

Analysis of Business and Governments Responses to Security Clearance through a Case Study Approach

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Abstract. With the ongoing trade disputes between China and the US in recent years, Chinese companies have struggled with their acquisitions in the US. Some studies have mainly focused on how Chinese companies should respond to US national security reviews, while there is a lack of unified recommendations on the responses of the two governments. Therefore, based on the case of the acquisition of Snapdragon by Asymchem, a case study approach is used to explore the tripartite role of Chinese companies, the Chinese and US governments in the national security review system. The analysis concludes that the security clearance issues faced by Chinese companies acquiring US companies are: industry attributes and sensitive technologies, derogation agreements and political risks. Corresponding strategies are therefore proposed for the three parties to respond: rights-limiting acquisition options, lobbying and a US-China bilateral investment agreement to facilitate bi-national investment with the joint role of companies and both governments.

Keywords: Case Study Method; Chinese companies; the Chinese and US governments; national security review system.

1. Introduction

CFIUS is the US regulator of foreign mergers and acquisitions, primarily reviewing and providing classified threat assessments for transactions involving national security [1]. China's cross-border acquisitions of the United States, which began in 2005, have increased rapidly in the following decade, and as a result, the primary source of foreign direct investment in the United States has changed. CFIUS review has also become more complex and difficult to address based on cross-border acquisitions under China's market economy. As a result, the US Congress passed FIRRMA in 2018, and US national security reviews have evolved since then as international transactions have become more dynamic.

In February 2022, Asymchem issued an acquisition announcement to acquire all of Snapdragon through a merger [2]. On 12 September, US President Biden announced the launch of the National Biotechnology and Biomanufacturing Initiative (NBBi) and on 15 September, the US government asked CFIUS to strengthen national security risk screening of foreign investments in high-tech industries, including biotechnology, particularly funds from "competing or hostile countries" [3]. On 19 September, Asymchem announced that the planned acquisition of the US company Snapdragon had been terminated for regulatory reasons in the US.

The "national security exception" to the WTO's multilateral trade rules gives members discretion to take measures to protect their "essential security interests". Therefore, the existing remedy of "investor-state" investment dispute arbitration is not applicable to most national security review remedies. Based on the case of the acquisition of Snapdragon by Asymchem, it is possible to analyse the prevailing security clearance issues faced by Chinese companies acquiring US companies across borders, and to make recommendations to both governments and acquiring companies with the aim of facilitating the deal as much as possible.

2. Security Clearance Issues

2.1 Industry Attributes and Sensitive Technologies

On September 12, 2022, a briefing was released on the White House website announcing that President Biden had officially signed an Executive Order to launch the National Biotechnology and Biomanufacturing Initiative [4]. On September 15, 2022, President Biden issued Executive Order 14083, which The Executive Order elaborates and expands on the existing list of factors that CFIUS considers when reviewing transactions for national security risks, citing sectors, including biotechnology, where supply chain resilience and U.S. technology leadership face increasing national security risks [5]. The Executive Order also describes three additional national security factors that CFIUS considers when reviewing transactions within its jurisdiction, which include general trends in industry investment [5]. It can be seen that this is the first time that the US has regulated the biotechnology sector with a separate act, meaning that the US restrictions in areas such as chips and energy are gradually being extended to the biological sector. Previously, the Chinese acquisitions of US companies suspended by CFIUS have occurred in non-pharmaceutical sectors such as energy, chemicals and electronic information.

Snapdragon's specialty is continuous response technology, which can shorten the material supply chain and improve production economics. Snapdragon has also been awarded a national grant to continue developing continuous response technology for U.S. manufacturing, to ensure the security of the domestic supply chain and to produce pharmaceuticals at a cost savings. It is clear that Snapdragon's technology is relevant to the main purpose of the Act and addresses the supply chain issues and biotechnology in E.O. 14083. The main purpose of the acquisition is to leverage Snapdragon's extensive customer base in Europe and the US to open up the US pharmaceutical market and to use it as a platform for its own overseas technology development, which naturally conflicts with the US government's recent emphasis on 'localising biomanufacturing'. In addition, Asymchem's plans to acquire the company outright have raised significant concerns among the relevant authorities, for example, that its widespread entry into the US and European markets could have an impact on the stability of the US pharmaceutical supply chain, touching on the industry trend in the Executive Order. As a result, it naturally faced more stringent national security scrutiny, which led to the failure of the acquisition. It can therefore be seen that the industry attributes involved in cross-border acquisitions and the need to acquire the corresponding sensitive technologies are important reasons why Chinese companies face US security scrutiny.

2.2 Derogation Agreements

In the US, parties to an M&A can negotiate with CFIUS to mitigate potential threats to national security by entering into a derogation agreement that allows CFIUS to conditionally pass the M&A project and achieve a compromise between the parties [6].

However, according to a news release from Asymchem on 19 September, the two parties decided to terminate the merger transaction due to regulatory reasons that prevented the company and Snapdragon from reaching agreement around future development plans and countermeasures [7]. It can be seen that a significant reason for the failure to close the acquisition was the failure to agree on meeting the mitigation provisions of the Committee on Foreign Investment in the US Treasury Department. In cases similar to those facing security reviews, CFIUS will require the parties to take certain measures to remedy the situation, such as the divestment of part of the business or product line in the transaction. It can be presumed that Asymchem and Snapdragon disputed the manner in which the business was cut, i.e., they did not adequately consider measures to face security reviews prior to the acquisition and had difficulty in reaching a consensus on a derogation agreement after the review occurred, which in turn led to the failure of the acquisition. It can be seen that inadequate preparation of companies for derogation agreements is also a shortcoming of Chinese companies when dealing with US security reviews.

2.3 Political Risks

Prior to the acquisition of Snapdragon by Asymchem, there were also a number of cross-border acquisitions in the Chinese pharmaceutical industry, such as the acquisition of GNC by Harbin Pharmaceutical Group in 2018 and the acquisition of Australian medical device company Sirtex by Grand Pharma and CDH Investment in 2019, both of which successfully passed the CFIUS review. The Hurun Institute's 2021 Hurun China Top 100 Cross-Border M&A List shows that healthcare had four outbound cross-border M&A in 2021, making it one of the most active sectors for Chinese companies going abroad for cross-border M&A, second only to metals and minerals and software and services while the value of overseas M&A deals by Chinese companies in the healthcare and life sciences sector increased by 240% year-on-year and the number of deals increased by 64% year-on-year, reaching the highest level ever for the same period in 2021 [8].

It can be seen that the pharmaceutical industry has been more active in cross-border acquisitions in recent years, and the failure of the planned acquisition of Callaine was the first cross-border acquisition transaction in the Chinese pharmaceutical industry to be blocked by CFIUS. The shift is mainly due to the changing political game in the US, where many administrative regulations have strategic considerations. Now that the US is facing mid-term elections, one of the aims of the previously cited bills is to increase employment, while national security issues have also been one of the hot topics of discussion in recent US presidential elections. Biden is naturally tightening his policies in order to boost his support and seek re-election in the general election. The timing of the Asymchem acquisition is therefore not good and the probability of failure has increased significantly, although the impact of the executive order will not last long as US companies may not support this for their own benefit and the capital behind the companies will lobby the US government in the future. How to deal with political risk and timing of acquisitions is therefore also an important issue for Chinese companies in dealing with US security reviews.

3. Analysis of Coping Strategies

3.1 Restricted Rights Acquisition Programme

The acquiring company can make certain commitments and restrictions on its rights in the transaction proposal to address CFIUS concerns [9]. For example, they may restrict their voting rights in the acquired company and make a commitment not to transfer technology. Such restrictions are common in derogation agreements, but to facilitate the review process, the parties may agree to restrict some of the acquirer's shareholder rights prior to the review process.

The technology that Snapdragon possesses is highly interchangeable for Asymchem, and Asymchem has indicated that it also possesses this technology, so the success of the acquisition will have no impact on Asymchem's business in the US. The biggest purpose of the acquisition is to expand the European and American markets and obtain orders from large pharmaceutical companies in Europe and the US by working with Snapdragon to access its accompanying resources of large European and American customers. Since Snapdragon's technology is not the focus of the acquisition for Asymchem, it is possible to negotiate the transaction with a pre-existing tender offer document that respects and supports Snapdragon's research and development and corresponding intellectual property rights, and does not change the ownership of the intellectual property rights.

In the autumn of 2020, Asymchem purchased newly issued shares in Snapdragon, becoming the majority shareholder with an 18.18% stake [10]. In its annual report, Asymchem stated that during the year it completed the development of a continuous response process with Snapdragon for a potential late-stage heavyweight drug in the clinical phase of a major European and American pharmaceutical company, and was awarded the corresponding production order [10]. As a result of this project, a number of major pharmaceutical companies in Europe and the US began to make enquiries to Asymchem. It is clear that the potential commercial benefits of simply acquiring a portion of the shares and working together would be sufficient for Asymchem to acquire 100% of Snapdragon

in order to take complete control of Snapdragon, which would be unnecessary and would raise CFIUS concerns about the transfer of key technologies and industry control.

While a rights-restricted takeover proposal would infringe on Asymchem's legitimate rights as an owner, these commitments serve to satisfy CFIUS requirements regarding the technological sensitivity of the industry in question, making it easier for national security reviews to pass, and the opportunity cost is lower in acquisitions that are not for technological purposes and can be appropriately adopted.

3.2 Lobbying

Lobbying has an important and far-reaching impact on American political life. Most lobbyists who are retired US officials or investment bank executives with a deep knowledge of the industry as well as a long history of lobbying, play a central role in political activism by conveying financial market expertise to lawmakers [11]. They are able to communicate quality advice to policy makers more efficiently, which objectively eliminates information imperfections in the making of US political decisions. During the national security review of Lenovo's acquisition of IBM, the two companies devoted themselves to lobbying in preparation. During this period, the companies hired Cockcroft, a former US national security advisor, to lobby specifically for US national security clearance, and the acquisition went smoothly [12]. It is clear that lobbying can play an important role in getting a company's cross-border acquisition through security clearance.

The late stage of the acquisition was problematic for Asymchem's acquisition with the introduction of new legislation and the tightening of issues relating to industry scrutiny. Without a strong lobbying team, it would have been difficult to respond to the rapidly changing landscape and find lobbyists that would have been favourable to its side. According to Asymchem, the suspension of the acquisition was due to its inability to respond to regulation, which suggests that its lobbying of the government was not satisfactory. Moreover, not all of the US biopharmaceutical industry is happy with the corresponding tightening of policy, which means that much of the industry's chain cannot be outsourced, so the likelihood of a successful acquisition would be greatly increased if the US biopharmaceutical industry could help in lobbying CFIUS.

The proper use of lobbying firms can be a good approach for Chinese companies facing security scrutiny in cross-border acquisitions. But the lobbying industry currently lacks effective legal regulation and is even in a grey area of the law. Lobbyists are well versed in the rules and have a variety of ways to get around them. If acquiring companies work with lobbyists who are not formally registered and are not legally responsible for any of the consequences, because of being not familiar with the lobbying industry in the host country, acquiring companies will not only fail in a merger that has taken a lot of effort, but also affect the reputation of the company in the business and media circles of the host country slowing down the entry into overseas markets. It is important for Chinese companies to develop their own lobbying teams, but it is difficult for them to specialise in security reviews in different host countries, and it is difficult for their own lobbying teams to gain the trust of the host government, so they can work with lobbying organisations that are legally registered in the host country.

For host governments, cooperation with local lobbying agencies can not only bring an impartial mode of bargaining to foreign companies under security review, but also provide CFIUS with an objective assessment of economic benefits. The host government can set up regulation of lobbying agencies in relation to cross-border mergers and acquisitions with the following options: sending personnel to regularly investigate and monitor; rating agencies for security and transparency and banning those that do not meet the registration requirements; improving the gaps in the corresponding laws; banning active government personnel from joining and strictly detecting bribery and corruption to ensure that lobbying actions are conducted legally. CFIUS can request industry recommendations from industry insiders and business reports on the target company, including but not limited to the employment benefits of the acquisition. This includes, but is not limited to, economic benefits such as increased employment and inflow of new technology resulting from the acquisition, in order to

reduce the information gap arising from the government's lack of understanding of specialist issues and to be able to reasonably judge and balance national security and commercial benefits. At the same time, if the acquiring company uses its own trained lobbying team, the host government can also work with local lobbying agencies to monitor the legitimacy and authenticity of their lobbying.

3.3 US-China Bilateral Investment Treaty (BIT)

In the case of Chinese companies facing security reviews in host countries, apart from resorting to lobbying agencies, the Chinese government should also limit the abuse of national security reviews by host governments at the macro level under the pretext of "government control" or "espionage", and limit and negotiate security reviews on a "government-government" basis. The CFIUS review mechanism grants judicial immunity from enforcement and presidential veto, essentially limiting the avenues for Chinese companies to seek redress. It rejects international arbitration jurisdiction on broad "national security" grounds, leaving the acquirer with no recourse to international arbitration if it has been unfairly treated. Therefore, the Chinese government can request CFIUS to disclose the reasons and considerations for refusal within the scope of the law in the BIT negotiations, and restrain the exercise of CFIUS's review power through consultation and negotiation.

3.3.1 Negative List Controlling Security Review

In the field of international investment law, the "negative list" model refers to an agreement in which contracting parties make limited reservations on measures, industries or activities for specific projects, provided that they agree that national treatment applies to all foreign investors and their investments [13]. Both the negative list system and the security clearance system regulate the right of access to foreign investment, but they have completely different functions. The negative list system embodies the legislative concept of "freedom without prohibition", while the security clearance system is a complete exception. However, countries may consider "subsuming" the security review system within the framework of the negative list regime and reconstructing a system of foreign investment access management around the negative list. Only foreign investments covered by the negative list would need to be subject to a security clearance application or the government authorities could initiate a security clearance ex officio, i.e. a negative list management system would be used to achieve reasonable control over the security clearance system. A more transparent negative list allows for the foreseeable identification of the industry sectors in which the security review will be applied, in order to reasonably avoid the sudden review of the "security industry" in the Asymchem acquisition.

Although the US and China have agreed on the modalities of the BIT negotiations, they have still not agreed on the outline of the negative list. The US side has reserved items such as infrastructure, important technologies and national security that are fundamental to the country, but has not given specific content to these items. If a Chinese company invests in a certain sector in the US, the US side can unilaterally stop the acquisition without liability based on an expanded interpretation of the terms of the agreement, or even add a "national security" review of the sector, as in the case.

Provisions relating to national security reviews therefore need to be further negotiated in the US-China BIT negotiations. The FIRRMA Act, for example, elevates technology and intellectual property rights to an important position in national security strategy, and whether cross-border acquisitions will actually have an impact on national security is itself a difficult issue to determine directly, as both sides need to define which acquisitions involving technology will touch on national security and which will only be for technology monopoly and technology protection.

Negotiations between the US and China on the negative list could be partly informed by the RCEP, which sets out each member's negative list of investment in Annex III of the RCEP agreement (the Schedule of Investment Reservations and Commitments on Inconsistent Measures). Members have included a number of sensitive areas in List II, reserving full policy space and allowing for more restrictive measures to be taken against foreign investment in these areas in the future. The list entries are structured to identify the Sector, Level of Government, Type of Obligation, Description of Measure and Source of Measure in which the reserved measures are to be applied. Some members'

negative lists further specify the subsector of the industry and the International Standard Industrial Classification (ISIC) to which it belongs [14].

3.3.2 New Dispute Resolution Platform

The current phase of the US-China BIT negotiations, the US-China Economic and Trade Agreement, includes provisions for bilateral evaluation and dispute settlement, in which the two sides agreed to establish a "Trade Framework Panel", which will meet every six months. The US-China Bilateral Evaluation and Dispute Settlement Office was established to hold regular consultations, discuss and monitor the implementation of the agreement, and receive inquiries and complaints from both sides of the transaction [15]. The establishment of the Trade Framework Panel and the U.S.-China Bilateral Assessment and Dispute Settlement Office is an innovative initiative to resolve disputes through dialogue, adding a diplomatic solution to bilateral investment disputes while retaining arbitration and WTO dispute settlement. In the future, the Trade Framework Panel and the U.S.-China Bilateral Assessment and Dispute Settlement Office could establish a Dispute Item Platform to compile items that have faced security reviews (either on their own initiative or by the review body) by investment companies on both sides within a six-month period. If there are review issues that arise during the consultation, review and investigation phases that cannot be addressed by the enterprise alone, they can be communicated through the bilateral review mechanism. Bilateral dialogue is used to diffuse national security risk concerns and resolve issues at the government level.

4. Conclusion

As the host country has the right to a "national security exception", it is largely difficult for international organisations, governments and companies to intervene in the adoption of national security reviews. Companies seem to be naturally opposed to security review bodies for their own benefit. But CFIUS is a "whole-of-government" review designed to ensure that every transaction is evaluated by the right subject matter experts in government, representing and balancing economics and security. It is possible to reconcile the two based on a common pursuit of economic benefits, but it requires a parallel effort on both sides.

As can be seen through the case of the acquisition of Snapdragon by Asymchem, Chinese companies will face more security clearance issues for cross-border acquisitions of US companies, but these issues need to be addressed jointly by companies and the government. In areas involving CFIUS-sensitive industry attributes and technologies, Chinese companies can make some concessions and self-restrictions, such as preparing rights-restricting acquisition proposals in advance of the acquisition, which can also reduce the hasty response to CFIUS reviews by proposing derogation agreements. To some extent, it is difficult to draw the line between national security issues and economic growth issues, so the appropriate balance between the two is an important issue for security review bodies such as CFIUS. The host government can regulate its own lobbying industry to ensure that acquiring companies receive professional and legitimate assistance, while guaranteeing that professional assessments of relevant economic interests can be successfully communicated to CFIUS to make an objective and fair judgement. The security review system, on the other hand, is uncertain due to its reliance on the free mind of the review body and could be limited by a relatively transparent negative list. At the same time the two governments could establish a new dispute resolution platform in the BIT negotiations to enable bi-national investment in the form of government-to-government dialogue. This paper reminds Chinese companies of the security clearance issues they face when acquiring US companies and proposes corresponding strategies to deal with them. It also calls on both governments to take appropriate legislative and negotiating measures, and makes recommendations to that effect. However, the paper does not include the reform and relief programmes of relevant international organisations, which could be further expanded in the future to facilitate an in-depth study of the issue.

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