA: FOREIGN DIRECT INVESTMENT DURING THE REFORM ERA 7 (2003).

[276] *Id.* at 223–24.

[277] *Id.*

[278] *Id*. at 136–37.

in managerial incentives.[279] China's capital markets are dominated by banks, especially the big four state-controlled banks. As China's financial system allocates resources according to a political rather than economic pecking order of firms,[280] inefficient SOEs enjoy a superior advantage in obtaining funds for investment. As pointed out by Morck, Yeung, and Zhao, China's recent FDI surge is likely a manifestation of its inability to reinvest efficiently its high corporate and individual savings.[281]

With superior access to financing, Chinese SOEs have been expanding not only in the domains of their specific industries, but also investing outside. Indeed, Chinese SOEs have been seen elbowing out private domestic firms in competitive industries, especially those with high risk and high return. This phenomenon has been known as "the state advances, the private sector retreats." The problem has been exacerbated by the recent financial crisis, as the Chinese government loosened monetary policies to increase bank lending and SOEs became the main benefactors of the policy. For example, a government spokesperson recently admitted that 74% of the SOEs owned by the central government are engaged in the highly profitable but risky real estate business and that these companies also run about 2,500 hotels in the country.[282] These SOEs face significant public pressure and the official media has criticized them for "not doing their proper business."[283] According to Xinhua News Agency, the Chinese government recently ordered 78 companies to withdraw their investments in the real estate sector.[284]

But an SOE's overseas investment faces less public scrutiny and fewer complaints from domestic competitors. In fact, takeovers of foreign firms can bring enormous national pride and serve the purpose of image building for the Chinese government. Moreover, managers of SOEs can use overseas investment to demonstrate their skill at managing international businesses, and thereby claim political credit for responding to the government's "going out" policy.[285] As such, CEOs of central SOEs may use their corporate careers as springboards into the national leadership. Cheng Li, an expert on Chinese leadership, observes that "[the] younger, business-savvy, politically connected and globally minded Chinese CEOs

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[279] Morck et al., *supra* note 70, at 344.

[280] HUANG, *supra* note 275, at 66.

[281] Morck et al., *supra* note 70, at 344; *see also* Ligang Song, Jidong Yang & Yongsheng Zhang, *State-Owned Enterprises' Outward Investment and the Structural Reform in China*, 19 CHINA & WORLD ECON. 38, 44 (2011).

[282] Cheng Li, *China's Midterm Jockeying: Gearing Up for 2012 (Part 4: Top Leaders of Major State-Owned Enterprises)*, 34 CHINA LEADERSHIP MONITOR 27 (2011).

[283] *Id.*

[284] *Id.*

[285] Song, Yang & Zhang, *supra* note 281, at 39.

have recently become a new source of the CCP leadership[,]" a phenomenon he attributes largely to the meteoric rise and growing power and influence of the SOEs. [286]

There is another important reason why managers at Chinese SOEs are anxious to grow their companies. Central SASAC, the supervisory commission overseeing the central government's interests in assets, has been gradually reducing the number of SOEs under its control. When SASAC was first established in 2003, it supervised 196 companies.[287] This number fell to 152 in 2007; [288] it currently only supervises 113 companies.[289] According to SASAC head Li Rongrong, central SASAC planned to reduce the number of central firms to well under 100 within the next few years, so that only the more efficient firms would survive.[290] According to Barry Naughton, a China expert, "This has touched off a furious scramble to expand beyond the cutoff point, since any manager who presides over a firm that doesn't make it into the elite hundred would lose his privileged rank and be perceived as a failure."[291]

The agency problems at SOEs are further exacerbated by the lack of financial disclosure. Financial economists have found that public financial disclosure can serve as a means to lower the cost of monitoring a firm and thus reduce agency problems.[292] Empirical studies also show that when disclosure quality reduces, managers can make suboptimal decisions such as empire building that maximizes their own interest at the expense of the firm.[293] But the level of financial disclosure varies significantly among Chinese SOEs. Since the early 1990s, the Chinese government has initiated a process of corporatizing the SOEs and selling their minority interests to private investors on both domestic and overseas stock exchanges.[294] To fulfill the listing requirements, these publicly listed Chinese SOEs will need to adopt modern corporate governance structures and make mandatory disclosures of their finances. But the non-listed SOEs are not subject to mandatory governance requirements, and very few of them have adopted modern corporate governance structure.[295] Carved out

[286] Li, *supra* note 282, at 1.

[287] Barry Naughton, *SASAC and Rising Corporate Power in China*, 24 CHINA LEADERSHIP MONITOR 2 (2008).

[288] *Id.* at 6.

[289] Yangqi Minglu, *The List of Central State-Owned Enterprises*, SASAC, http://www.sasac.gov.cn/n1180/n1226/n2425/index.html (last visited Apr. 28, 2014).

[290] Naughton, *supra* note 287, at 2.

[291] *Id.*

[292] Robert M. Bushman & Abbie J. Smith, *Financial Accounting Information and Corporate Governance*, 32 J. ACCT. & ECON. 237 (2001).

[293] Hope & Thomas, *supra* note 274, at 592.

[294] OECD, OECD REVIEWS OF REGULATORY REFORM, *supra* note 261.

[295] For a detailed discussion on the corporate governance issues of Chinese SOEs, see Donald C.

of the ministries during early rounds of reform, these SOEs maintain strong networks of bureaucrats and officials and shoulder the policy burdens of the SOEs. Many of these companies are loss making[296] and have little incentive to provide financial disclosures. As a consequence, there is little public information available about the outward investments they make, thus providing them with the perfect camouflage for overexpansion. Worryingly, this is precisely the reason that many Chinese SOEs prefer to use a non-listed SOE (particularly the parent or the sister company of the listed SOE) as the vehicle for making overseas acquisitions.[297]

Notably, Chinese outward investments are subject to investment approvals from various government agencies when they exceed certain thresholds.[298] However, those bureaucratic approvals are unlikely to serve as an effective check on the management decisions of powerful Chinese SOEs, particularly those that are directly controlled by the central government. Repeated administrative reforms and industrial overhauls, which are part of the broader movement of China's transition from a planned to a market economy, have abolished most of the central bureaucracies responsible for the regulated industries and transferred their administrative, institutional, and personnel capacity as well as their bureaucratic rank to central SOEs.[299] Furthermore, many of the large SOEs have gone listed and were able to raise funds overseas. These SOEs usually structure their holding companies offshore in tax havens such as the Cayman Islands or in Hong Kong and with subsidiaries incorporated in China. The proceeds of the financing they obtain from public securities or bond offerings may be held offshores and used for foreign acquisitions, thus bypassing the regulations of the Chinese government.[300] Using the oil and gas sector as an example, the following part investigates the agency problems of Chinese NOCs and provides a behavioral explanation of why such problems tend to be neglected during policy debate about their outbound acquisitions.

Clark, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494 (2003).

[296] *See generally* HONG SHENG & NONG ZHAO, CHINA'S STATE-OWNED ENTERPRISES: NATURE, PERFORMANCE AND REFORM (2013).

[297] MCGREGOR, *supra* note 13, at 59.

[298] For a general discussion of the Chinese regulatory regime on outward FDI, see Yadong Luo, Qiuzhi Xue & Binjie Han, *How Emerging Market Governments Promote Outward FDI: Experience from China*, 45 J. WORLD BUS. 68 (2010).

[299] *See generally* DALI YANG, REMAKING THE CHINESE LEVIATHAN: MARKET TRANSITION AND THE POLITICS OF GOVERNANCE IN CHINA (2004).

[300] *See* HOWARD CHAO & RUCHUN JI, O'MELVENY & MYERS LLP, OBTAINING FUNDING AND APPROVAL FOR CHINESE OUTBOUND INVESTMENT 1 (2008).

B. A Study of the Chinese Oil and Gas Sectors

Chinese SOEs in the oil and gas industry have been the most active in making overseas investment. According to a study by Deloitte, the oil and gas industry has dominated Chinese outbound merger and acquisition (M&A) investments, accounting for 28% of the overall market by deal volume from 2005 to the third quarter of 2012; they also made up 66% of all Chinese outbound M&A investments in terms of value during the same period, with a total of U.S. $187.3 billion spent.[301] At the same time, acquisitions by Chinese NOCs also tend to cause the most alarm in Western countries—there is a perennial concern that "China will lock up oil supplies and distort international oil markets to the detriment of other economies."[302] Many Western observers believe that these Chinese NOCs are in "a highly-coordinated quest for oil and natural gas assets," one designed by their political masters in Beijing.[303] This perception is reinforced by a number of high profile visits in which Chinese leaders have travelled with executives from China's NOCs to oil-producing states in order to sign agreements for energy cooperation with the host countries, sometimes in conjunction with other investment, aid, and trade deals.[304] All these facts seem to suggest a coherent story: the Chinese government is driving the NOCs' overseas forays. "What you see is all there is," as Kahneman says.[305]

But appearances can be deceptive and the story is far from complete. Undoubtedly, Chinese NOCs are willing and capable of serving the economic interests of the Chinese government when doing so is compatible with their own interests. However, they have also shown reluctance to be "puppets" of their principal.[306] As revealed in the studies of two leading experts on Chinese energy security, Erica Downs of the Brookings Institute and Bo Kong of Johns Hopkins University, the liberalization of the Chinese energy sector over the past two decades has resulted in a shift of power and resources away from the central government and toward the NOCs.[307] The three major NOCs in China, including China National Petroleum

[301] DELOITTE CHINA, THE RESURGENT DRAGON—SEARCHING FOR VALUE IN TROUBLED TIME 6 (2012), *available at* https://www.deloitte.com/assets/Dcom-Germany/Local%20Assets/Documents/03_CountryServices/2012/CSG_China_Outbound_MuA_Report_2012_EN.PDF.

[302] John Lee, *China's Geostrategic Search for Oil*, 35 WASH. Q. 75, 85 (Summer 2012).

[303] Erica S. Downs, *The Fact and Fiction of Sino-African Energy Relations*, 3 CHINA SEC. 42, 48 (July 28, 2007).

[304] *Id.*

[305] KAHNEMAN, *supra* note 37, at 85.

[306] BO KONG, CHINA'S INTERNATIONAL PETROLEUM POLICY 93–94 (David L. Goldwyn et al. eds., 2010); *see also* Edward A. Cunningham, *China's Energy Governance, Perception and Reality*, MIT CTR. FOR INT'L STUD. SER. (March 2007), http://web.mit.edu/cis/pdf/ Audit_03_07_Cunningham.pdf.

[307] KONG, *supra* note 306, at 1; Downs, *supra* note 303, at 49.

Corporation (CNPC), China Petrochemical Corporation (Sinopec), and China National Offshore Oil Corporation, were all created from government ministries in the 1980s.[308] Since the 1990s, repeated administrative reforms and industrial overhauls in China's petroleum sector have abolished the central bureaucracies responsible for the petroleum industry and transferred their administrative, institutional, and personnel capacity as well as their bureaucratic rank to the NOCs.[309] The "remaining regulatory power over the petroleum industry at the central level continues to be fragmented among different bureaucracies," who often lack the clout or staff necessary to regulate the petroleum industry.[310] As a result, the regulatory agencies often defer to the three NOCs over important policy problems and increasingly have relied on them to identify policy problems, formulate corresponding responses, and implement policies.[311] Kong suggests that this asymmetric distribution of power over petroleum policy between the government and the NOCs has resulted in "the latter becom[ing] the driver of the country's domestic and international petroleum policy."[312] This is also echoed by Downs' observation regarding the investment decisions made by Chinese NOCs:

> Beijing has certainly encouraged China's NOCs to expand internationally, provided them with varying levels of diplomatic and financial support, and occasionally intervened in the companies' foreign investment decision-making. However, when it comes to choosing where to invest, the companies are almost always in the driver's seat and the Chinese government, while occasionally offering general advice about the direction they should travel, . . . is often just along for the ride with little idea of the final destination.[313]

Indeed, when assessing the motives of Chinese NOCs venturing abroad, people tend to neglect the principal-agent relationship between the Chinese government and the NOCs. Although the Chinese government owns the NOCs, they do not run these companies and, instead, delegate their authority to the NOCs. Conflicts therefore arise when the NOCs pursue agendas that advance their own interests at the expense of those of the Chinese government. For instance, many Chinese oil analysts and the

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[308] Erica Downs, *Business Interest Groups in Chinese Politics: The Case of Oil Companies,* BROOKINGS INST. PRESS 122 (July 29, 2010).

[309] KONG, *supra* note 306, at 144–45.

[310] *Id.* at 145.

[311] *Id.* at 2, 16.

[312] *Id.* at 144–45.

[313] Downs, *supra* note 303, at 48.

government believe that "equity oil" enhances petroleum security as it would give Chinese NOCs additional security in times of market turbulence and supply disruption.[314] Accordingly, Chinese NOCs have been aggressively acquiring upstream assets abroad under the pretext of enhancing energy security. Yet industry experts have pointed out that this kind of arrangement is neither politically feasible nor political desirable in cases of severe security crisis.[315] As producing countries are often reluctant to cede residual rights to foreign countries for economic and security reasons, China's foreign upstream investments typically involve limited ownership rights.[316] Moreover, Chinese "NOCs do not ship all their equity oil back home, despite a degree of support from the Chinese government."[317] According to China's customs data, industry intelligence, and news reports, "Chinese NOCs shipped back only one-third of their overseas equity production and sold the remaining to the international market" for profits.[318]

So what has motivated these NOCs to make overseas acquisitions, since it is not at all clear whether they really enhance national security? There are at least two important reasons. First, the big difference between profit margins of the upstream sector and the downstream sector in China has motivated NOCs to acquire more upstream assets abroad. Even though the NOCs need to import oil at the international market price, the downstream prices are often artificially suppressed by the Chinese government. Due to worries about inflation and its political implications, the central government still sets prices for downstream products such as diesel and gasoline.[319] Consequently, China's NOCs have lost billions of dollars in their refining and marketing sectors in recent years.[320] This is a particularly serious problem for Sinopec and CNPC because both companies have significant downstream business. As a result, these companies have constantly lobbied the Chinese government for subsidies in order to compensate their losses. On several occasions, they even exported their products to foreign markets in order to gain higher profits, resulting in several rounds of severe artificial fuel shortage in China.[321]

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[314] *See* KONG, *supra* note 306, at 92 (Equity oil refers to "the proposition of crude production that a concession owner has the legal and contractual right to retain or sell as a guarantee on investment under the production-sharing agreements.").

[315] JOSEPH FRANCOIS, WALTRAUT URBAN & FRANZ WIRL, FIW, CHINA'S FOREIGN OIL POLICY: GENESIS, DEPLOYMENT AND SELECTED EFFECTS (2010); *see also* Erica S. Downs, *The Chinese Energy Security Debate*, 177 CHINA Q. 21, 35–36 (2004).

[316] FRANCOIS, URBAN & WIRL, *supra* note 315, at 52.

[317] KONG, *supra* note 306, at 93–94.

[318] *Id.*

[319] Downs, *Business Interest*, *supra* note 308, at 130.

[320] *Id.*

[321] KONG, *supra* note 306, at 24.

The other important motivating factor is empire building. Like other SOEs in China, the amount of the high-quality assets of a NOC determines its political clout. As noted by Downs: "The more high-quality assets a company acquires, the more likely it is to obtain diplomatic and financial support from the Chinese government for its subsequent investments."[322] This explains the lack of coordination among Chinese NOCs in their race for overseas expansion. Indeed, they have reportedly criticized each other's foreign investments to third parties both inside and outside the Chinese government.[323] According to one Chinese consulting firm, "CNOOC's real enemies are China National Petroleum Corp (CNPC) and Sinopec. The little brother . . . has to have more assets to have a louder voice."[324] Indeed, the ultimate holding companies of CNPC and Sinopec are both ministry-level companies, whereas the holding company of CNOOC has only the lower status of a general bureau. "Bureaucratic ranks," of course, "are very important in China because negotiations are conducted among bureaucracies of equal rank, and only high-rank bureaucracies can issue orders to low-rank bureaucracies."[325] As CNOOC competes at a political and economic disadvantage with the other two big NOCs, it is most pressured to pursue overseas expansion.

Such agency problems are further exacerbated by lack of disclosure by Chinese NOCs. It has been observed that CNPC and Sinopec have both preferred to use the holding company of the listed company to take the lead in international mergers and acquisitions.[326] Since the Chinese government wholly owns the holding company, it is not subject to public disclosure requirements, nor is it constrained by public shareholders or independent board members from undertaking risky projects. It is thus no surprise that both CNPC and Sinopec have preferred to use these non-listed companies to make substantial investments in countries where there are high political risks.[327] In comparison, CNOOC has only made overseas acquisitions via its listed subsidiary.[328] But this fact seems to have less to do with CNOOC's incentives to be more transparent than with the restriction CNOOC imposed upon itself when it was seeking to get listed in Hong

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[322] Downs, *supra* note 303, at 50.

[323] *Id.*

[324] Neil Gough, Eric Ng & Mark O' Neil, *CNOOC Gains Tactical Edge from Battle*, S. CHINA MORNING POST (Aug. 4, 2005), http://www.scmp.com/article/510850/cnooc-gains-tactical-edge-battle; *see also* STEINFELD, *supra* note 192, at 202 (discussing the incentives for CNOOC to outperform CNPC and Sinopec).

[325] KONG, *supra* note 306, at 16.

[326] Erica S. Downs, *China's NOCs: Lessons Learned from Adventures Abroad*, BROOKINGS INST. PRESS 27 (July 2008), *available at* http://www.brookings.edu/~/media/research/files/articles/2008/7/china%20downs/07_china_downs.pdf.

[327] *Id.* at 30.

[328] *Id*.

Kong in 2001.[329] In order to increase attractiveness to international investors, CNOOC entered into a non-compete agreement with its parent company, which prohibits the parent company from engaging in the more profitable upstream activities.[330] As a result, only the listed CNOOC can make overseas acquisitions of upstream assets. In fact, CNOOC has attributed its unsuccessful bid for Unocal partly to the delay it encountered in garnering support from skeptical independent shareholders.[331] It thereafter attempted unsuccessfully to amend the non-compete agreement to allow only its parent company to engage in upstream activities.[332]

This leads to a puzzle: if the empire-building incentives of SOEs have been so well documented in economic literature and there have been abundant examples of Chinese SOEs using free cash flow to pursue risky investments, why are these agency problems seldom mentioned by the Western media or regulators during policy debates? This Article posits that at least three reasons account for such an anomaly. First, the Western public and regulators tend to take mental shortcuts when making judgments about Chinese FDI. They tend to focus on facts that are on screen. Starting from the premise that Chinese SOEs are "owned" by the Chinese government, they jump to the conclusion that these SOEs are also "controlled" by the Chinese government and, moreover that the communist state is lurking behind their operations and management. At the same time, they tend to ignore the facts that are off screen—the principal-agent relationship between the Chinese government and the SOEs whereby the latter may maximize their own interests at the expense of the former. Second, once the public, the media, and regulators form the belief that Chinese SOEs are mere puppets of the Chinese government, they tend to proactively seek evidence that confirms this belief, while ignoring evidence that challenges or discredits it. Accordingly, studies on the agency problems of Chinese SOEs tend to be downplayed or ignored during media discussions and policy debates. Third, well-organized entities including private interest groups, the media, and the government can endogenously generate fear of Chinese FDI in order to advance their own agendas, thus further tipping the policy debate on Chinese FDI to their favor.

[329] *Id*.

[330] *See* CNOOC Ltd., Annual Report (Form 20-F) 21 (Dec. 31, 2012) ("[China National Offshore Oil Company] has undertaken to us that we [CNOOC] will enjoy the exclusive right to exercise all of [its] commercial and operational rights under PRC laws and regulations relating to the exploration, development, production and sales of oil and natural gas in offshore China".).

[331] *See* STEINFELD, *supra* note 192, at 212–15 (Steinfeld explains that the delay in CNOOC's bidding process was largely attributed to its need to comply with the Hong Kong exchange's listing rules, which requires the approval by independent shareholders of the Unocal transaction. As part of the process, CNOOC and its independent directors were required to appoint an independent financial advisor to assess the proposed transaction.).

[332] Downs, *supra* note 326, at 30.

VI. IMPLICATIONS AND CONCLUSION

This Article catalogues the various heuristics and cognitive biases that can influence people's judgment of FDI. It finds that people resort to various mental shortcuts when thinking about FDI, and that perceptions and judgments of Chinese FDI are often guided directly by general impressions of Chinese acquisitions and by feelings toward China and not through deliberation of the merits of particular proposed transactions. What the Western public and regulators often fail to realize is that they have merely turned impressions into beliefs and that what they see on the surface is not all there is. Indeed, when information about Chinese FDI is limited, System 1 thinking can operate as a machine for quick conclusions. Worryingly, various well-organized entities, such as private interest groups, the media, and governments, are all too willing to promote, amplify, and exploit such fear.

This Article thus calls for more effortful thinking about Chinese FDI by Western policymakers. No informed FDI policy can be created without a careful risk assessment of the particular FDI transaction. Before a government acts, it must first assess the magnitude of the problem through quantitative analysis. In judging the risks posed by Chinese investment, policymakers should be aware that impulsive and intuitive responses can often be biased. As the accuracy of the current official data on FDI is likely distorted by a number of factors, it is especially important for policymakers in both China and in Western countries to exert efforts to improve the statistical tracking of Chinese FDI. Moreover, rigorous empirical research is needed to evaluate the costs and benefits of Chinese FDI in Western countries. How have Chinese companies operated and performed in Western economies? What is their impact on local economies? Have there been any Chinese investments that have posed risk to national security? Without an accurate understanding of Chinese FDI investment profiles, motives, and impacts on host countries, undue fears about Chinese FDI are likely to be exploited by various interest groups seeking regulatory response.

Second, no understanding of the FDI is complete without a comprehensive picture of political and economic dynamics in China. The fact that Chinese SOEs have been most active in making overseas acquisitions in fact reflects the institutional characteristics of the distorted Chinese economy, which has allocated resources to less efficient but politically more powerful SOEs. Empire building incentives, exacerbated by weak corporate governance structures and the lack of financial disclosure, have been one of the most important factors in powering the overseas expansion of Chinese SOEs.

Third, investment reviews of Chinese FDI should be conducted by experts who understand both FDI and Chinese political economy. FDI experts are less vulnerable to cognitive biases and social influences as they have routine access to accurate sources of information. Thus they are more likely to reach a balanced view regarding the costs and benefits of a particular foreign investment. In the case of the United States, CFIUS, an expert agency that specializes in screening Chinese FDI, seems to be the most capable of filling this role. At the same time, Congress' increased interference with FDI review makes it likely that the FDI review process will remain susceptible to outside political forces and interest group lobbying, as revealed in the CNOOC-Unocal transaction. The U.S. Government should therefore be vigilant against the use of FDI regulations as a protectionist tool by various interests groups—groups that often foster anti-Chinese sentiment to advance personal agendas. In the case of Europe, the merger unit within the Commission is unlikely to be a suitable organization for dealing with FDI review of Chinese SOEs. While it is well equipped with economic and legal experts on merger control assessment, its staff may not possess the expertise in Chinese political economy necessary for understanding the unique corporate governance structure of Chinese SOEs. As reflected in recent cases involving Chinese SOEs' acquisitions in Europe, the intricate relationship between the CCP and the SOEs has presented significant challenges to the Commission during its antitrust reviews.

Fourth, in dealing with Chinese FDI, Western regulators should be careful to avoid adopting extreme precautionary measures in response to irrational fears, as this precludes a rational assessment of the costs and benefits of proposed actions. Congress' hostile response to CNOOC's proposed acquisition of Unocal has had severe political and economic repercussions. As the world's biggest outward foreign investor, the United States has an interest to maintain an open foreign investment environment. Similarly, the "worst-case scenario" approach that the Commission has adopted in reviewing mergers involving Chinese SOEs shows that the agency has clearly not thought through potential consequences. Such an approach could jeopardize its jurisdiction on future important antitrust cases involving Chinese SOEs. Moreover, it will tarnish the EU's hard-earned reputation as being an open investment environment. In such circumstances, governments could explore alternative and more pragmatic approaches and consider whether there are less intrusive measures that could best minimize the costs of regulation.

Fifth, rather than viewing Chinese FDI as a threat, it is important to remind ourselves that the increased FDI inflow from China is only part of an overall trend of globalization. In fact, China's growing integration with the world economy should be viewed as a hopeful sign that China envisages a peaceful relationship with other parts of the world. China is currently the largest recipient of FDI. The more China invests in Western countries, the more Chinese assets will be subject to foreign regulatory control. This, in turn, could impose constraints on China as unequal treatment of foreign firms operating in China could spark retaliation against Chinese firms operating abroad. This balance of power could thus minimize conflicts and frictions between China and other countries.

Sixth, Chinese FDI presents challenges and opportunities not only to Western countries, but to China as well. Chinese firms that venture overseas will need to play the Western game. This could very well pressure Chinese companies to adopt better corporate governance structure and to provide greater transparency in operations and management. It also pushes the Chinese government to conduct further reform and restructuring of Chinese SOEs. Indeed, the reform of Chinese SOEs is still a work-in-progress and the challenges that Chinese companies face abroad are a blatant reminder for the Chinese government that more radical political and economic reforms are needed for China to achieve a successful transition into a true market economy. It is imperative for Chinese SOEs, whether listed or non-listed, to improve their corporate governance structures and to provide more public disclosure of their overseas investments.

Last but not least, this Article casts doubt on the wisdom of Chinese SOEs pursuing overseas expansion. Chinese policymakers will do well to remember that market reform carried out in China in the past three decades has contributed to its astonishing economic success. But overseas expansion by Chinese SOEs marks a reversal of such a trend. The defects in the institutional structure of the Chinese economy, coupled with the weak corporate governance structure of Chinese SOEs and the lack of financial disclosure, makes it highly likely that state assets are squandered and wasted in overseas acquisitions. As SOEs are the main players in Chinese outward investment, such expansion could lead to unintended consequences in the form of further entrenching their position in China—a development that would stifle market reform and have far-reaching political and economic consequences for the future of China.