

# **The EU's Foreign Investments Regime: Screening for State-Control**

Bridging EU Definitions with Realities of Political Governance in China

OTMU8006 Yhtiö globaalissa taloudessa ja yhteiskunnassa  
Master's thesis

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Tässä tutkielmassa käsitellään Euroopan unionin oikeudellista järjestelmää, joka koskee suoria ulkomaisia sijoituksia ("FDI") ja niiden seulontaa, keskittyen valtiokontrollin käsitteeseen erityisesti kiinalaisten sijoitusten osalta. Tutkielmassa tarkastellaan FDI-seulontajärjestelmää vuoden 2019 asetuksen ja vuonna 2024 ehdotetun uudistuksen kautta. Tutkielma analysoi miten EU:n määritelmä valtiokontrollista vastaa Kiinan valtiosektorilla yleisesti ilmeneviä poliittisen hallinnon mekanismeja. Näin ollen tässä tutkielmassa analysoidaan perusteellisesti myös Kiinan valtiosektoria.

Tutkimuksessa käytetään oikeusvertailevaa analyysia ja oikeusdogmaattista tutkimusta, jotta voidaan ymmärtää valtiokontrollin käsitettä EU:n sääntelykehyksessä ja asettaa se vastakkain poliittisen hallinnon käytännön realiteettien kanssa, sellaisina kuin ne ilmenevät Kiinan valtiosektorilla.

Keskeiset havainnot osoittavat, että EU:n määritelmä valtiokontrollista, joka perustuu pääasiassa perinteisiin hallintorakenteisiin, kuten omistukseen ja rahoitukseen, ei täysin kata Kiinan kommunistisen puolueen poliittista vaikutusvaltaa kiinalaisiin yrityksiin. Tutkimuksessa todetaan, että EU:n FDI-järjestelmää voidaan joutua kehittämään edelleen, jotta voidaan ottaa huomioon Kiinan poliittisen hallinnon monimutkaisuus ja varmistaa tehokkaampi seulontaprosessi EU:n taloudellisten ja turvallisuusetujen turvaamiseksi. Suosituksia ovat muun muassa poliittiseen valvontaan liittyvien näkökohtien sisällyttäminen valtiokontrollin määritelmään ja aiempaa monipuolisempi lähestymistapa FDI-seulontaan, jossa otetaan huomioon kiinalaisten valtioon sidoksissa olevien yritysten erityispiirteet.

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This thesis explores the European Union's foreign direct investment ("FDI") screening regime, focusing on the concept of state-control, particularly in the context of Chinese investments. The study examines the EU's FDI regime as established by the 2019 Regulation and the proposed 2024 revision of said regulation. It investigates how the EU's definition of state-control aligns with the political governance mechanisms prevalent in China's state-sector. Accordingly, this thesis also provides an in-depth analysis of the Chinese state-sector

The research employs comparative legal analysis and doctrinal legal research to understand the notion of state-control within the EU's regulatory framework and contrast it with the practical realities of political governance as they manifest in China's state sector.

Key findings reveal that the EU's definition of state-control, primarily based on traditional governance structures like ownership and funding, does not fully capture the political influence exerted by the Chinese Communist Party (CCP) over Chinese enterprises. The study concludes that the EU's FDI regime may require further refinement to address the complexities of political governance in China, ensuring a more effective screening process to safeguard the EU's economic and security interests. Recommendations include the incorporation of political control aspects into the definition of state-control and a more nuanced approach to FDI screening that considers the unique characteristics of Chinese state-affiliated enterprises.



# Table of Contents

SOURCES.....	VII
LIST OF ABBREVIATIONS .....	XIV
<b>1 INTRODUCTION.....</b>	<b>1</b>
1.1 DELIMITATIONS .....	4
1.2 METHODOLOGY.....	6
<b>2 EU'S FDI REGIME: SCREENING FOR STATE-CONTROL .....</b>	<b>8</b>
2.1 OVERVIEW OF THE EU'S APPROACH TO FDI SCREENING.....	8
2.1.1 <i>Key Concepts and Terms</i> .....	8
2.1.2 <i>Background to the FDI Regulation</i> .....	9
2.1.3 <i>The 2019 FDI Regulation</i> .....	12
2.1.4 <i>Omissions and the 2024 Proposal for a New FDI Regulation</i> .....	15
2.2 THE ROLE OF STATE-CONTROL IN THE EU'S FDI REGIME.....	18
2.2.1 <i>From Indicative Factors To Mandatory Screening of State-Control</i> .....	19
2.2.2 <i>Defining State-Control in the 2024 Proposal</i> .....	21
2.2.3 <i>Chinese State-Control and Its Implications for the Regime</i> .....	25
<b>3 THE LANDSCAPE OF STATE-CONTROLLED ENTERPRISES IN CHINA .....</b>	<b>27</b>
3.1 THE SCALE AND IMPACT OF THE CHINESE STATE-SECTOR.....	28
3.2 EVOLUTION AND TRANSFORMATION OF CHINA'S STATE-SECTOR.....	32
3.2.1 <i>Transition from State Monopoly to a Market-Oriented State-Sector</i> .....	32
3.2.2 <i>Xi Jinping's Reforms: Mixed-Ownership and Party-Building</i> .....	35
<b>4 POLITICAL INFLUENCE IN CHINESE ENTERPRISES .....</b>	<b>41</b>
4.1 GOVERNANCE OF SOES: THE LETTER OF THE LAW.....	42
4.1.1 <i>The Formal Regulatory Framework for Corporate Governance in China</i> .....	42
4.1.2 <i>SASAC: The Backbone of State-Control?</i> .....	45
4.2 THE POLITICAL GOVERNANCE OF CHINESE SOES.....	48
4.2.1 <i>CCP's Corporate Extensions: In-House Cells within the Chinese State-Sector</i> .....	48
4.2.2 <i>Party Influence Codified: The Institutionalization of In-House Cells</i> .....	54
<b>5 RECONCILING EU'S FORMULATION OF STATE-CONTROL WITH CHINESE GOVERNANCE PRACTICES .....</b>	<b>57</b>
5.1 POSSIBILITY FOR INSIGHTS FROM ESTABLISHED LEGAL TERMINOLOGY IN EU LAW.....	58
5.2 INTERPRETING GOVERNMENTAL ORIGIN: THE ROLE OF THE CCP IN THE EU'S FDI REGIME.....	60
5.3 ANALYZING THE CONTROL CRITERIA: MANIFESTATIONS OF CONTROL IN THE CHINESE STATE-SECTOR.....	62
5.3.1 <i>Exploring the Control Criterion and Ambiguities within the FDI Regime</i> .....	63
5.3.2 <i>Other manifestations of control as proxies for political control</i> .....	64

6 CONCLUSIONS..... 70

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## List of Abbreviations

BoD	Board of Directors
CCL	1993 Company Law of China (“Chinese Company Law”)
CCP	Communist Party of China (“Chinese Communist Party”)
EU	European Union
FDI	Foreign Direct Investment
IHC	In-House Cell
IMF	International Monetary Fund
JSLC	Joint Stock Limited Company
LLC	Limited Liability Company
MOE	Mixed-Ownership Enterprise
PRC	People’s Republic of China
SOE	State-owned Enterprise
UN	United Nations
WSOE	Wholly State-owned Enterprise

## 1 Introduction

In today's global economy, foreign direct investment ("FDI") holds immense significance for all economies, including the European Union ("EU"). FDI plays a pivotal role in stimulating economic growth, job creation, and technological advancement. FDIs, in essence, are investments made by a firm or individual in one country into business interests located in another country, which involve the transfer of a certain degree of control over the foreign business. FDIs are economically extremely beneficial, as they inject foreign capital into an economy, fostering domestic industries, infrastructure development, employment, and innovation.

However, rising concerns about foreign actors, particularly state-controlled entities, gaining control over EU assets – especially those in strategic sectors – have become increasingly prominent. These concerns are underscored by growing geopolitical tensions and are especially prominent with respect to China, whose expansive investment strategies have raised questions about economic security and sovereignty.

It was against this backdrop that the EU enacted Regulation 2019/452 establishing a framework for the screening of foreign direct investments into the EU (hereinafter, the "2019 Regulation" or the "2019 Regulation")<sup>1</sup>, aiming to create a framework for the screening of foreign investments that may affect security or public order in the EU. The 2019 Regulation provides for the possibility of screening by Member States and the Commission of foreign direct investments where those investments may affect security or public order.

However, this regulation was not without its shortcomings; it included several omissions and ambiguities. Moreover, subsequent global crises – the COVID-19 pandemic and the Russian invasion of Ukraine – and escalating geopolitical tensions further highlighted the urgency for a more robust and clearer framework for screening of FDI which could adequately safeguard critical assets.

In response to these evolving challenges and the lessons learned from the application of the 2019 Regulation, the European Commission (hereinafter, the "Commission") has proposed a

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<sup>1</sup> Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union (hereinafter, the "2019 Regulation")

new regulation, unveiled in early 2024. This proposal seeks to address the deficiencies of the previous framework and strengthen the EU's ability to protect its economic interests.

The 2019 Regulation and the 2024 Proposal (hereinafter together, the EU's "FDI regime") have introduced a novel concept to EU law: state-control. In the screening of FDI, the 2019 Regulation granted the Member States and the Commission the possibility to consider state-control, i.e., whether a foreign investor is controlled directly or indirectly by the government of a third country. With the 2024 Proposal, the EU's Member States and the Commission would seemingly be mandated, under certain circumstances, to screen FDI that originate from state-controlled entities.

The inclusion of state-control is closely linked to growing concerns about investments from countries like China, where the state's influence in business is profound. However, the formulation of state-control within the EU's FDI regime is quite ambiguous. It is unclear, regardless of the Commission's intent, whether this formulation can fully capture the entire breadth of Chinese state-control, which extends beyond mere ownership.

State-control in China is a complex web of political governance mechanisms that allow the Chinese State and the Chinese Communist Party (hereinafter also, the "CCP") to exert substantial influence over the Chinese state-sector. Influence is exerted through a combination of traditional corporate governance mechanisms and more uniquely Chinese mechanisms of political governance.

Notably, simultaneous reforms under Xi Jinping aimed at increasing private ownership in the state-sector while also strengthening the power of the CCP's party apparatus within these companies pose significant challenges. It is unclear whether the notion of state-control, as formulated within the FDI regime, can facilitate the state-control which is exerted through the CCP's mechanisms of political governance.

This thesis will continue as follows. In Chapter 2, this thesis explores the notion of state-control in the EU's FDI regime, encompassing both the 2019 Regulation and its proposed revision unveiled by the Commission in 2024. This chapter will explain the foundational principles, basic concepts and contextual background relevant to this regime. Central to this examination is the novel concept of state-control introduced in the FDI regime. This chapter will trace how the screening of state-control has evolved from the 2019 Regulation to the adjustments proposed in 2024 by the Commission. Moreover, Chapter 2 will introduce the cornerstone of

this thesis; that is, the complexities surrounding the concept of state-control and its application, particularly concerning the Chinese state-sector.

Chapters 3 and 4 serve as essential groundwork for understanding the issue at hand. In Chapter 3, the focus of this thesis shifts towards the Chinese landscape, where a detailed examination of the Chinese state-sector is necessary for contextualizing the issue. This chapter will highlight the sheer magnitude of the state-sector within domestic markets, contrasting it starkly with its European counterparts. Further, Chapter 3 will assess the historical evolution of China's state-sector from the early days of the Communist Era to the present day, paying specific attention to the mixed-ownership reforms and party-building policies implemented under President Xi Jinping. Understanding these reforms is crucial as they illustrate how state-control is exerted in modern China. Increasingly, influence is wielded through political mechanisms rather than just ownership.

Chapter 4 will examine the practical realities of governance in China's state-sector. This chapter will explore the unique dual governance structure that permeates the state-sector. This examination will explore both formal corporate governance as defined by Chinese corporate law and the mechanisms of political governance employed by the Communist Party. Of particular interest will be how the Chinese Communist Party maintains influence over the state-sector, increasingly bypassing traditional ownership-based control.

Chapter 5 will explore into the notion of state-control as formulated in the EU's FDI regime, aiming to determine whether it may be applied to the political governance mechanisms employed by the CCP. This chapter will begin with juxtaposing the legal terminology of the FDI regime with terminologies from other branches of EU law to explore potential interpretative insights. Given the absence of authoritative interpretation guidance for the FDI regime's text, this analysis seeks to discern how these terms should be understood. This chapter will evaluate whether any of the manifestations of control listed in the text of the 2019 Regulation and the proposed revision could serve as effective proxies for the mechanisms of political governance employed by the CCP.

Through this examination, this thesis attempts to answer the following research question, which is further divided into two secondary research questions:

1. How does the EU's formulation of state-control in the FDI Regulation align or conflict with the practical realities of Chinese state-control?

- a) How is state-control formulated within the EU's FDI screening regime?
- b) How does the Chinese State and the Communist Party of China exert influence over China's state-sector?

Current academic literature delving into the intersection of Chinese FDI and the 2019 Regulation does exist. Most often this literature has taken looked at the issue at a broader level, often focusing on the effect of Chinese FDI on the enactment of the 2019 Regulation. As of yet, no academic literature has problematized the definition of state-control, as posed by the 2019 Regulation or the 2024 Proposal. This is most likely because that, regarding the former, state-control was only included in an indicative list of factors, and thus there was no clarity on whether such definition was authoritative in any way. Further, since the 2024 Proposal was published only in January of 2024, it is too recent to have been thoroughly analyzed in academic research. This thesis, thus, represents a pioneering effort in the academic examination of the notion of state-control within the FDI regime, especially concerning its practical application.

## 1.1 Delimitations

The explicit mention of state-control within the FDI Regulation represents the particular security concerns that are perceived to be associated with state-influenced investments. There has been much discussion on whether this perceived risk has been overstated, especially with regard to Chinese investment. There's an ongoing debate over whether FDI screening serves primarily as a protective measure or if it acts more as a tool for strategic advantage. Some scholars supporting the latter stance contend that intervention in FDI markets is primarily driven by geopolitical competition and nationalism rather than any security risks.<sup>2</sup> Official statements by the European Commission denoting China as a competitor and systemic rival would seem to echo such sentiments.<sup>3</sup> Such scholars often note a Western tendency for assigning strategic,

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<sup>2</sup> Lenihan, Ashley Thomas 'Balancing Power without Weapons: State Intervention into Cross-Border Mergers and Acquisitions' (Cambridge University Press, 2018) 45-46; McLaughlin, Mark, 'State-Owned Enterprises and Threats to National Security Under Investment' (2020) *Chinese Journal of International Law* 283, 285

<sup>3</sup> Kuipers, Bart; van der Putten, Frans-Paul, and Martin, Xiaoxue; 'China's strategic relevance to the port of Rotterdam' (Clingendael Institute, October 2023), 20; Zwartkruis, Wolf, and de Jong, Bas, 'The EU Regulation on Screening of Foreign Direct Investment: A Game Changer?' (2020) *European Business Law Review* 447, 450-45; Hanemann, Thilo, and Rosen, Daniel, 'China Invests in Europe: Patterns, Impacts and Policy Considerations' (Rhodium Group, 2012), 60-61; Meunier, Sophie, 'Divide and conquer? China and the cacophony of foreign direct investment rules in the EU' (2014) *Journal of European Public Policy* 996, 1009; European Commission, 'Commission Staff Working Document: Impact Assessment Report on the EU-China Investment Relations' (SWD(2013)185 final, 2013) 18; Conrad, Björn and Kotska, Genia, 'Chinese investments in Europe's energy sector: Risks and opportunities?' (2017) *Energy Policy* 644, 64; Hanemann, Thilo and

security-related aspects to all Chinese investment.<sup>4</sup> Other scholars note very real security risks related to, inter alia, espionage, data security, technology transfers, and critical infrastructure.<sup>5</sup>

Especially state-controlled investments are often viewed as inherently riskier than private investment due to several key factors. The primary fear is that such investments are not solely driven by commercial motives; rather, they may be influenced by broader national interests or political objectives that may not align with the economic or security interests of the host country receiving the investment.

Specifically, regarding China, this debate is not limited to scholarly debate but also extends to disagreements between EU member states. The consensus among Member States on the perceived risks of FDI and the level of intervention required at the European level is far from uniform. Countries such as the Scandinavian nations, Ireland, the UK, Spain, Portugal, and Greece have traditionally perceived measures restricting FDI, even when justified by security concerns, as protectionist in nature. Additionally, some Eastern EU Member States, specifically Hungary, demonstrate a more receptive attitude towards Chinese investments and perceive it to be rather risk free.<sup>6</sup>

While the potential security risks of Chinese state-controlled FDI remain open to debate, it is clear that the attention it garners is disproportionate compared to the actual volume of Chinese inward FDI in the EU. While the volume of Chinese FDI has grown tremendously since the turn of the century, it is still relatively small when compared to the entirety of inward FDI in the EU and there has even been a slight decline in recent years.<sup>7</sup>

This thesis does not attempt to contribute to such discussion on whether state-controlled FDI constitutes a particular security risk. Instead, the focus is strictly on analyzing how the EU's formulation of state-control aligns with the realities of state-control in Chinese state-affiliated

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Huotari, Mikko, 'Chinese FDI in Europe and Germany: Preparing for a New Era of Chinese Capital' (2015, Mercator Institute for China Studies and Rhodium Group), 39-40

<sup>4</sup> Brattberg, Erik; Le Corre, Philippe; Stronski, Paul, and de Waal, Thomas, 'China's Influence in Southeastern Central, and Eastern Europe: Vulnerabilities and Resilience in Four Countries' (Carnegie Endowment for International Peace, 2021) 9

<sup>5</sup> Hanemann and Huotari (2012) 41; Radu, Roxana, and Amon, Cedric, 'The governance of 5G infrastructure: between path dependency and risk-based approaches' (2021) 7 *Journal of Cybersecurity* 1, 8-9

<sup>6</sup> Zwartkruis and de Jong (2020) 468

<sup>7</sup> Graham, Edward M., and Marchick, David M., 'US National Security and Foreign Direct Investment' (Peterson Institute for International Economics, 2006) 100; Hanemann, Thilo; Huotari, Mikko, and Kratz, Agatha, 'Chinese FDI in Europe: 2018 Trends and Impact of New Screening Policies' (Rhodium Group and the Mercator Institute for China Studies, 2019) 13 and 18

enterprises, without delving into the broader security implications of investments made by such enterprises.

## **1.2 Methodology**

The primary methods used in this thesis are comparative legal analysis and doctrinal legal research. These are employed to compare the EU's formalistic approach to state-control within its FDI regime with the practical realities of state-control as they manifest in the Chinese system.

This comparative legal analysis is complemented by doctrinal legal research, which aims to provide a comprehensive understanding of the notion of state-control within the EU's FDI regime. This approach is essential for interpreting the specific provisions of the EU's FDI regime relating to state-control.

The first step in this process involves a close textual analysis of the 2019 FDI Regulation and the 2024 Proposal. This entails a studious reading of the legal texts to understand the specific language used to define state-control, such as terms like "directly or indirectly controlled by the government" and the entities included under this definition, such as state bodies, regional or local authorities, and armed forces. By dissecting these provisions, the study aims to clarify the scope and criteria of state-control as envisioned by the EU legislators.

In addition to primary legal texts and case law, this research consults academic commentaries, journal articles, and legal treatises. These secondary sources offer diverse perspectives and in-depth analyses that complement the primary textual analysis. By integrating scholarly commentary, this study situates the legal provisions within the broader academic discourse, enhancing the robustness and depth of the doctrinal analysis.

The comparative legal analysis begins with a descriptive examination of how state-control is exerted in China. This involves providing a detailed description of the structure, scale, and historical evolution of the Chinese state-sector. This analysis will also focus on the governance structures within Chinese enterprises, involving the examination of the dual governance structure which includes both formal corporate governance and political governance.

The focus of the comparative analysis is on understanding how state-control is conceptualized and regulated within the EU's FDI regime, and how these regulatory mechanisms align or conflict with the governance practices in China. Comparative legal analysis serves as an

effective tool for this research due to its ability to bridge different legal systems and provide a nuanced understanding of complex regulatory landscapes. The aim is to understand the effectiveness, challenges, and implications of the EU's FDI regime in the context of China's state-controlled economy.

Through the integration of doctrinal legal research and comparative legal analysis, this thesis aims to bridge the theoretical constructs of the EU's regulations with the practical realities of Chinese governance practices. This combined methodological approach ensures a nuanced and comprehensive understanding of state-control within the EU's FDI regime, offering valuable insights for policymakers and legal scholars alike.

## **2 EU's FDI Regime: Screening For State-Control**

The global investment landscape is rapidly evolving, shaped by geopolitical tensions, shifting economic strategies and recent global crises. In response, the EU has had to rethink its historically positive attitude towards FDI. This has culminated in the enactment of a regime for the screening of foreign direct investments. This regime aims to balance openness to foreign investment with the need to protect its strategic interests, particularly from state-controlled entities. Safeguarding the EU's economy from the potential risks associated with state-controlled actors has become increasingly relevant with the rise of state-influenced economies like China.

The 2019 FDI Regulation was the EU's first comprehensive attempt to create a coordinated framework for screening FDI. It allowed member states to implement national screening mechanisms and established a cooperative process for sharing information and concerns. Despite these advances, the regulation left significant discretion to member states, leading to inconsistencies in how FDI was screened, especially regarding state-control. In response, the European Commission proposed a revised FDI Regulation in 2024, which aims to further harmonize FDI screening mechanisms.

This chapter will examine the key concepts related to FDI and present the background regarding the EU's regulatory approach. It will assess the EU's FDI regime and its evolution from the 2019 Regulation to the 2024 Proposal, with special focus on the notion of state-control and the challenges presented by the EU's formulation thereof.

### **2.1 Overview of the EU's Approach to FDI Screening**

The European Union's approach to FDI has evolved significantly during the past decade, reflecting growing concerns over national security and economic sovereignty. This section examines the historical shift from a liberalized stance to a more cautious one, culminating in the enactment of the 2019 Regulation. It assesses the 2019 Regulation, and explores the 2024 Proposal, aimed at addressing the shortcomings of its predecessor.

#### **2.1.1 Key Concepts and Terms**

Foreign direct investment, or FDI, refers generally to the purchase of assets – usually by companies – in a foreign jurisdiction in such a way that it gives the buyer control over said

asset. In the EU, FDI is legally defined as investments by foreign investors intended to establish or maintain lasting and direct links with the entrepreneur or undertaking receiving the capital and which allow effective participation in the management or control of a company engaged in economic activity. FDI, thus, does not include portfolio investments or other indirect investments, as these do not entail the acquisition of control in the target.<sup>8</sup> In the EU, the legal term for the foreign company or individual making an FDI in the EU is a “foreign investor”.<sup>9</sup>

FDI can occur in a plethora of ways. Often FDIs are divided into two broad categories. The first one includes mergers and acquisitions, which – in the context of FDI – entails the transfer of ownership of existing assets to a foreign owner. In a merger, a foreign company combines with a domestic company to form a single entity. In an acquisition, a foreign company acquires all or part of the shares of a domestic company. The second category is greenfield investment, which involves the creation of a subsidiary by a foreign parent company.<sup>10</sup>

### 2.1.2 Background to the FDI Regulation

In the EU, FDI has, for most of the European Union’s history, been maintained within the competences of Member States and, thus, been governed nationally. FDI was transferred to the exclusive competence of the European Union only in 2009 with the entry of force of the Treaty of Lisbon. This meant that the EU was not a formally recognized actor in international investment, even when all of its Member States collectively, by the time of the Treaty of Lisbon, were the largest exporters and the largest recipients of FDI.<sup>11</sup> According to Article 206 TFEU, the EU “shall contribute ... to the progressive abolition of restrictions ... on foreign direct investment”. According to Article 207 TFEU, “the common commercial policy shall be based on uniform principles, particularly with regard to ... foreign direct investment”.

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<sup>8</sup> Opinion 2/15, Free Trade Agreement between the EU and Singapore [2017], EU:C:2017:376, paras 36, 80, 83-84; 2019 Regulation, Recital 19.

<sup>9</sup> 2019 FDI Regulation, Art. 2(2)

<sup>10</sup> European Commission, ‘Types of Investment’ <<https://trade.ec.europa.eu/access-to-markets/en/content/types-investment>> accessed 18 May 2024

<sup>11</sup> Esplugues, Carlos, ‘Towards a Common Screening System of Foreign Direct Investment on National Interests Grounds in the European Union’ (2018) Vol. 12, No. 1, Culture, Media and Entertainment Law 1-56, 2; European Commission, ‘Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee and the Committee of the Regions: Towards a comprehensive European international investment policy’ (COM(2010)343 final, 2010) (hereinafter, the “Communication on European International Investment Policy”), 3; According to Eurostat, this remained the case in 2021 with Europe being both the largest source and destination of FDI stocks in the world, see Eurostat, ‘World direct investment patterns’ (Eurostat, 2023) <[https://ec.europa.eu/eurostat/statistics-explained/index.php?title=World\\_direct\\_investment\\_patterns&oldid=614610#Stocks\\_of\\_foreign\\_direct\\_investment](https://ec.europa.eu/eurostat/statistics-explained/index.php?title=World_direct_investment_patterns&oldid=614610#Stocks_of_foreign_direct_investment)> accessed 13 January 2024

The post-Lisbon TFEU granted the EU powers to “contribute to the progressive abolition of restrictions on foreign direct investment”. Capitalizing on this new competence in FDI, the European Commission initiated measures to liberalize markets, aligning with the Treaty’s intentions. According to Moberg and Hindelang (2020), the Commission “embarked on an ambitious negotiating agenda for free trade agreements”, specifically targeting the further liberalization of FDI flows.<sup>12</sup>

This proactive stance taken by the Commission is also evident in its 2010 Communication, which outlined an international investment policy strategy. The document reflected an overwhelmingly positive outlook towards FDI, particularly in the context of outward investments, emphasizing the Commission’s commitment to using its new powers to ease investment restrictions and promote a more open and liberal global investment environment.<sup>13</sup>

Conversely, during this period, inward FDI received far less attention.<sup>14</sup> When it was considered, the focus was predominantly on further liberalizing the flow of FDI into the EU and removing existing restrictions. This liberalizing approach of the EU towards inward FDI is exemplified in its stance regarding the pre-existing screening mechanisms of certain member states, notably Germany and France. The European Commission actively encouraged these countries to relax their existing protective measures for FDI, which they showed little appetite for. The Commission's commitment to this liberalization agenda was so strong that it went as far as to initiate infringement proceedings against France due to a law that enacted an authorization procedure for investments in specific sectors.

In the immediate post-Lisbon landscape, there was a noticeable lack of urgency from any of the interested parties – that is, the Commission, Member States, or business groups – in addressing any issues regarding inbound FDI. In fact, most FDI related reports from the time period may raise issues such as human rights and sustainable development, but concerns regarding security are nowhere to be found.<sup>15</sup> However, by the mid-2010s, this relaxed and generally positive approach towards inward FDI began to shift.<sup>16</sup> This shift was due to increased attention and

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<sup>12</sup> Moberg, Andreas, and Hindelang, Steffen, ‘The Art of Casting Political Dissent in Law: The EU’s Framework for the Screening of Foreign Direct Investment’ (2020) 57(5) *Common Market Law Review* 1427, 1433

<sup>13</sup> Moberg and Hindelang (2020) 1432-1433; Communication on European International Investment Policy (2010) 2-3

<sup>14</sup> Meunier (2014) 1008-1009; Moberg and Hindelang (2020) 1433

<sup>15</sup> See, for example, World Investment Report (2011) III.5 ‘EU FDI Policymaking’

<sup>16</sup> Warchol, Joanna, ‘The Birth of the EU Screening Regulation’ in Hindelang, Steffen and Moberg, Andreas (eds), *YSEC Yearbook of Socio-Economic Constitutions 2020: A Common European Law on Investment Screening (CELIS)*, (Springer International Publishing, 2021), 56

concern over a rising global actor, China, and in particular the global operations of its state-sector.

Since the mid-2010s, there has been a growing apprehension towards Chinese inward FDI in the EU, especially that from state-controlled enterprises. This growing apprehension was articulated in a joint letter by the governments of France, Germany, and Italy to the European Commission in February 2017. They expressed concerns about the potential loss of European expertise and the lack of reciprocity in investment relations. They urged the EU to implement FDI screening measures at the EU level.<sup>17</sup> These calls resonated in the European Parliament, where a proposal was introduced for an EU act on the screening of foreign investment in strategic sectors.<sup>18</sup>

While the calls for stricter scrutiny of inward FDI were not entirely new – reminiscent, in fact, of similar concerns during the aggressive expansion of Japanese financial institutions in Europe in the 1980s<sup>19</sup> – the context of Chinese investment is distinct. Unlike traditional major exporters of FDI, which were predominantly market economies with democratic systems<sup>20</sup>, China's investment comes from a country with an authoritarian political regime and a fragile security relationship with the EU.<sup>21</sup>

In response, the Commission issued a Reflection Paper that presented a departure from its previous stance. This paper starkly contrasted the attitude seen just a few years earlier; for instance, in 2012, the Trade Commissioner had dismissed national security concerns as a "false pretense" used to justify protecting certain European sectors.<sup>22</sup> The Reflection Paper's acknowledgment of the potential risks associated with FDI, particularly regarding security and the lack of reciprocity, marked a significant shift in the Commission's approach, indicating a newfound willingness to address these complex issues.<sup>23</sup>

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<sup>17</sup> Warchol (2021) 57; Simon, Sven, 'Investment Screening: The Return of Protectionism? A Political Account' in Hindelang, Steffen and Moberg, Andreas (eds), *YSEC Yearbook of Socio-Economic Constitutions 2020: A Common European Law on Investment Screening (CELIS)*, (Springer International Publishing, 2021), 45; Moberg and Hindelang (2020) 1434; Esplugues (2018) 17

<sup>18</sup> Moberg and Hindelang (2020) 1434

<sup>19</sup> Bakker, Age, 'The Political Economy of Capital Controls and Liberalization in the European Union' in Hindelang, Steffen and Moberg, Andreas (eds), *YSEC Yearbook of Socio-Economic Constitutions 2020: A Common European Law on Investment Screening (CELIS)*, (Springer International Publishing, 2021), 21-22

<sup>20</sup> With a few caveats, like Russia and Singapore.

<sup>21</sup> Hanemann and Huotari (2015) 41

<sup>22</sup> Moberg and Hindelang (2020) 1434; De Gucht, Karel, European Commissioner for Trade, 'EU-China Investment: A Partnership of Equals' (Speech at Bruegel Debate, Brussels, 7 June 2012) <

[https://ec.europa.eu/commission/presscorner/detail/en/SPEECH\\_12\\_421](https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_12_421)>, accessed 10 December 2023

<sup>23</sup> European Commission, 'Reflection Paper on Harnessing Globalisation', (COM(2017)240 final, 2017), 15

This increasing awareness and concern among the EU institutions and Member States about the potential risks associated with inward FDI, particularly from China, led to a response from the European Commission, culminating in the enactment of 2019 Regulation on the screening of foreign direct investments. While Chinese state-controlled FDI as a whole represents only a small piece of the EU's overall inward FDI, it nonetheless presents a particularly acute issue in the EU. While historical examples give some reason to be weary of FDI into sectors crucial for a nation's security by state-owned companies from countries with whom one might have potential conflict with, most issues stem from the unique features of Chinese state-controlled companies more generally.

With the CCP's tight grip over state-controlled companies, especially SOEs, these entities are able to be used for advancement of China's broader prerogatives, which are not purely commercial and also include political and security-oriented objectives. This control has direct implications for FDI in the EU, particularly in sectors considered critical for the bloc's security.

As such, the FDI Regulation was a long-overdue response to safeguard against these potential risks by screening FDI and aiming to ensure that critical sectors remain secure from foreign influence that could undermine the EU's security interests.

### 2.1.3 The 2019 FDI Regulation

The 2019 FDI Regulation is comprised of several key components. Firstly, it authorizes Member States to implement a national screening mechanism for FDI originating from outside the EU, focusing specifically on issues of public order and security. Secondly, it establishes a cooperation mechanism that facilitates interaction and information exchange between Member States and the European Commission. Additionally, the 2019 Regulation endows the Commission with significant soft powers. However, it stops short of granting the Commission hard, enforceable powers, reflecting a deliberate balance between EU-wide coordination and respect for national autonomy in the realm of FDI screening.

Article 3(1) of the 2019 Regulation permits Member States to develop, modify, or retain mechanisms for scrutinizing FDI on the basis of security or public order. This provision does not mandate Member States to establish such mechanisms but subtly encourages them to either strengthen existing ones or introduce new ones if absent. Even the option for a Member State to remove an existing screening mechanism is not precluded.

Public order and security serve as the primary, and most likely exclusive, grounds for screening FDI as per the Regulation. This point of view is contested among scholars, with some suggesting that these grounds might not be exhaustive.<sup>24</sup> However, the prevailing opinion asserts that public order and security constitute a definitive list of reasons for restricting FDI.<sup>25</sup>

The interpretations of these terms – public order and security – can vary significantly. A broader interpretation could lead to extensive protective measures, while a narrower view might limit screening and restrictions to highly exceptional cases. Traditionally, security concerns were primarily focused on the state, particularly in relation to military technologies, but recent trends suggest a shift towards a more expansive understanding of security, potentially encompassing aspects like territorial, physical, economic, ecological, social, and political security.<sup>26</sup>

Further insight is provided by Article 4 of the Regulation, which outlines factors that Member States might consider when assessing if an FDI impacts security or public order. The lists provided by the Article, while not exhaustive, offer guidance on what might be deemed relevant in the screening process but stops short of providing detailed criteria, leaving that to national legislation.<sup>27</sup> Article 4(1) contains factors which pertain to the nature of the foreign investment and are categorized into areas such as critical infrastructure, critical technologies, sensitive information, and media freedom and pluralism.<sup>28</sup> The inclusion of these sectors in the regulation offers a glimpse into the range of industries that fall under its purview. This array of different industries suggests a broad interpretation of what sectors could be affected by public order and security concerns.<sup>29</sup> Article 4(2) adds another layer by allowing Member States to consider characteristics related specifically to the foreign investor, such as government control or involvement in illegal activities.

In practice Article 4(1) outlines a non-exhaustive list of factors that Member States and the Commission can consider when determining if an FDI is likely to affect public order or security, while Article 4(2) effectively serves as a second level of screening, including factors related to

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<sup>24</sup> Maïllo, Jerónimo, ‘New Screening of Foreign Direct Investment (FDI) in Europe: A First Step Towards a New Paradigm?’ (2020) *The Spanish Yearbook of International Law* 180, 199-200

<sup>25</sup> Nettesheim, Martin, ‘Screening for What Threat: Preserving “Public Order and Security”, Securing Reciprocity in International Trade, or Supporting Certain Social, Environmental, or Industrial Policies?’ in Hindelang, Steffen and Moberg, Andreas (eds), *YSEC Yearbook of Socio-Economic Constitutions 2020: A Common European Law on Investment Screening (CELIS)*, (Springer International Publishing, 2021), 485

<sup>26</sup> Zwartkruis and de Jong (2020) 448

<sup>27</sup> Simon (2021) 49; Zwartkruis and de Jong (2020) 461

<sup>28</sup> Simon (2021) 49

<sup>29</sup> Zwartkruis and de Jong (2020) 461-462

the foreign investor rather than the FDI itself. These considerations are indicative, meaning they are examples rather than an exhaustive checklist. They provide a broad spectrum of entry points for Member States to assess the implications of FDIs.

Specifically, Article 4(2)(a) of the 2019 Regulation attempts to specifically incorporate the unique security risks arising from state-controlled FDI, according to which:

“[In determining whether a foreign direct investment is likely to affect security or public order, Member States and the Commission may also take into account, in particular] ... whether the foreign investor is directly or indirectly controlled by the government, including state bodies or armed forces, of a third country, including through ownership structure or significant funding”.

Finally, the Regulation sets common standards for all national controls, including transparency, judicial review, and non-discrimination, alongside the protection of confidential information. These standards are not particularly groundbreaking, given their preexistence in ECJ case law on capital movements.<sup>30</sup> These standards have been called something that is to be expected as a logical consequence of the EU being governed by the rule of law.<sup>31</sup>

The Regulation introduces a pivotal cooperation mechanism that involves both Member States and the European Commission. This mechanism is applicable to all Member States, irrespective of whether they have an established FDI screening process.<sup>32</sup>

The Regulation's FDI control mechanism is activated either when a recipient State uses its national screening process for an FDI, or if another Member State or the Commission raises concerns about the FDI's potential impact on security or public order. This depends on the specific application of the screening process for each specific case.

In cases where the screening process is activated, the recipient State must provide detailed FDI information to the Commission and other Member States. Conversely, if there's a concern from other Member States or the Commission about an FDI in a State without an active screening, they can request relevant information from that State. Additionally, the recipient State has the authority to request necessary information from the foreign investor involved.<sup>33</sup>

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<sup>30</sup> Maillo (2020) 205

<sup>31</sup> Moberg and Hindelang (2020) 1447

<sup>32</sup> Moberg and Hindelang (2020) 1455; Maillo (2020) 196

<sup>33</sup> Maillo (2020) 196

Beyond the cooperation mechanism, the Regulation endows the Commission with new, albeit soft, powers. Notably, the Commission can issue non-binding opinions on FDIIs that might impact public order or security. This power is exercised in situations where either an EU interest project is involved, or when the FDI is believed to affect multiple Member States, or when the Commission holds relevant FDI information. Furthermore, if a request is made by at least one-third of the Member States, the Commission is obliged to provide an opinion.

Despite their non-binding nature, these Commission opinions carry significant weight. The recipient Member State is expected to seriously consider the Commission's opinion and the comments from other Member States.<sup>34</sup> In cases involving EU interest projects, the Member State must “take utmost account” of the Commission's opinion and must explain any deviation from it. However, there is no formal obligation to adhere to the Commission's viewpoint. It is anticipated, though, that in practice, these opinions will be influential.<sup>35</sup>

In addition to providing opinions, Member States are mandated to submit annual reports to the Commission about inbound FDIIs, regardless of whether they have a screening mechanism.<sup>36</sup> This requirement ensures a continuous flow of information and enhances the overall effectiveness of the cooperation mechanism.

#### 2.1.4 Omissions and the 2024 Proposal for a New FDI Regulation

The 2019 Regulation was seen as step in the right direction. It was certainly a far cry from the calls of some for a centralized European mechanism dedicated to overseeing strategic investments and fell short of establishing an independent EU-level screening mechanism. However, it also included some notable omissions.

In addition to such criticism, safeguarding the Union's security and public order had grown tremendously in importance since the enactment of the 2019 Regulation. The COVID-19 pandemic had revealed vulnerabilities in FDI markets as well as the European supply chains. Most notably, Russia's illegal invasion of Ukraine in 2022 had underlined the need to be able to better identify and protect the EU's strategic assets from foreign control.<sup>37</sup>

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<sup>34</sup> Maillo (2020) 196; Simon (2021) 50

<sup>35</sup> Maillo (2020) 196-197

<sup>36</sup> Maillo (2020) 198; Moberg and Hindelang (2020) 1455

<sup>37</sup> European Commission, Evaluation of Regulation 2019/452 accompanying 2024 Proposal (2024) Staff Working Document 23 (hereinafter, “Evaluation of 2019 Regulation”), 6

In January 2024, amid the criticism levelled against the 2019 Regulation and the changing geopolitical situation of the EU, the Commission proposed EU's 2024 proposal for a revision of the FDI Regulation (hereinafter, the "2024 Proposal" or the "Proposal").<sup>38</sup> This proposal seeks to repeal and replace the 2019 Regulation with a new, more updated version.

First, a significant critique of the 2019 Regulation was the lack of a screening mechanism which would be mandatory for Member States to implement. Observers noted that due to the fundamental freedoms of the EU, such non-mandatory screening mechanisms may allow for the circumvention of the intended protective measures. According to the principles of freedom of establishment outlined in the TFEU, companies have the liberty to expand their operations across different Member States. This opens a pathway for third-country companies to establish a foothold in one Member State, where FDI screening is less stringent or non-existent, and then extend their investments into others that may have more robust FDI controls in place.<sup>39</sup>

The concerns about potential evasion of screening is, however, largely theoretical despite the FDI Regulation not requiring mandatory screening mechanisms, as its subtle nudge nonetheless effectively promoted the enactment of such frameworks. Consequently, by 2024, only five Member States had yet to implement a screening mechanism nationally.<sup>40</sup> Nonetheless, the 2024 Proposal put forward a requirement to adopt FDI screening mechanisms, with Article 3(1) of the Proposal making the establishing screening mechanisms mandatory for all Member States.<sup>41</sup> This will compel the remaining Member States without such mechanisms to adopt them. This effectively reduces the fear of malicious actors attempting to circumvent screening by strategically targeting their FDI towards Member States lacking a mechanism.

In addition, the 2019 Regulation and the freedom of establishment allowed for the circumvention of FDI screening by foreign companies through the use of subsidiaries established in the EU. The 2019 Regulation's scope only covered "foreign investors", which were defined in said regulation as "a natural person of a third country or an undertaking of a

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<sup>38</sup> Proposal for a Regulation of the European Parliament and of the Council on the screening of foreign investments in the Union and repealing Regulation (EU) 2019/452 of the European Parliament and of the Council (2024) COM/2024/23 final (hereinafter, the "2024 Proposal")

<sup>39</sup> Maillo (2020) 202-206

<sup>40</sup> Myles, Danielle, 'EU seeks tighter grip on FDI screening' fDi Intelligence (30 January 2024) <<https://www.fdiintelligence.com/content/locations/global/asia-pacific/china/eu-seeks-tighter-grip-on-fdi-screening-83383>> accessed 25 March 2024

<sup>41</sup> 2024 Proposal, 31

third country”.<sup>42</sup> As such, the 2019 Regulation was unable to account for the subsidiaries of foreign companies, so long as they were established in the EU.

This was exemplified in the ECJ’s only case thus far regarding the Regulation. In Case C-106/22 the ECJ held that even though a subsidiary established in the EU is part of a group of companies whose ultimate parent company is established in a third country, that subsidiary has the right to rely on the freedom of establishment. The ECJ underlined that it does not follow from any provision of EU law that the origin of the shareholders of an EU company affects the right of such a company to rely on the freedom of establishment. As such, the Member State in question was not permitted to prohibit the execution of an acquisition by such a subsidiary of a foreign parent on the basis of security.<sup>43</sup>

Due to these practical implications, the 2024 Proposal is set to extend the scope of the FDI Regulation to also capture the EU-subsidiaries of non-EU companies, effectively alleviating fears regarding the exploitation of the EU’s freedom of establishment. The 2024 Proposal does this by broadening the scope of screening to include foreign investments, covering both foreign direct investments and “investments within the Union with foreign control”. The latter aligns with the legal definition of FDI but is distinguished by being carried out by a foreign investor through its subsidiary.<sup>44</sup> In this thesis, when referring to FDI, this term will be used to also encompass such foreign investments carried out through a subsidiary.

Most notably, the non-exhaustive screening criteria set out in Article 4 of the 2019 Regulation faced much backlash. As mentioned, Article 4 doesn't harmonize Member States' screening mechanisms; it merely suggests factors for consideration.<sup>45</sup> The actual factors used in national legislation are left to the discretion of each Member State. Article 4, as it is in the 2019 Regulation, can be seen as the “substantive test” to determine whether FDI is likely to affect security or public order.<sup>46</sup> As mentioned, Article 4(1) included factors related to the foreign direct investment itself while Article 4(2) included factors related to the foreign investor. It is

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<sup>42</sup> 2019 Regulation, Art. 2(2)

<sup>43</sup> Case C-106/22, Xella Magyarország [2023] ECLI:EU:C:2023:568

<sup>44</sup> 2024 Proposal, Art 1(1) and Art 2(1)-(3)

<sup>45</sup> Hindelang, Steffen, and Moberg, Andreas, 'A Complex Setting of Cooperation and (Potential) Conflict: Regulation (EU) 2019/452 in a Doctrinal Perspective' in Hindelang, Steffen, and Moberg, Andreas (eds), *YSEC Yearbook of Socio-Economic Constitutions 2020*, (Springer International Publishing, 2021) 843

<sup>46</sup> 2024 Proposal, 24

in the latter in which Member States were permitted to factor in state-control of a foreign investor when screening FDIs.

This aspect of the Regulation faced criticism for lacking a clear, cohesive framework for Member State action, as highlighted by Nettesheim, who went as far as to claim that “even an experienced observer will have a hard time to discern a clear and workable normative framework for Member State action”.<sup>47</sup> Notably, the formulation of state-control in Article 4 of the 2019 Regulation was criticized for its ambiguity and the discretion it afforded to Member States, leading to divergent national interpretations and practices.

The Commission does recognize some of these criticisms within the text of the 2024 Proposal. Specifically, the Commission notes that, among private sector stakeholders, the ambiguity of the substantive test in Article 4 was seen as a significant issue. The indicative nature of the factors listed therein effectively translated into differences between Member States regarding the formulation of key concepts of FDI screening. In particular, the national differences in the formulation of risk factors related to the foreign investor were seen as problematic. Similarly, the inconsistencies regarding the required threshold of influence over a target company by a foreign investor for a review to be initiated were also noted.<sup>48</sup> Effectively, such issues echo concerns over the lack of a clear definition of state-control in the 2019 Regulation.

The 2024 Proposal seeks to remedy these issues by seemingly introducing more stringent and harmonized requirements for national screening mechanisms as it regards the formulation and screening of state-control in foreign investors. This shift from discretionary to a more standardized criteria marks a significant change in the regulatory landscape.

## **2.2 The Role of State-Control in the EU’s FDI Regime**

The evolution of the formulation of state-control from the 2019 Regulation to the 2024 Proposal is a drastic change. The 2019 Regulation’s definition of state-control was non-exhaustive and ambiguous, leaving Member States with considerable discretion and causing inconsistencies. It was left unclear if it was meant to be authoritative in any way, or whether it was merely indicative, allowing Member States the freedom to define it as they saw fit at the national level.

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<sup>47</sup> Nettesheim (2021) 486

<sup>48</sup> 2024 Proposal, 24

The 2024 Proposal, ostensibly, seeks to establish a definition which is more standardized and clear, creating – in practice – a minimum harmonized standard for state-control in screening mechanisms. Seemingly, the Proposal also seeks to establish state-control as a mandatory criteria in screening of FDIs. This new definition, however, is far from perfect, as it still leaves several ambiguities. This stems from both the 2024 Proposal’s text itself, but also from the lack of authoritative guidelines or interpretations from EU bodies such as the Commission or the ECJ. Moreover, the 2024 Proposal’s formulation of state-control differs greatly from how state-control has previously been defined at the EU level, with regards to, inter alia, state-owned enterprises of Member States.

### 2.2.1 From Indicative Factors To Mandatory Screening of State-Control

The 2019 Regulation outlined various requirements for Member States, some of which are purely indicative and non-exhaustive, giving wide discretion to Member States, and mandatory elements expected to be implemented. Notably, the factors included in Article 4 which may be considered when assessing whether a FDI may impact public order or security, such as state-control, are purely indicative. The specific criteria formulated in national screening mechanisms is left to the Member States.

The practical implications of the factors listed in Article 4 being described as indicative were twofold with regard to state control. First, due to the indicative nature of the article, Member States were not required to take into account state-control when screening for state-control. As has been mentioned, FDIs by state-controlled entities are inherently riskier than those made by private companies when considering their impact on public order and security. Therefore, when a specific transaction falls under national screening mechanisms, Member States can most likely take into account the state-controlled nature of the transaction during their case-by-case analysis of its impacts on security and public order.

However, this case-by-case assessment only occurs for transactions that meet the existing criteria for screening under national mechanisms. Because the 2019 Regulation does not require Member States to screen specifically for state-control, some state-controlled FDIs that may pose a risk to security and public order could slip past the screening process. This may occur in situations where such FDIs wouldn’t be considered risk-averse if made by private actors.

Second, it was unclear whether the formulation of state-control within the 2019 Regulation was authoritative in any way, and whether it set any specific guidelines for how state-control should

be defined within national screening mechanisms. Most likely, the answer for both is in the negative. The explicitly indicative nature of Article 4, compounded with Articles 1 and 3 of the 2019 Regulation, which emphasize the autonomy of Member States in establishing their screening mechanisms, suggests that national authorities have the prerogative to define state-control as they see fit. Further, as acknowledged by the Commission in the 2024 Proposal, the indicative factors in Article 4 were criticised for leading to inconsistent definitions and interpretations at the national level. As state-control is one such factor, this criticism most likely extends to it as well.

Building on this, the 2024 Proposal formulates the state-control in a significantly different way. Where the 2019 Regulation established factors which may be taken into account by Member States when drafting the specific criteria employed by national screening mechanisms, one of which being state-control, the 2024 Proposal incorporates state-control within the remit of the cooperation mechanism. Furthermore, while the 2019 Regulation effectively divided into separate subsections the effects stemming from the FDI itself and the specific circumstances related to the foreign investor, the 2024 Proposal integrates these into one.

Article 4, as articulated in the 2024 Proposal, would include minimum requirements for national screening mechanisms. According to the proposed Article 4(4), member states are required to screen foreign investment where such investment involves an EU target that either participates in a project of EU interest or is economically active in areas of particular importance for the security or public order interests of the EU.<sup>49</sup> Regarding the latter, such areas of particular importance are listed out in Annex II, including the technologies, assets, facilities, equipment, networks, systems, services and economic activities which the EU sees as vital for its security and public order (hereinafter, “areas of interest”).<sup>50</sup>

In this context, according to the 2024 Proposal’s Article 5(1)(b) and its clause (i), Member States must notify the Commission as well as other Member States vis-à-vis the cooperation mechanisms of foreign investments under certain circumstances. Such notification must be made where a foreign investment in a Union target established within their territory meets the criteria set out in Article 4(4)(b), as outlined above, and additionally fulfills one of the conditions specified in the article. One of these conditions, as set out in Article 5(1)(b)(i), is state-control. Thus, the 2024 Proposal more clearly formulates state-control as something

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<sup>49</sup> 2024 Proposal, 16

<sup>50</sup> 2024 Proposal, 17

intrinsically linked to the foreign investment itself, rather than as a factor that Member States can evaluate independently of the investment.

The key distinction in the formulation of state-control between the 2019 Regulation and the 2024 Proposal lies, thus, how it is integrated into the regulatory framework. In the 2019 Regulation, state-control was one of the various factors that Member States could consider within their national screening mechanisms when considering whether an FDI is likely to affect security or public order. This gave Member States the discretion to ultimately decide whether to account for state-control in their national screening mechanism. Consequently, if national screening mechanisms do not encompass certain FDIs, Member States are not obligated to proactively inform the Commission or other Member States about such FDIs within their territory. This is because the cooperation mechanism – as formulated in Article 6 of the FDI Regulation – only required Member States to inform the Commission and other Member States regarding FDIs which *are* undergoing screening.<sup>51</sup>

The 2024 Proposal, however, specifically requires that Member States inform through the cooperation mechanism the Commission and other Member States of *all* state-controlled foreign investments which concern Union targets in areas of interest. The 2024 Proposal, thus, shifts the emphasis of state-control from being a discretionary factor in national screening mechanisms to a mandatory element within the cooperation mechanism. Even though the 2024 Proposal does not explicitly mandate that the inclusion of state-control within the screening criteria of national mechanisms, it effectively results in such a requirement, as it obligates Member States to report on such state-controlled foreign investments in the areas of interest.

### 2.2.2 Defining State-Control in the 2024 Proposal

Under the 2019 Regulation, the treatment of state-control was notably ambiguous. The 2019 Regulation did not appear to definitively require Member States to include state-control as a criterion for national screening. Furthermore, it was not clear whether the formulation of state-control in the 2019 Regulation was to be authoritative of how state-control was to be defined and applied within national screening mechanisms.

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<sup>51</sup> It should be mentioned, that according to Article 7(1) of the 2019 Regulation any Member State may raise concerns directly with the Member State where an FDI is located, even if said FDI is not undergoing national screening.

As is outlined above, the 2024 Proposal makes a distinct pivot, with reporting of state-controlled foreign investments now explicitly mandated within the cooperation mechanism, effectively elevating state-control to a *de facto* mandatory screening criterion. As such, the formulation of state control in Article 5(1)(b)(i) is particularly significant. It not only specifies how “state-control” is defined within the framework, but, as the proposed Article 5(1) would mandate the reporting of state-controlled investments that meet this definition – assuming they occur in the areas of interest – it also arguably sets an EU-wide minimum standard for the definition of state-control. According to Article 5(1)(b)(i) state-control is defined in the following way:

“[T]he foreign investor or the foreign investor’s subsidiary in the Union is directly or indirectly controlled by the government, including state bodies, regional or local authorities or armed forces, of a third country, including through ownership structure, significant funding, special rights or state-appointed directors or managers”.

The formulation of state-control in the 2024 Proposal thus includes two concurrent factors: first, a foreign investor or their subsidiary must be subject to a form of control, either direct or indirect. Second, this control must be exerted specifically by a non-EU government, as defined in the Regulation. In this thesis, these criteria for state control will be termed as the *control criterion* and the *governmental origin criterion*, respectively. While these two criteria remain identical to those included in the 2019 Regulation, the 2024 Proposal significantly expands upon them.

The 2019 Regulation likewise employed the term “government”, however, it left significantly less clear what was meant by that term. It did not adequately define the scope of what constitutes “government” for the purposes of fulfilling the governmental origin criterion. The non-exhaustive list of proxies, i.e., the entities and representatives to which the term “government” can be attributed in the context of the Regulation, was somewhat shorter. While the 2019 Proposal only included state bodies and armed forces as instances where control is perceived to be exerted by the government, the 2024 Proposal expands upon this indicative list by also including regional and local governments (“subnational governments”).

In the context of the 2019 Regulation’s definition, it was unclear whether such subnational governments were to be included in the scope of its formulation of state-control. If interpreted through its conventional definition, a “government” is the system according to which a state is governed. “Government” often refers to the national government of the state as well as its subnational counterparts, like provincial and local governments. However, according to a

narrower definition, “government” may refer merely to the executive branch of the government, including the head of government and head of state as well as the ministers with executive powers. For example, in the Finnish version of the FDI Regulation, the term “hallitus” is used to denote control by a third country, which corresponds to the English term “cabinet”, rather than “hallinto”, which would align with the conventional definition outlined above. Likewise, in the Swedish version, the term “regering” is used, which corresponds to the English term “cabinet”.

While the 2024 Proposal’s definition for state-control clarifies any questions regarding the inclusion of subnational governments in its definition, it still leaves open several questions. It should be mentioned that the Commission’s decision to employ the term “government” is rather unprecedented in EU law and would appear to be the first time that “government” is employed as a term to define control. Previous EU law instruments which have created specific rules for entities under state-control have used terms such as “public authority” or “public body”, which prima facie seem to allow for a much broader inclusion of state-controlled entities than the FDI Regulation.<sup>52</sup>

While the existing definition in EU law for “public body”, for instance, includes all entities which have been established for the specific purpose of meeting needs in the general interest, which have legal personality and are either financed for the most part or controlled directly by any other public body. ECJ case law has specifically stated that this definition includes bodies such as universities and other higher education establishments as well as chambers of commerce and industry. Further guidelines have additionally included executive agencies and hospitals within the meaning of the term “public body”.<sup>53</sup>

Perhaps even more difficult to articulate is the control criterion. What exactly is meant by the 2024 Proposal’s phrasing, “directly or indirectly controlled”, is left unclear. There is no elaboration on the Proposal’s notion of control. A non-exhaustive list for mechanisms of control is included in the Proposal’s text. According to the phrasing of the proposed Article 5(1)(b)(i), control can manifest, inter alia, through ownership structure, significant funding, special rights

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<sup>52</sup> Commission Directive 2006/111/EC of 16 November 2006 on the transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings, para 11; Case C-516/19, NMI v EuroNorm [2020] ECLI:EU:C:2020:754, para 50

<sup>53</sup> European Data Protection Board, ‘Guidelines 2/2020 on articles 46 (2) (a) and 46 (3) (b) of Regulation 2016/679 for transfers of personal data between EEA and non-EEA public authorities and bodies’ (2020, version 2) 6

or state-appointed directors or managers. Additionally, while the Proposal’s preamble does not provide for much further clarity, it does include another manifestation of control. According to the preamble, control may be determined also by assessing whether the foreign investor is “involved in pursuing policy objectives of third countries to facilitate their military capabilities”.<sup>54</sup>

There are no guidelines on any specific thresholds or criteria for these mechanisms of control. Ownership structure, in particular, is quite an obscure term, and it is left unanswered whether it refers to majority ownership, a controlling interest, or any form of ownership stake in a company. The degree of ownership required to constitute control is not specified.

The Proposal does not elaborate either on whether the mere presence of such manifestations of control automatically equates to state-control, or if such control must explicitly allow for the government’s influence over the entity to be considered state-control. While various forms of control are mentioned in the Proposal’s text, it does not clarify if these mechanisms inherently establish state-control or if they need to demonstrably facilitate governmental influence.

One thing, however, is clear with regard to the control criterion: the mechanisms of control outlined in the 2024 Proposal reflect a traditional understanding of state-control, primarily focusing on the state as a shareholder or significant funder. These conventional criteria are rooted in tangible, quantifiable relationships between the state and the entity, which can be easily identified and measured.

However, the Proposal does not *prima facie* address the nuances of political influence, which can be equally, if not more, pervasive. Political control often extends beyond straightforward ownership or financial involvement. It can manifest through indirect means such as regulatory pressure, policy directives, or – most notably – influence exerted by political parties and their networks. The omission of political control in the Proposal’s definition is particularly concerning when compounded with the lack of clarity on whether the governmental origin criterion may be satisfied with control wielded by a political party, rather than the central government.

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<sup>54</sup> 2024 Proposal, 25

### 2.2.3 Chinese State-Control and Its Implications for the Regime

In contexts where political parties wield substantial influence over state-owned or state-affiliated enterprises, the lack of explicit consideration for political influence means that entities under significant political control might not be classified as state-controlled under the current criteria. This gap can undermine the effectiveness of the regulation, as it may fail to capture the full spectrum of state influence, particularly in non-democratic regimes where political and governmental controls are often indistinguishable. For example, in countries where the government and ruling political party are closely intertwined, political influence can be exerted without direct ownership or funding. This type of control, although less visible, can significantly impact an entity's operations and strategic decisions.

One such country is China. The Chinese state-sector is a prime example of how political influence can permeate through the economic activities and governance of its companies without relying solely on traditional forms of state-control, such as ownership or funding. In China, the Communist Party of China (hereinafter, the “Chinese Communist Party” or “CCP”) plays a central role in guiding and directing both state-owned and ostensibly private enterprises. This influence is often exerted through mechanisms of political governance that are not easily detectable by depending on standard criteria which have been created with traditional forms of state-control in mind, such as ownership, financial involvement or managerial control.

The 2019 Regulation or 2024 Proposal do not specifically target any one country, as the provisions included are universal in their applicability. However, it is clear that China has been one of the driving forces behind the EU’s reorientation in its international investment policy. The Proposal, *inter alia*, mentions the increase of investment by Chinese entities in key sectors in the EU, which may pose a EU-wide risks to security or public order. This, according to the Commission’s evaluation of the 2019 Regulation, is particularly true when the foreign investor is owned or controlled by the state.<sup>55</sup>

When this key motivation behind the EU’s FDI regime is combined with China’s massive state-sector and its unique model of state-control, characterized by political governance, the ambiguity related to the 2024 Proposal’s definition of state-control is particularly troubling with regard to the effectiveness of the regime. It is unclear whether control exerted through the CCP

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<sup>55</sup> European Commission, Evaluation of 2019 Regulation (2024) 2-3

may be classified as state-control, as the governmental origin criterion may not be satisfied, with the CCP being a political party nominally distinct from the central government.

If control exerted by a political party may, however, fulfil the governmental origin criterion, it is still unclear whether the mechanisms of political governance as exerted by the Chinese Communist Party sufficient to fulfil the control criterion. In the text of the Article itself, the Proposal envisages more traditional modes of control, such as ownership, funding, special rights, or the ability to appoint executives or management.

### **3 The Landscape of State-controlled Enterprises in China**

The EU's FDI screening regime, particularly with the proposed 2024 update, emphasizes the importance of assessing whether a foreign investor is controlled directly or indirectly by the government. The focus on state-control is heightened when dealing with investments from countries with different political and economic systems, such as China. China's economic structure presents unique challenges for the EU and its regulators, stemming from several fundamental differences compared to Western economies. Unlike market economies with democratic systems, China's state-sector operates within an authoritarian political regime, where the lines between state and corporate governance are often blurred.

The Chinese state-sector is incredibly vast, playing dominant roles in several markets, both domestic and international. Understanding the unparalleled scale of state influence in China is important for Western observers, who stem from market economies where private enterprises dominate. Further, the sheer size and economic impact of these enterprises mean that any regulatory framework, such as the EU's FDI regulation, must be equipped to handle the complexities and nuances associated with state-controlled entities.

State-control has been an intrinsic quality of the Chinese economy since the early days of Communist China. Then, the economy operated under a strict state monopoly, with the state owning and controlling all means of production. As China's economy matured, successive reforms increasingly granted more power to private entities. However, under Xi Jinping, there has been a marked shift. Mixed-ownership reforms and party-building policies under Xi are particularly important in the context of this thesis, as they have resulted in state-control being increasingly exerted by the CCP through political governance rather than the state, which has taken more of a backseat in direct management through shareholding.

Understanding the development of the Chinese state-sector, especially its recent evolution under Xi, is of profound importance for EU policymakers as they attempt to safeguard the EU economy from unwanted state-controlled influence stemming from third countries. By examining these recent developments, this chapter illustrates how the EU's approach to state-control may be attempting to regulate a bygone era of increasing privatization as it fails to fully capture the political dimensions of state-control that have become central in Xi's China.

This chapter provides an overview of the Chinese state-sector and its evolution, with a focus on the reforms under President Xi. Understanding these developments is crucial for

contextualizing the issues stemming from the EU's FDI regime's notion of state-control. By tracing the transformation from state monopoly to the modern state-sector and detailing the specific reforms championed by Xi, this chapter lays the groundwork for comprehending how state-control is exercised in China.

### 3.1 The Scale and Impact of the Chinese State-Sector

In the European Union, observers often perceive state-ownership through the regional norms expected from the state-sector. State-ownership is often assumed to be concentrated in certain sectors.<sup>56</sup> In the EU, for instance, state-ownership is most typically found in sectors affected by risks of market failure and externalities, such as utilities, transportation and energy.<sup>57</sup> These sectors typically operate within the domestic market of their respective home countries. In contrast, the Chinese state-sector is entrusted with a wider range of objectives, leading to involvement in a much more diverse range of sectors. Indeed, China is unparalleled globally in terms of the significant contribution of the state-sector to its economy.<sup>58</sup> Chinese state ownership remains pervasive in various sectors which are considered strategic for a broad array of interests, like national security, economic and societal stability, technological advancement, and international competitiveness.<sup>59</sup>

Furthermore, and most significantly, when speaking of the state-sector in modern China, there's often a misconception – particularly within Western imaginations – of a clear demarcation between the state and private sector. This is influenced by research often relying on Chinese government data when assessing the extent of state ownership. This data, however, only classifies as state-owned enterprises those enterprises in which the state retains 100 %

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<sup>56</sup> UN Trade and Development (UNCTAD), 'World Investment Report 2019: Special Economic Zones' (United Nations, 2019) 26

<sup>57</sup> European Commission, 'State-Owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context' (Directorate-General for Economic and Financial Affairs, 2016A) Institutional Paper 031, 8; García-Herrero, Alicia, and Xu, Jianwei, 'How to handle state-owned enterprises in EU-China investment talks' (Bruegel, 2017) Policy Brief Issue 18 <<https://www.bruegel.org/policy-brief/how-handle-state-owned-enterprises-eu-china-investment-talks>> accessed 18 March 2024, 7

<sup>58</sup> Leutert, Wendy, 'State-Owned Enterprises in Contemporary China' in Bernier, Luc; Florio, Massimo, and Bance, Philippe (eds) *The Routledge Handbook of State-Owned Enterprises* (1<sup>st</sup> edn, Routledge 2020) 2; according to Leutert, China "the world's largest total number of SOEs and the highest share of SOEs among its biggest companies".

<sup>59</sup> Graham and Marchick (2006) 106; Sayari, 'Tip Sheet: Identifying Chinese State Ownership' (April 2021) <<https://sayari.com/wp-content/uploads/2021/12/Sayari-Tip-Sheet-China-State-Ownership.pdf>> accessed 26 March 2024; García-Herrero et al. (2017) 8-9; Leutert (2020) 3; Clarke, Donald C., 'Corporate Governance in China: An Overview' (2003) 14 *China Economic Review* 494, 496-497

ownership, i.e., wholly-state owned enterprises (“WSOEs”). In 2017, the Chinese economy included over 350,000 such WSOEs.<sup>60</sup>

Such numbers estimating the precise number of companies falling within each classification should be considered with slight caution. Companies within the state-sector are often organized as multi-tiered enterprise groups, encompassing numerous subsidiaries. These complex structures often lead to different estimations regarding the exact number of companies with state ownership.

Consideration of these WSOEs is no doubt important and their significance cannot be overstated, as the sheer size and impact of these companies makes them stand out on an international stage. Indeed, compared particularly to the EU, China’s state-owned companies far surpass their EU counterparts’ size and economic impact. Even if considering only the approximately 100 WSOEs that are directly managed by the State-Owned Assets Supervision and Administration Commission (SASAC), the central government’s asset management arm, the scale of WSOEs’ economic impact becomes evident. The annual revenues in 2021 of only these 100 or so enterprises amounted to 36.3 trillion yuan or nearly 5.7 trillion USD.<sup>61</sup> For context, this makes the annual revenues of the roughly 100 central SOEs in China comparable to the combined economies of Italy, Spain, the Netherlands, Sweden, and Poland.<sup>62</sup> Furthermore, WSOEs overall still account for about 25 % of Chinese GDP.<sup>63</sup>

In addition to these WSOEs, research is often concentrated on “state-owned enterprises” (“SOE”) in general. The term is used to refer to those companies in which the state holds a controlling majority, whether or not such companies also include private shareholding. When setting such the threshold of state ownership to be 50 % or more, we get a slightly clearer picture of the state’s influence in the Chinese economy. Such SOEs, which also include WSOEs,

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<sup>60</sup> Stanford University, Center of China’s Economy and Institutions, ‘Reassessing the Role of State Ownership in China’s Economy’ SCCEI China Briefs (15 January 2024) <[https://sccci.fsi.stanford.edu/china-briefs/reassessing-role-state-ownership-chinas-economy#:~:text=The%20researchers%20find%20that%20state,total%20assets\)%20than%20private%20firms.](https://sccci.fsi.stanford.edu/china-briefs/reassessing-role-state-ownership-chinas-economy#:~:text=The%20researchers%20find%20that%20state,total%20assets)%20than%20private%20firms.)> accessed 6 May 2024

<sup>61</sup> Using an approximate exchange rate of 6.3756 yuan per USD from the end of 2021.

<sup>62</sup> World Bank, ‘GDP (current US\$) - European Union’ (World Bank Data 2021) <<https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=EU>> accessed 28 March 2024

<sup>63</sup> Goldberg, Itzhak, ‘China’s Heavy Economic Legacy of State Ownership and Central Planning’ The Diplomat (Tokyo, 17 November 2023) <<https://thediplomat.com/2023/11/chinas-heavy-economic-legacy-of-state-ownership-and-central-planning/>> accessed 28 March 2024; Leutert (2020) 2

amounted to a total of nearly 600,000 enterprises by the end of 2017.<sup>64</sup> In 2023, these SOEs accounted for roughly 50 % of the total market capitalization of the largest listed companies.<sup>65</sup> Further, these SOEs are extremely global in their operations. According to the International Monetary Fund (“IMF”) figures from 2018, SOE assets among the world’s 2,000 largest firms amounted to USD \$45 trillion. Chinese SOEs alone accounted for over half of these assets.<sup>66</sup> Among the roughly 1,500 SOEs which the United Nations (“UN”) classifies as “state-owned multinational enterprises”, 45 % were Chinese.<sup>67</sup>

These SOEs hold a huge grasp over the Chinese economy. According to data compiled by BusinessEurope, in 2018 SOEs had overwhelming control of key industries, i.e., sectors deemed critical for economic infrastructure and national security, with a nearly 90 % market share. In pillar industries – those considered essential for economic development and growth – SOEs had a market share of over 40 %.<sup>68</sup>

These figures are considerable on their own, and the impact of state-control in the economy purely through such SOEs should not be discounted. However, the Chinese state’s presence as a shareholder is nonetheless much more pervasive throughout the Chinese economy than these figures would indicate. Research which focuses purely on SOEs overlooks the significant role of mixed-ownership enterprises (“MOEs”), in which ownership is shared between the state and private entities. In the Chinese context, MOEs play a particularly important role, as a total of nearly 1,4 million enterprises include some degree of ownership.<sup>69</sup> Moreover, MOEs account

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<sup>64</sup> Allen, Franklin; Cai, Jeff; Gu, Xian; Qian, Jun; Zhao, Linda, and Zhu, Wu, ‘Centralization or Decentralization? The Evolution of State-Ownership in China’ (SSRN, 17 November 2022) <<https://ssrn.com/abstract=4283197>> accessed 6 May 2024, 2-3

<sup>65</sup> Huang, Tianlei, and Véron, Nicolas, ‘China’s State vs. Private Company Tracker: Which Sector Dominates?’ (PIIE, 17 July 2023) <<https://www.piie.com/research/piie-charts/2023/chinas-state-vs-private-company-tracker-which-sector-dominates>> accessed 6 May 2024; Zhang, Xianchu, ‘Integration of CCP Leadership with Corporate Governance: Leading Role or Dismemberment’ (2019) 1 *China Perspectives* 55, 57

<sup>66</sup> International Monetary Fund, ‘State-Owned Enterprises: The Other Government’ in *Fiscal Monitor – April 2020* (IMF, 2020) Chapter 3 <<https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020>> accessed 28 March 2024, 49

<sup>67</sup> UNCTAD (2019) 25

<sup>68</sup> BusinessEurope, ‘The EU and China: Addressing the Systemic Challenge – A Comprehensive EU Strategy to Rebalance the Relationship with China’ (2020) <[https://www.busesseurope.eu/sites/buseur/files/media/reports\\_and\\_studies/the\\_eu\\_and\\_china\\_full\\_february\\_2020\\_version\\_for\\_screen.pdf](https://www.busesseurope.eu/sites/buseur/files/media/reports_and_studies/the_eu_and_china_full_february_2020_version_for_screen.pdf)> accessed 19 March 2024, 97; Key industries include defense, electricity, oil and gas, telecommunications, coal, shipping, aviation and rail. Pillar industries include auto, chemicals, construction, electronics, equipment manufacturing, non-ferrous metals, prospecting, steel and technology.

<sup>69</sup> Allen, et. al. (2022) 3

for a further 13 % of the market capitalization of China's largest listed companies, bringing the total of the state-sector to over 60 %.<sup>70</sup>

This thesis will employ the following definitions, unless otherwise stated. "WSOEs" will be used to refer to enterprises in which the State owns all shares. "SOEs" will refer to enterprises in which the State has a controlling majority, including WSOEs. "MOEs" will be used to refer to enterprises which have some degree of state shareholding, but in which the State is not the controlling shareholder. "State-sector", "state-affiliated enterprises", and related terms will be used to refer to all of the above.

The pervasiveness of China's state-ownership is a result of both the particular history of China's economy and state sector as well as the specific policies championed by the CCP, especially under the leadership of President Xi Jinping. MOEs emerged in the late 20<sup>th</sup> century when the state-sector experienced its first waves of privatization. Under Xi, mixed-ownership reforms have been championed and intensified, transforming many SOEs into MOEs. These reforms have typically involved introducing private shareholding into SOEs to leverage the private sector to boost the efficiency, governance and competitiveness of these enterprises while retaining state influence.<sup>71</sup>

The inclusion of MOEs in the assessment of state-control in China is of particular significance when considering state-control through the lens of the EU's regime for screening FDI. Firstly, based on the rationale of the EU's FDI screening regime, i.e., the safeguarding of public order and security, these enterprises are crucial. MOEs – much like the broader state sector – have a large role in crucial sectors, such as those related to national security, technological advancement, and international competitiveness. This alignment with the EU's FDI screening regime's focus is key to their importance.

Second, MOEs pose a unique conundrum when assessing state-control through its formulation in the EU's framework for FDI screening. The EU's regime typically envisions state-control to be exerted through traditional means, including ownership, funding, or the appointment of directors or management.<sup>72</sup> However, in the context of Chinese MOEs, the state has deliberately taken a backseat in the day-to-day management of these companies, as it has allowed private

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<sup>70</sup> Huang, and Véron (2023)

<sup>71</sup> Meyer, Marshall, and Wu, Changqi, 'Making Ownership Matter: Prospects for China's Mixed Ownership Economy' (Paulson Institute, 2014) 1-3

<sup>72</sup> See proposed Article 5(1)(b)(i) of the 2024 Proposal

capital and management into these companies. In MOEs, the state acts more or less as a normal shareholder. Even so, this influence has not been ceded entirely to private shareholders. The mixed-ownership reforms under Xi came hand-in-hand with reforms to strengthen and institutionalize the role of the Communist Party in these enterprises. The Communist Party's organization is embedded within the governance of these enterprises through in-house cells ("IHCs"). This integration of political governance challenges the EU's formulation of state-control, which is primarily associated with more direct control mechanisms.

## **3.2 Evolution and Transformation of China's State-Sector**

China's state-sector has undergone profound changes over the decades, transforming from a rigid state-controlled monopoly to a more market-oriented yet politically governed entity through a series of reforms. This section explores the key phases of this transformation, starting with the transition from state monopolies to market oriented state-owned enterprises, and progressing to the reforms under Xi Jinping. These reforms have significantly expanded mixed-ownership within the state-sector, allowing for the greater influx of private capital. These reforms have gone hand-in-hand with party-building policies, which have aimed to strengthen the role of the Communist Party within the state-sector.

### **3.2.1 Transition from State Monopoly to a Market-Oriented State-Sector**

To truly understand how state-control is wielded in modern Chinese enterprises, one must understand the history that gave birth to these giants. Since the beginning of communist rule in China, the state largely held a monopoly over the country's economic landscape.<sup>73</sup> The precursors to what would eventually become state-owned enterprises operated as basic production units, which were run as government agencies. These units were an integral and inseparable part of the State, serving as direct arms of the government rather than as separate corporate entities under the State's control. These units had been formed by the state's takeover and conversion of private and foreign-owned businesses. This structure persisted until the late 1970's, when the Chinese government initiated broad economic reforms under the "Reform and Opening Up" policy.

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<sup>73</sup> Jin, Xiankun; Xu, Liping; Xin, Yu, and Adhikari, Ajay, 'Political Governance in China's State-Owned Enterprises' (2022) 15(2) *China Journal of Accounting Research*, 4; Lin, Lauren Yu-Hsin, 'Institutionalizing Political Influence in Business: Party-Building and Insider Control in Chinese State-Owned Enterprises' (2021) 45 *Vermont Law Review* 441, 445-446; Wang, Jiangyu, 'The Political Logic of Corporate Governance in China's State-Owned Enterprises' (2014) 47(3) *Cornell International Law Journal*, 632, 644

The reforms emerged on the heels of the widespread social and political upheaval of the Great Leap Forward (1958-1962) and the Cultural Revolution (1966-1976). These two major policies sought to rapidly industrialize and collectivize China, and purge capitalist and traditional elements from Chinese society, respectively.<sup>74</sup> Instead, they culminated to economic disarray in the country.<sup>75</sup> After the death of Mao Zedong in 1976, the Chinese Communist Party (CCP) was able to attempt to turn the tide of the stagnant economy and the ailing production units by modernizing and opening up the economy.

Against the backdrop of the general state of the Chinese economy and broader social conditions, these production units confronted specific challenges. As they were directly under the central government under a planned economy, the state dictated their output targets and left them with very little autonomy in commercial and strategic decisions. As these units were tied to predetermined plans made by the central government, they often disregarded market demands. Profits generated by these units were turned over to the state, which also absorbed any losses incurred by them. This system culminated rampant inefficiency.<sup>76</sup> These units, as they existed in the era prior to the reforms, were in no place to assist the CCP in overcoming the economic hardships caused by the disastrous policies of the past decades.<sup>77</sup>

The impact of the economic reforms of the late 70s and 80s was considerable, as they led to the establishment of legally separate entities from the former government production units, creating what may legitimately be called SOEs. The main objective of the initial enterprise these reforms was to enhance the independence of these units and, ultimately, their profitability. This first stage of reform granted managers a certain level of autonomy in areas like production and production. The operational autonomy received by SOEs at this time should not, however, be overstated as this stage of reforms largely left the planned economy intact.<sup>78</sup> In the 1980s, China's SOE reforms were characterized by the Contract Responsibility System, which

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<sup>74</sup> Jung, Hsiung-Shen, and Chen, Jui-Lung, 'Causes, Consequences and Impact of the Great Leap Forward in China' (2019) 11(2) *Asian Culture and History* 58, 58

<sup>75</sup> While this discussion is primarily focused on the economic repercussions of these policies, specifically their impact on SOEs, the human cost of these policies should not be overlooked. These policies not only lead to economic chaos but also resulted in the deaths of millions of people, with some estimates suggesting a toll as high as 50 million.

<sup>76</sup> Lin, Karen Jingrong; Lu, Xiaoyan; Zhang, Junsheng, and Zheng, Ying, 'State-owned enterprises in China: A review of 40 years of research and practice' (2020) 13 *China Journal of Accounting Research* 31, 36-37; Zhang, Dong, and Freestone, Owen, 'China's Unfinished State-Owned Enterprise Reforms' (Australian Department of the Treasury, 2013) <<https://treasury.gov.au/publication/economic-roundup-issue-2-2013-2/economic-roundup-issue-2-2013/chinas-unfinished-state-owned-enterprise-reforms>> accessed 27 March 2024

<sup>77</sup> Lin et al. (2020) 37

<sup>78</sup> Lin (2021) 446; Jin, et al. (2022) 3

decoupled ownership from management to boost efficiency and incentivize managers by sharing profits.<sup>79</sup>

The early 1990s witnessed a radical shift in the Chinese economy with the establishment of a socialist market economy.<sup>80</sup> Part of these reforms was a deeper transformation of SOEs, as earlier reforms had largely failed to significantly enhance the profitability or efficiency of SOEs, with many continuing to face financial losses into the early 1990s.<sup>81</sup> As part of the sweeping economic reforms marking this period, China initiated the establishment of the modern enterprise system in 1994, which encompassed the restructuring of state-owned enterprises to align with the principles of a socialist market economy.<sup>82</sup>

The enactment of the landmark Company Law of 1993 – the first of its kind in China – established the framework for corporatization.<sup>83</sup> The Company Law redefined SOEs, turning them into modern corporations with a shareholder structure, a board of directors, and a supervisory board, thereby embedding the contemporary corporate governance models into SOEs.<sup>84</sup> Furthermore, this period also witnessed the establishment of China's first stock exchanges in Shanghai and Shenzhen, creating platforms for the listing and capital financing of SOEs.<sup>85</sup>

The corporatization brought by the reforms restricted the state's power by opening up the potential for the dilution of the state's shareholding and by establishing formal corporate governance structures.<sup>86</sup> Corporatization, however, was a necessary evil. Struggling SOEs were in desperate need of capital – something outside the financial capacity of the government.<sup>87</sup> Furthermore, global shifts towards more market-oriented economies pressed China to adapt.

The combination of these reforms gave rise to the modern Chinese state-owned enterprise. These reforms set the stage for SOEs to turn into massive corporations, able to competitively participate in the global economy, i.a., through FDI. However, the onset of corporatization and, thus, corporate governance, presented the CCP with a new challenge: balancing political and

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<sup>79</sup> Lin et al. (2020) 37-38; Wang (2014) 645

<sup>80</sup> Wang (2014) 645-646

<sup>81</sup> Lin et al. (2021) 39; Wang (2014) 646-647 and 664

<sup>82</sup> Wang (2014) 646

<sup>83</sup> Jin (2022) 4; Lin (2021) 446

<sup>84</sup> García-Herrero et al. (2017) 6

<sup>85</sup> Jin et al. (2022) 4

<sup>86</sup> Wang (2014) 664

<sup>87</sup> Wang (2014) 664

corporate governance. As will be outlined in the chapters to come, the CCP has been able to accomplish what was seen as unlikely by many observers: fostering incredible economic growth, while retaining a tight grip over SOEs.

The onset of the modern enterprise system saw the overhaul of SOEs under the slogan “Grasping the large, letting go of the small”, which led to the privatization of smaller SOEs and the transformation of larger ones into corporatized entities.<sup>88</sup>

These policies lead to the very first MOEs. As corporatization permitted the listing of SOEs, non-state shareholding was allowed in. However, the state still most often retained its position as the controlling shareholder.<sup>89</sup>

### 3.2.2 Xi Jinping’s Reforms: Mixed-Ownership and Party-Building

Under the presidency of Xi Jinping, a new stage in the reform of the state-sector has come underway. Most scholars mark 2013 as the beginning of this wave of reforms, when the Third Plenum of the CCP<sup>90</sup> announced its commitment to significant reforms of the state sector, with the main function of strengthening of the state-sector. The stated focus of these reforms was diversifying government shareholding, reducing state ownership with mixed-ownership reform, further consolidation, as well as further entrenching the influence of the Communist Party in state-affiliated enterprises.<sup>91</sup>

These reforms have also resulted in a more nuanced approach to state-control, transitioning from direct government oversight to a more complex party-state model. This shift presents significant implications for international observers such as the EU, particularly regarding its FDI regime. It raises questions whether the EU’s FDI regime is able to fully account for the evolving nature of state-control in China.

The market-oriented reforms in the decades preceding the 2010s afforded SOEs a degree of autonomy and power was delegated more to local governments.<sup>92</sup> These reforms were intended

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<sup>88</sup> García-Herrero et al. (2017) 7; Li, Shaomin, and Xia, Jun, ‘The Roles and Performance of State Firms and Non-State Firms in China’s Economic Transition’ (2008) 36(1) *World Development* 39, 43

<sup>89</sup> Tong, Sarah, and Yin, Xiangru, ‘Mixed Ownership Reforms of China’s State-owned Enterprises’ (2019) 11(02) *East Asian Policy* 104,106

<sup>90</sup> Plenums function as the top forum for meetings of the full Central Committee of the CCP, the highest organ in the country.

<sup>91</sup> Yu, Hong, ‘Reform of State-owned Enterprises in China: The Chinese Communist Party Strikes Back’ (2019) 43(2) *Asian Studies Review* 332, 336

<sup>92</sup> Yu (2019) 334

to cure the chronic ailments of SOEs, namely inefficiency, indebtedness, overstaffing, and low profitability. These reforms, while certainly being positive contributions, did not completely resolve these deep-seated issues. A joint study by the World Bank and the Chinese state from 2012 found that one in four of China's SOEs were unprofitable, while another study found that the total accumulated losses of Chinese SOEs from 2001 to 2009 amounted to 1.72 trillion yuan when accounting for various forms of state support.<sup>93</sup> With Xi calling for “stronger, better and bigger” SOEs, it's clear that these reforms were not intended to get rid of SOEs, but rather enhance them.<sup>94</sup>

As such, under Xi the reform of the SOE sector and bolstering the strength of SOEs has involved consolidating them. The most pressing motive behind these mergers is the creation of large corporate entities capable of competing globally. This approach is part of the national champion strategy of the CCP, which attempts to emphasize national security and economic safety by fostering larger and stronger SOEs.<sup>95</sup> As a result, the number of mergers involving SOEs have increased significantly, with the number of mergers involving central SOEs growing more than twofold in the immediate years after 2013.<sup>96</sup> Examples include the mergers of the two biggest state-owned shipbuilders, creating a huge company with 21 % market share globally, and the merger of two giant train manufacturers, creating the global market leader in the industry. Some scholars suggest that these mergers reflect the CCP's ambitions to establish new strategic monopolies.<sup>97</sup> These mergers allow these large SOEs to better compete globally.

Reducing state shareholding has been pushed by mixed-ownership reforms. Mixed-ownership reform aimed at restructuring SOEs by incorporating private and foreign capital, turning these SOEs into MOEs, i.e., entities where ownership is shared between state and private entities.<sup>98</sup> The injection of private capital and shareholding into SOEs was paired with further

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<sup>93</sup> Yu (2019) 335

<sup>94</sup> China Daily, 'Xi calls for furthering SOE Reform' (18 October 2017) <[https://www.chinadaily.com.cn/china/2017-10/18/content\\_33403609.htm](https://www.chinadaily.com.cn/china/2017-10/18/content_33403609.htm)>, accessed 20 March 2024

<sup>95</sup> Zhang (2019) 57

<sup>96</sup> BusinessEurope (2020) 98-99; China's Ministry of Industry and Information Technology, '关于加快推进重点行业企业兼并重组的指导意见 (Guiding Opinions on Accelerating the Merger and Reorganization of Enterprises in Key Industries)' (2013) No. 16 <[https://www.gov.cn/zwggk/2013-01/22/content\\_2317600.htm](https://www.gov.cn/zwggk/2013-01/22/content_2317600.htm)> accessed 20 March 2024

<sup>97</sup> Yu (2019) 337; BusinessEurope (2020) 100; Wendy Leutert and François Godement, 'Big is Beautiful? State-Owned Enterprise Mergers Under Xi Jinping', in Jérôme Doyon (ed), *China Analysis* (European Council on Foreign Relations, November 2016), 1-2

<sup>98</sup> Wang, Jiangyu, and Cheng-Han, Tan, 'Mixed Ownership Reform and Corporate Governance in China's State-Owned Enterprises' (2020) 53(3) *Vanderbilt Journal of Transnational Law* 1055, 1060

corporatization of these entities, the role of corporate governance organs – such as Boards of Directors – was enhanced.<sup>99</sup> The rationale for these reforms is largely economic, as results show that these entities often see an improvement in both innovation and the return on assets following mixed-ownership reform.<sup>100</sup> Thus, these reforms aim to enhance the efficiency, governance, and competitiveness of the state-sector.

Mixed-ownership reforms have been rolled out vigilantly, reflecting both the economic and strategic importance of the state sector, as well as its vast scale and deep integration within the Chinese economy, making any reforms a formidable task.<sup>101</sup> The injection of private capital into SOEs has initially been concentrated in SOEs operating in globally competitive sectors. In these sectors, the State has been open to allow significant private shareholding, even if it means not maintaining majority control of those SOEs. Conversely, the State has employed a more cautious stance with regard to SOEs that the State deems strategically significant. In these SOEs, the Chinese government has been hesitant to relinquish its position as controlling shareholder.<sup>102</sup>

The mixed-ownership reforms began in 2014 with pilot programs in only a few SOEs. Since then, these reforms have been expanded upon through several phases, with continuous acceleration throughout the late 2010s. The most recent phase in 2019 marked a substantial expansion, with the transformation of 160 SOEs into MOEs.<sup>103</sup>

The aim of these reforms was to strengthen state-affiliated entities, not relinquish party control. According to Yu, “by beefing up SOEs in this way, the Party-state ... signaled its intention for these firms to continue to play a dominant role in the Chinese economy”.<sup>104</sup> However, with the introduction of market forces, these economic reforms led to the delegation and – to a degree – dilution of the State’s control over SOEs. Thus, the new set of reforms have gone hand in hand

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<sup>99</sup> Lin, Lauren Yu-Hsin, and Milhaupt, Curtis, ‘Party Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance’ (2021) ECGI Law Working Paper 493/2020 <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3510342](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3510342)> accessed 29 March 2024, 8

<sup>100</sup> The Economist, ‘Xi Jinping’s grip on Chinese enterprise gets uncomfortably tight’ (26 November 2023) <<https://www.economist.com/business/2023/11/26/xi-jinpings-grip-on-chinese-enterprise-gets-uncomfortably-tight>> accessed 6 May 2024

<sup>101</sup> Tong and Yin (2019) 107

<sup>102</sup> Tong and Yin (2019) 109

<sup>103</sup> Wang and Cheng-Han (2020) 1060; Nan, Zhong, ‘100 SOEs to join 4th round of mixed ownership reform’ (China Daily, 4 April 2019)

<<https://global.chinadaily.com.cn/a/201904/17/WS5cb67648a3104842260b697c.html>> accessed 5 May 2024; Xinhua, ‘China Accelerates Mixed Ownership Reform of SOEs’ (17 May 2019)

<[http://www.xinhuanet.com/english/2019-05/17/c\\_138067229.htm](http://www.xinhuanet.com/english/2019-05/17/c_138067229.htm)> accessed 5 May 2024

<sup>104</sup> Yu (2019) 337

with the party's "party building" - dangjian – policy with the objective of strengthening the role of the CCP within SOEs.<sup>105</sup> According to Xi, these initiatives aim to afford the CCP a "leadership role" in the governance of SOEs by ensuring that the Party is the "political core" of SOEs.<sup>106</sup> Furthermore, according to Xi, state-affiliated companies should be treated as the "supporting forces for the Party to govern and prop up the country".<sup>107</sup> The combination of such party building policies with the injection of private capital indicate that true privatization is not an option for the Communist Party.

The core vehicle for party-building is the institutionalization of the role of in-house cells ("IHCs") within Chinese enterprises. IHCs operate as in-house branches of the Communist Party, required by law in nearly all Chinese enterprises – regardless of their characterization as state-owned, private, or even foreign. While these IHCs have long been embedded within corporate China, it is their institutionalization and their growing influence which worries outside observers. The primary mode for institutionalization of IHCs is via amendments of the corporate charters, such as the articles of association, of Chinese enterprises. Initially, this policy only extended to the Chinese state-sector, with the CCP requiring that the power and role of IHCs be enshrined into the corporate charter of all state-affiliated companies.<sup>108</sup> In practice, institutionalization means formalizing and elevating the role of IHCs in corporate governance.<sup>109</sup>

The combination of the mixed-ownership reforms and the party-building policies have turned SASAC into a backseat driver in exerting state-control. SASAC has turned more into a typical shareholder rather than an entity actively pushing political policies within the state-sector. The ground it has ceded, however, has not been ceded entirely to private shareholders but rather to the CCP.

The prevailing view on the CCP's party-building policies indicates that these policies are designed to counterbalance any potential dilution of stemming from the injection of private capital following mixed-ownership reform in SOEs.<sup>110</sup> However, characterizing these policies

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<sup>105</sup> Lin and Milhaupt (2021) 193

<sup>106</sup> BusinessEurope (2020) 99; Leutert (2020) 12

<sup>107</sup> Cho, Yusho, and Kawase, Kenji, 'How China's State-backed companies fell behind' (Nikkei Asia, 23 May 2018) <<https://asia.nikkei.com/Spotlight/The-Big-Story/How-China-s-state-backed-companies-fell-behind>> accessed 6 May 2024

<sup>108</sup> Lin and Milhaupt (2021) 9

<sup>109</sup> Lin and Milhaupt (2021) 1

<sup>110</sup> Tong and Yin (2019) 107; Lin and Milhaupt (2021) 9

as simply an aid to the mixed-ownership reforms in SOEs would do them injustice. Since the inception of dangjian in 2013, the Communist Party has expanded its ambition to include the entirety of corporate China. Private and foreign entities were initially largely able to refrain from participation in the policy, mainly since the CCP did not actively impose it upon them. However, when the Communist Party comes knocking in China, companies have only limited ability to resist.

Accordingly, in late 2018, the Code of Corporate Governance for Listed Firms was amended to require all publicly listed firms in China to adopt party-building provisions in their corporate charters. State-affiliated companies, specifically, were required to codify party leadership into their corporate charters.<sup>111</sup>

According to Blanchette (2019), Xi's party-building reforms have been indiscriminate and companies throughout the Chinese economy – regardless of ownership – have faced mounting pressure to adopt corporate charter provisions which would codify the position of the IHC and, thus, the Communist Party within the company's governance structures. Private and foreign companies have been pressured in particular to give IHCs say over personnel decisions. Thus, rather than being an effort limited to the state sector, these party-building policies should be seen as “a manifestation of the CCP's desire to have insight and input into all economic, civil, and political activity within the country”.<sup>112</sup>

These reforms have led to an ever more blurred line between the state and China's private sector. According to Pearson et. al. (2023), Xi's reforms indicate a move from state capitalism, where the economy is centred around the state, towards party-state capitalism, where it is instead centred around the Communist Party.<sup>113</sup> Others would agree. The Economist (2020) posited that Xi's reforms, dubbed “Xinomics”, are effectively reinventing state capitalism.<sup>114</sup>

These descriptions may be apt. Lin and Milhaupt (2021) describe the party-building policies as a truly groundbreaking endeavour by the Communist Party, noting that no previous corporate

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<sup>111</sup> Leutert (2022) 139

<sup>112</sup> Blanchette, Jude, ‘Against Atrophy: Party Organisations in Private Firms’ (Made in China Journal, 18 April 2019) <<https://madeinchinajournal.com/2019/04/18/against-atrophy-party-organisations-in-private-firms/>> accessed 7 May 2024

<sup>113</sup> Pearson, Margaret; Rithmire, Meg, and Tsai, Kellee, ‘The State and Capitalism in China’ (Cambridge University Press, 2023) 21-23

<sup>114</sup> The Economist, ‘Xi Jinping is reinventing state capitalism. Don't underestimate it’ (13 August 2020) <<https://www.economist.com/leaders/2020/08/13/xi-jinping-is-reinventing-state-capitalism-dont-underestimate-it>> accessed 7 May 2024

governance initiatives have ever attempted to formalize the role of a political party within business enterprises.<sup>115</sup>

The policies driven by the CCP under President Xi poses significant questions with regard to the EU's FDI screening framework. Notably, it may be suitable to ask whether its formulation of state-control is outdated even when before the latest revision has been implemented. This formulation suggests that the EU has failed to take into consideration the considerable impact of Xi's reforms.

Increasingly in modern China, state-control is not exerted directly through the government, but rather the Communist Party. Further, while exertion of political influence through traditional corporate governance mechanisms bestowed upon all shareholders is still significant in SOEs where the state remains the controlling shareholder, the Chinese economic landscape is increasingly defined by MOEs where the State does not hold such a role. In these companies, state-control is exerted through political governance, which does not neatly fit within the definition of state-control as formulated by the EU's 2024 Proposal for a revised FDI Regulation.

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<sup>115</sup> Lin and Milhaupt (2021) 9

## 4 Political influence in Chinese enterprises

For European policymakers, an acute concern is whether Chinese SOEs are making commercial decisions, such as those regarding FDIs, on the basis of commercial and market considerations. The *raison d'être* for including state-control within the screening criteria of is precisely this. This chapter will examine the ways in which the State apparatus and the CCP are able to influence the commercial decisions of Chinese SOEs.

A key fact to understand about corporate governance in China is that it operates under a parallel structure of legal corporate governance, as set out in China's Company Law, and political governance. In the early phases of establishing the modern enterprise system, China adopted "best practices", including governance models, from Western nations. However, during the past decades the governance structures of Chinese enterprises has evolved into a model suited, as Tricker and Li note, "to a country in which the law, the judiciary, and the courts serve the state and are not an independent check on the legislature as in most democracies".<sup>116</sup>

In state-affiliated companies within which the State still holds a significant stake – especially those in which it is the controlling shareholder – the mechanisms of corporate governance established under China's Company Law are still crucial in how the State exerts influence within the state-sector. After all, ownership is one of the defining forces in the operational and strategic direction of any corporation. Shareholders hold large sway over the operational and commercial decisions of a company, and ultimately, its objectives. The Chinese government's equity stake is enormous and pervasive throughout the economy. Furthermore, it still remains a controlling shareholder in a large chunk of China's largest companies.

However, within the increasing number of enterprises in which the Chinese government is not the controlling shareholder, the exertion of influence takes place through the Communist Party's apparatus. An assessment of the governance of China's state-sector that focuses purely on the formal system found in the law, however, will be inherently insufficient. It is incorrect to assume that all of the rights and responsibilities of corporate officers and stakeholders arise from the provisions of China's Company Law.<sup>117</sup> Moreover, it is incorrect to assume that all corporate bodies with influence over the management of Chinese companies, especially those

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<sup>116</sup> Beck, Kasper Ingeman, and Brødsgaard, Kjeld Erik, 'Corporate Governance with Chinese Characteristics: Party Organization in State-owned Enterprises' (2022) 250 *The China Quarterly* 486, 486-487; Tricker, Bob, and Li, Gregg, 'Understanding Corporate Governance in China' (Hong Kong University Press, 2019) 13

<sup>117</sup> Lin and Milhaupt (2013) 701; Wang (2014) 648

within the state-sector, are necessarily found within the formal governance structures of the CCL. In parallel with this formal structure, there exists a pervasive system of political governance controlled by the Communist Party, such as the involvement of IHCs within companies.

#### **4.1 Governance of SOEs: The Letter of the Law**

When the owners of a business entrust the responsibility of its management to others, they require mechanisms that guarantee that these managers fulfil their duties and achieve goals set for the business. In essence, this is what corporate governance is about: the methods through which owners exercise power over corporate bodies.<sup>118</sup> Chinese corporate law sets out the parameters for corporate governance and grants the state a formal role in governance in those enterprises in which it has shareholding.

##### **4.1.1 The Formal Regulatory Framework for Corporate Governance in China**

At the heart of the legal system of corporate governance is the system established by China's Company Law of 1993 ("CCL").<sup>119</sup> The CCL introduced a formal system of corporate governance, establishing roles such as shareholders, directors, supervisors, and managers.

The CCL is the general law in China governing matters related to the operation of companies, including corporate governance. The 2005 revision of the Company Law introduced some of the important provisions regarding corporate governance, such as rules regarding minority shareholders, and updated some of the existing ones.<sup>120</sup> In addition to the CCL, the operation of corporations is influenced by a plethora of other laws.<sup>121</sup> This assessment, however, will focus mainly on the CCL and its implications on the governance of SOEs.

The CCL established a standardized corporate framework applicable to all Chinese corporations. This framework includes features such as a separate legal personality for corporations, limited liability for its shareholders and the ability to transfer shares or equity. Moreover, it mandates a board-centred management system and shared ownership by

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<sup>118</sup> Tricker and Li (2019) 5-6

<sup>119</sup> People's Republic of China, 'Company Law of The People's Republic of China (中华人民共和国公司法)' 1993, as amended in 1999 and 2004 <[http://www.npc.gov.cn/zgrdw/englishnpc/Law/2007-12/12/content\\_1383787.htm](http://www.npc.gov.cn/zgrdw/englishnpc/Law/2007-12/12/content_1383787.htm)> (hereinafter, the "Chinese Company Law" or "CCL") accessed 29 March 2024

<sup>120</sup> Pisacane, Giovanni, 'Corporate Governance in China: The Structure and Management of Foreign-Invested Enterprises Under Chinese Law' (Springer, 2017) 2-3

<sup>121</sup> Wang (2014) 648

investors.<sup>122</sup> Chinese corporations share these features with nearly all major commercial jurisdictions.<sup>123</sup>

The introduction of these formal corporate governance mechanisms was designed as a response to several issues within SOEs. As mentioned earlier, the corporatization of SOEs enables them to raise equity capital, something that was in severe need. In addition, these structures were aimed at tackling chronic inefficiency within SOEs by improving their management.<sup>124</sup> As Clarke notes, the CCP prioritizes stringent state oversight over all else.

The CCL applies to Chinese companies incorporated as either Limited Liability Companies (“LLC”) or as Joint Stock Limited Companies (“JSLC”).<sup>125</sup> According to Wang, an LLC is the “functional equivalent” of a private company in the UK or a closely held corporation in the US.<sup>126</sup> In LLCs, a shareholder is liable to the company to the extent of the amount of the shareholder’s capital contribution.<sup>127</sup> Furthermore, their shares can’t be traded publicly, and they are limited to 50 shareholders.<sup>128</sup> This structure results in LLCs typically being smaller companies with simpler structures and fewer corporate governance requirements.

In JSLCs, the total share capital is divided into shares of equal value, and the shareholders are liable to the company to the extent of the shares they hold. JSLCs shares are the only ones that can be freely and publicly traded (subject to regulatory requirements), and, thus, being a JSLC is a prerequisite for listing on the stock market.<sup>129</sup> As a general characterization, JSLCs are subject to more stringent corporate governance rules. Furthermore, JSLCs may be subject to China’s Securities Law due to their ability to raise public capital.

The legalized corporate governance structure of your typical Chinese company features three statutory bodies: the shareholder’s general meeting (“General Meeting”) as well as a two-tiered board including the Board of Directors (“BoD”) and the Supervisory Board (“SB”). These

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<sup>122</sup> Wang (2014) 648-649; See CCL art. 3A, 4 and 143, as well as Chapter III, Section 3.

<sup>123</sup> Hansmann, Henry, and Kraakman, Reinier, ‘The End of History for Corporate Law’ (2000) Harvard Law School Discussion Paper 280, 3/2000, 1-2

<sup>124</sup> Clarke (2003) 496-498

<sup>125</sup> CCL, art. 2; These companies are also referred to by some scholars as ‘Companies Limited by Shares’ (“CLS”). However, this thesis will adopt the term Joint Stock Limited Company, as this term is used in the official English translation of the CCP published by the National People’s Congress.

<sup>126</sup> Wang (2014) 648

<sup>127</sup> CCL, art. 3A

<sup>128</sup> CCL, art. 23-25

<sup>129</sup> Haijing, Cao, ‘Corporate Governance Model of State-Held Listed Companies in China’ (PhD thesis, National University of Singapore, 2009) 4; Wang (2014) 651; CCL art. 77, 126, 127, 130, 135, and 145.

governing bodies are, in substance, the same in both LLCs and JSLCs.<sup>130</sup> The General Meeting is at the top of the Chinese governance model, while the BoD and SB operate with separate functions on the same level of governance.<sup>131</sup> In addition, most Chinese companies feature a general manager.

The General Meeting is cited by some scholars as the “power organ” of the company, suggesting that more power is concentrated in the hands of the shareholders, relative to other jurisdictions.<sup>132</sup> Indeed, the convergence of ownership and governance is a matter often discussed in contemporary literature. Research suggests that the degree to which the shareholding of a company is concentrated indicates how much control ownership grants over the governance of the company. In companies with concentrated shareholding structures, shareholders usually have a stronger influence over company decisions and management.<sup>133</sup> China is labelled by some scholars as a “concentrated ownership jurisdiction”, referring to the fact that a significant amount of its companies – both private and state-owned – have a concentrated shareholding structure. While this is true also for private enterprises in China, this is mostly due to the significance of SOEs in the Chinese economy.<sup>134</sup> Thus, it comes as little surprise that Chinese corporate law retains a strong position for shareholders.

The General Meeting has the usual powers of electing directors and supervisors familiar from Western jurisdictions. However, the General Meeting also has the responsibility to decide on the business policy and investment plan of the company.<sup>135</sup>

The BoD acts as a central operational and implementation body, executing decisions made by the General Meeting and managing the company’s overall structure. The BoD is entrusted with three categories of powers. Wang (2014) calls these the decisional powers, appointment powers and oversight powers of the BoD. The first refers to the BoD’s role in shaping the company’s direction and financial planning, making decisions on matters such as operational initiatives, investment direction, budgeting, profit allocation as well as fundamental corporate changes. The second refers to the BoD’s power to appoint the company’s executives, including the

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<sup>130</sup> Schipani, Cindy A., and Junhai, Liu, ‘Corporate Governance in China: Then and Now’ (2001) William Davidson Working Paper Number 407, 7

<sup>131</sup> Haijing (2009) 102-103; Wang (2014) 649-650

<sup>132</sup> Wang (2014) 649

<sup>133</sup> Haijing (2009) 85-86

<sup>134</sup> Lim, Ernest WK., ‘Corporate Ownership, State-Owned Enterprises and Corporate Governance’ (2021) 41(3) Oxford Journal of Legal Studies 663, 666; Haijing (2009) 85

<sup>135</sup> CCP, art. 38

general manager, and their compensation. The final set of powers refers to their supervisory duties vis-à-vis the management of the company. The SB, conversely, serves as a type of watchdog, tasked with overseeing the actions of the BoD and executive officers. The SB ensures legal and regulatory compliance of the BoD. The SB also protects the shareholders' interest.<sup>136</sup>

#### 4.1.2 SASAC: The Backbone of State-Control?

Within the Chinese non-financial state-affiliated enterprises, it is the central government's asset management arm, the State-owned Assets Supervision and Administration Commission (SASAC), that acts as the state shareholder. SASAC was created in 2003 to act as the chief controller of state assets, reporting directly to the State Council, the cabinet of China.<sup>137</sup> The State Council is the state shareholder, with the use of its ownership powers delegated to SASAC.<sup>138</sup>

For the Chinese financial system, which is entirely state run<sup>139</sup>, Central Huijin Investment Ltd., a subsidiary of China's sovereign wealth fund, acts as the state shareholder and the "Big Four" commercial banks are run by Central Huijin.<sup>140</sup> The particular differences between the use of the State's shareholder rights between Central Huijin and SASAC are outside the remits of this paper, and this examination will focus on SASAC. However, Central Huijin does operate exert state-control much in the same way as SASAC. SASAC was created in 2003 to act as the chief controller of state assets, reporting directly to the State Council, the cabinet of China.<sup>141</sup> The State Council is the state shareholder, with the use of its ownership powers delegated to SASAC.<sup>142</sup>

Central SOEs are typically structured as multi-tiered enterprise groups, with the group company – the parent company under the direct control of the State – often encompassing a number of subsidiaries.<sup>143</sup> While these central SOEs may contain joint ventures or entities listed on stock

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<sup>136</sup> Wang (2014) 649-650

<sup>137</sup> Lin, Li-Wen, and Milhaupt, Curtis J. 'We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China' (2013) 65(4) *Standord Law Review* 697, 735; Milhaupt, Curtis J., and Zheng, Wentong, 'Beyond Ownership: State Capitalism and the Chinese Firm' (2015) 103 *Georgetown Law Journal* 665, 676

<sup>138</sup> Wang (2014) 653

<sup>139</sup> The Big Four commercial banks (the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank, and the Agricultural Bank of China) are among the largest banks in the world. Each is state owned. Of the second-tier banks, the State also holds a majority share in 90 %.

<sup>140</sup> Wu (2016) 273-274

<sup>141</sup> Lin and Milhaupt (2013) 735; Milhaupt and Zheng (2015) 676

<sup>142</sup> Wang (2014) 653

<sup>143</sup> Leutert (2020) 5

exchanges, SASAC stands atop these business groups as the ultimate controlling shareholder of the group company. SASAC holds the entirety of the shares for each of the central SOEs' group companies.<sup>144</sup> Today, SASAC stands as the largest single controlling shareholder globally, with control over the majority of the Chinese firms listed on the Fortune Global 500 list of the world's largest corporations.<sup>145</sup>

The structure of SASAC is replicated on each level of government. Each local government maintains their local equivalent of SASAC, which act as controlling shareholders of their respective local SOEs, and which report up to the central government's SASAC.<sup>146</sup> The central government's SASAC coordinates broader policy objectives with the state asset supervision of local SASAC's.

SASAC exercises the powers of the state shareholder in accordance with the provisions of China's State-Owned Assets Law.<sup>147</sup> While this thesis separates the notions of legal and political governance, it would be mistaken to assume that SASAC itself is not subject to such political governance. SASAC, as Chinese state bodies in general, is an inherently political entity. No structural barriers exist to separate SASAC from the political institutions of the State. Quite the opposite: there has been a deliberate strategy to integrate Communist Party influence within SASAC.<sup>148</sup>

This political influence of the CCP is particularly evident in the appointment of corporate and executive officers in the largest SOEs. In these, it is the Communist Party's Central Committee, rather than any state body, which directly appoints and evaluates top executives. Furthermore, appointments of lesser executives are managed by SASAC's Party Building Bureau, underscoring how deeply intertwined party mechanisms are. This bureau also manages all appointments for other than the largest SOEs.<sup>149</sup>

With regard to the appointment of corporate and executive officers, SASAC's legal authority varies depending on whether the company is WSOEs, on one hand, or a state-owned-capital entity, on the other. WSOEs, as the name suggests, are entities in which the State owns 100 %

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<sup>144</sup> Milhaupt and Zheng (2015) 676

<sup>145</sup> Wu (2016) 271

<sup>146</sup> Wu (2016) 271

<sup>147</sup> People's Republic of China, 'Law of the People's Republic of China on State-Owned Assets in Enterprises', 2008 <[http://www.npc.gov.cn/zgrdw/englishnpc/Law/2011-02/15/content\\_1620615.htm](http://www.npc.gov.cn/zgrdw/englishnpc/Law/2011-02/15/content_1620615.htm)> accessed 29 March 2024

<sup>148</sup> Lin and Milhaupt (2021) 8

<sup>149</sup> Milhaupt & Zheng (2015) 678

of the Company. As has been stated above, this includes the group companies of all central SOEs, the shares of which are entirely held by the State. In WSOEs, SASAC has broad authority to appoint all of senior management, including the general manager and chief of financial affairs, as well as all members of the BoD and SB along with the chairmen of these organs.<sup>150</sup> In practice, however, much of this authority has been ceded to IHCs.

State-owned capital entities include state-owned-capital holding companies and state-owned-capital joint stock companies. The former refers to enterprises where the State holds a controlling interest, while the latter refers to companies in which the State has a stake in the enterprise but does not have a controlling interest. In practice, state-owned capital entities is a broad umbrella term used similarly as state-affiliated entities is used within the remits of this thesis. In these types of enterprises, SASAC has the right to propose to the General Meeting candidates for directors and supervisors.<sup>151</sup>

However, SASAC's role is set to change significantly under Xi's mixed-ownership reforms, highlighting the trend of the state becoming less involved in the state-sector. Within MOEs, SASAC's role as an asset manager will be transitioned to that of a capital manager. The State is set to establish various capital management companies, to which the use of the State's ownership rights would be transferred. SASAC would become the controlling shareholder in these capital management companies.<sup>152</sup>

If Chinese SOEs would act purely based on the provisions set out in law, SASAC, alongside other possible shareholders, would elect the members of the BoD and SB during the General Meeting. The BoD would then act according to its legal authorities as defined by law. In practice, the functioning of a Chinese SOE is not that straightforward. Chinese SOEs do not operate merely based on these and, instead, much of critical decision-making is in the hands of the Communist Party, an influence it maintains through the twin governance structure of these enterprises.

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<sup>150</sup> CCP, art. 22

<sup>151</sup> CCP, art. 22

<sup>152</sup> Wang and Cheng-Han (2020) 1067

## 4.2 The Political Governance of Chinese SOEs

With the State increasingly taking a back seat under Xi, the practical impact of traditional corporate governance mechanisms has been somewhat diluted. Simultaneously, however, the grip of the Communist Party's apparatus on the state-sector has been strengthened.

Several different definitions have been given to the concept of "political governance". In the context of this thesis, in particular concerning Chinese SOEs, the term is broadly used to describe the various practices which the Communist Party employs within these enterprises to ensure alignment with overarching policy goals of the CCP.

### 4.2.1 CCP's Corporate Extensions: In-House Cells within the Chinese State-Sector

A core vehicle in pushing the CCP's party-building agenda and, thus, integrating political governance into the state-sector are the Party organizations within enterprises. Both the CCP and scholars use a range of terms to describe these entities, either based on the type or size of the organization in which it is embedded, or to collectively refer to the broad category they represent. Examples include internal party groups, party cells, party committees, party organizations, internal party cells and party branches.<sup>153</sup> This thesis has adopted the term in-house cell ("IHC") to refer to the units of the CCP embedded within enterprises. These cells function as the CCP's extensions within corporate entities, providing political guidance, promoting the party's ideology, and, ultimately, ensuring that company policies align with the CCP's objectives.<sup>154</sup>

IHCs have existed in all Chinese entities since the very beginning of communist rule in China.<sup>155</sup> IHCs have been required since the enactment of the 1993 CCL, but these provisions were not strictly enforced. In the firms where they did exist, they were nowhere near as powerful as today, as initial economic reforms aimed to separate the Party's political control from the day-to-day business management of enterprises. During these initial days of IHCs, IHC members would usually refrain from serving additionally as corporate officers.<sup>156</sup> Nonetheless, even since these early days, the role of the IHC was, according to law, to "guarantee and

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<sup>153</sup> Livingston, Scott, 'The New Challenge of Communist Corporate Governance' (Center for Strategic & International Studies, 2021) CSIS Briefs <[https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/210114\\_Livingston\\_New\\_Challenge.pdf](https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/210114_Livingston_New_Challenge.pdf)> accessed 30 March 2024, 3

<sup>154</sup> Leutert (2020) 10

<sup>155</sup> Pearson, et. al. (2023) 24

<sup>156</sup> Zhang (2019) 56; Livingston (2021) 2

supervise the implementation of the ... principles and policies of the [Communist] Party and the state in the enterprise”.<sup>157</sup>

The significance of the IHCs was enhanced notably after the 1989 Tiananmen Square protests and subsequent massacre<sup>158</sup>, though with the concurrent onset of the reforms establishing the modern enterprise system, the IHCs generally continued to play a supportive role to the corporate management in the administration of enterprises. The significance of IHCs in the governance of SOEs really began to surge after the creation of SASAC in 2003, and especially after the beginning of Xi’s tenure.<sup>159</sup>

Under Xi, fortifying the role of IHCs has been a significant policy agenda. The most recent set of structural reforms of the state-sector under Xi, as outlined in chapter 3.2.2, was accompanied with a push to strengthen party control. The 2015 Guiding Opinions, while including many market-oriented reforms, underscored the reinforcement of CCP’s leadership in SOEs, placing a strong emphasis on in-house cells:<sup>160</sup>

“The Party’s leadership over SOEs shall be upheld. This is the political direction and principle that must be held fast to in deepening SOE reform. It is critical to enforce the guidelines of comprehensively tightening Party discipline, give full play to the core political role of the Party organizations of enterprises.”

The aim of reforms under Xi have sought to standardize the presence of IHCs as well as to reinforce their role in the governance of the state-sector and beyond. Most observers, nonetheless, have noted a stronger presence of IHCs within private and foreign enterprises alike as well as within mixed-ownership entities since the start of Xi’s party-building policies. Moreover, as was mentioned above, in 2018 China’s securities regulator mandated party units in all enterprises seeking to list on Chinese stock exchanges, whether state, private, or foreign

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<sup>157</sup> People’s Republic of China, ‘Law of the People’s Republic of China on Industrial Enterprises Owned by the Whole People’ (1988) Law of China <<http://www.lawinfochina.com/Display.aspx?lib=law&ID=1188>> accessed 30 March 2024

<sup>158</sup> The Tiananmen Square protests were student-led, pro-democracy demonstrations held in Beijing in 1989. The intensity of these protests prompted the Chinese government to declare martial law and initiate a military crackdown. This intervention subsequently led to tragic events often referred to as the Tiananmen Square massacre. Official accounts report a minimum of 300 fatalities, though there is a degree of skepticism around these figures, with alternate estimates suggesting the death toll could exceed 1,000: History.com, ‘Tiananmen Square Protests’ (9 June 2019) <<https://www.history.com/topics/asian-history/tiananmen-square>> accessed 30 March 2024

<sup>159</sup> Zhang (2019) 57-59; Leutert (2020) 12; Chang and Lin (2021) 720; Lin (2021) 451

<sup>160</sup> Chinese State Council, ‘Guiding Opinions of the CPC Central Committee and the State Council on Deepening the Reform of State-owned Enterprises’ (2015) <<https://www.lawinfochina.com/display.aspx?id=26805&lib=law&EncodingName=big5>> accessed 30 March 2024 (hereinafter, the “2015 Guiding Opinions”), section 1(2)

owned. Concurrently, such enterprises were required to provide “necessary conditions” for IHCs in carrying out party-building activities.<sup>161</sup> As Xi’s party-building policies progress, Blanchette (2019) suggest that it is not only possible, but probable, that IHCs will become more actively involved in the daily operations and strategic decisions of companies, even those in which the State does not hold a controlling interest.<sup>162</sup>

The political encroachment into companies in which the State does not hold a controlling interest is a newer development.<sup>163</sup> As such, there is limited scholarly work on the inner workings of IHCs in these companies. However, as IHCs have long operated within SOEs, an abundance of literature exists focusing on the role of IHCs within these enterprises. Thus, assessment of the role of IHCs will be concentrated to SOEs. Nonetheless, this discussion is essential as it establishes the baseline for understanding how IHCs exert influence within the corporate governance of enterprises.

The push for fortifying the role of IHCs has involved the stricter enforcement of existing provisions regarding them. According to Article 30 of the Constitution of the Communist Party IHCs are mandated in any Chinese organization, whether state-owned, private, or foreign-funded, that has at least three CCP members:<sup>164</sup>

“A primary-level Party organization shall be formed in any enterprise, villagers’ committee, government organ, school, research institute, subdistrict and community, social organization, company of the People’s Liberation Army, and any other primary-level danwei [an organization where people work] where there are three or more full Party members.”

It’s worth noting that the extensive reach of the Communist Party, with its membership near 100 million in 2022, permeates a significant portion of the Chinese population.<sup>165</sup> Consequently, numerous organizations find themselves obliged to adopt this mandate. Today, are widespread not only among the state-sector but across the entirety of China’s businesses and social structures. For instance, by 2018, the CCP reported had reported that IHCs had been

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<sup>161</sup> Pearson, et. al. (2023) 24

<sup>162</sup> Blanchette (2019)

<sup>163</sup> Pearson, et. al. (2023) 25

<sup>164</sup> National Congress of the Communist Party of China, ‘Constitution of the Communist Party of China’, as revised in 2017,

<[http://www.xinhuanet.com/english/download/Constitution\\_of\\_the\\_Communist\\_Party\\_of\\_China.pdf](http://www.xinhuanet.com/english/download/Constitution_of_the_Communist_Party_of_China.pdf)> accessed 29 March 2024 (hereinafter the “CCP Constitution”) art. 30

<sup>165</sup> Statista ‘Number of Chinese Communist Party (CCP) members in China from 2012 to 2022’ (2023)

<<https://www.statista.com/statistics/281378/number-of-chinese-communist-party-ccp-members-in-china/>> accessed 26 March 2024

established in 73.1 % of private enterprises. Meanwhile, an IHC is present in virtually every enterprise within the state-sector.<sup>166</sup>

IHCs are deeply integrated with the ideology and policy objectives of the CCP. According to official guidance, IHC's are required to maintain "a high degree of consistency with the Party Central Committee in terms of ideology, politics, and actions, conscientiously implementing the party's line, principles, [and] policies ...".<sup>167</sup> As can be seen here, IHC's are required to specifically mirror the ideology and principles of the CCP's Central Committee – the most powerful decision-making body in China – rather than adhere to a vague notion of party principles. In fact, the Secretary of the IHC has a statutory requirement to "love the [CCP's] work".<sup>168</sup> This direct linkage to the highest tiers of power illustrates the clear intention to centralize the CCP's command within SOEs directly under the most authoritative entity within China.

While being key in providing the CCP oversight over state-sector activities, the IHC is often not a mere silent observer. Within SOEs, the IHC is an active participant in the company's broader objectives and commercial decisions as well as its day-to-day activities. IHCs participate in decision-making on "important matters" of SOEs, as well as "provide support" to corporate and executive officers in performing their duties.<sup>169</sup>

One might argue, however, that members of a SOE's IHC extend beyond merely supporting corporate and executive officers. In fact, the system of joint appointments, known as "two-way entry and cross-appointment" and mandated in all SOEs, results in a single individual often holding both a role in executive management and the IHC. Under this system, the Secretary of the IHC often serves as the Chairman of the BoD. For WSOEs as well as SOEs in which the State has a controlling interest, inclusion of IHC members among management executives as

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<sup>166</sup> CCP Central Committee, '2017 Statistical Communique on Internal Statistics of the Communist Party of China' (12371.cn, 30 June 2018) <<https://news.12371.cn/2018/06/30/ARTI1530340432898663.shtml>> accessed 30 March 2024, para 10

<sup>167</sup> CCP Central Committee and SASAC, 'Opinions on strengthening and improving the party building work of central enterprises' (12371.cn, 2004) <[https://news.12371.cn/2015/03/12/ARTI1426131063462262\\_all.shtml](https://news.12371.cn/2015/03/12/ARTI1426131063462262_all.shtml)> accessed 30 March 2024 (hereinafter the "2004 Joint Opinions on SOE Party Building") para 4

<sup>168</sup> CCP Central Committee, 'Regulation on the Work of Branches of the Communist Party of China', (2018), <<http://politics.people.com.cn/n1/2018/1126/c1001-30420219.html>> accessed 30 March 2024 (hereinafter the "2018 Regulation on IHCs") art. 21

<sup>169</sup> Wang (2014) 656; Fa, Zhong, 'Notice of the Central Committee of the CCP on Further Strengthening and Improving the Party Building Work in SOEs' (CCP Central Committee, 1997) <<http://cpc.people.com.cn/GB/64162/71380/71382/71383/>> accessed 27 March 2024 (hereinafter the "1997 Notice on Party-building")

well as on the BoD and SB is a specific requirement.<sup>170</sup> This practice of joint appointments consolidates authority, as it effectively narrows the hierarchy between the CCP and SOEs. It also makes the lines between political and commercial increasingly blurred.

As mentioned, IHCs are also have a voice in decision-making, especially when it comes to key decisions, observing the “three majors, one large” principle. Three majors refers to matters which involve either macroeconomic controls, national strategy, or national security. One large refers to other matters which are deemed important or broad in scope.<sup>171</sup> On these matters, the BoD and General Manager must “consult and respect the opinion of the party organization” before finalizing a decision and subsequently report back on the execution of these decisions.<sup>172</sup> While there is no precise official guideline defining the range of matters which require the IHC’s input, the intention seems to favour a broad interpretation rather than a narrow one. Consequently, it stands to reason that the outward FDI activities of the company would be included within this scope.

In addition to the above key decisions, IHCs hold much sway over the personnel management of SOEs. The Party-state’s personnel system operates under the principle of Party Control of Cadres, under which the CCP dominates the appointment of all state officials. This system also extends to SOEs. In addition to exercising much of appointment SASAC’s powers over executive officers and directors, which have in practice been delegated to IHCs, the system requires IHC participation in the appointment and management of all SOE managers above the middle level.<sup>173</sup> When selecting such middle-level and above managers, the criteria is explicitly political, with IHCs having to take into account both “ability and political integrity”.<sup>174</sup> According to Lin and Milhaupt (2013) among these criteria is, first and foremost, party membership.<sup>175</sup> Promotions within SOEs are no exception; IHC approval is required for individuals to be promoted beyond certain levels.<sup>176</sup>

The political nature of appointments within SOEs can be seen further in the overlap between SOE executives and people in powerful, explicitly political positions. This “revolving door” –

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<sup>170</sup> 2018 Regulation on IHCs; 2004 Joint Opinions on SOE Party Building, paras 5 and 10; Leutert (2020) 8, 11; Wang (2014) 657;

<sup>171</sup> Leutert (2020) 10-11

<sup>172</sup> Wang (2014) 656; 1997 Notice on Party Building

<sup>173</sup> 2004 Joint Opinions on SOE Party Building, para 10; Wang (2014) 658-659

<sup>174</sup> 2004 Joint Opinions on SOE Party Building, para 10

<sup>175</sup> Lin and Milhaupt (2013) 737

<sup>176</sup> Wu (2016) 280

a term referring to the movement of individuals between executive roles in government and positions in the SOEs – is highly significant in the Chinese state sector. In 2010, a considerable majority of China’s provinces had a former SOE executive working as either a governor or vice governor. This trend reflects the perception that executive roles in the largest SOEs are often auditions for future leadership positions in politics. Thus, according to Chang and Lin (2021), it is political advancement that is the main motivation for top executives of the largest SOEs, rather than monetary compensation.<sup>177</sup> The political nature of SOE executives is further exhibited by a portion of SOE executives serving concurrently on State and CCP bodies.<sup>178</sup>

While IHCs are an integral part of political governance within the Chinese state-sector, this thesis would be remiss if it wouldn’t mention another profound aspect of CCP influence which lies in the strict discipline mandated by the CCP. This is one of the most fundamental by which the CCP ensures adherence to its policies. According to the CCP Constitution, all CCP members must comply with the Party’s policies and political objectives, as well as place “the interest of the Party ... above everything”.<sup>179</sup> This adherence required by members is not merely rhetorical. As the anti-corruption campaigns under Xi showcase, violations of CCP discipline can have extremely serious consequences.<sup>180</sup>

In the state-sector, the vast majority of managers, mid-level and above, are CCP members alongside a significant portion of the overall workforce. In the private sector, a notable number of executives also choose to become CCP members, driven largely by the political advantages afforded by such affiliation. According to Milhaupt and Zheng (2015), 95 % of the founders or de facto controllers of China’s 100 largest private enterprises were members of central or local Communist Party organizations.<sup>181</sup> As such, this enforcement of Party discipline in overall Chinese society can have grave influence on the governance of Chinese enterprises.

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<sup>177</sup> Chang, Yun-Chien, and Lin, Lauren Yu-Hsin, ‘Do State-Owned Enterprises Have Worse Corporate Governance? An Empirical Study of Corporate Practices in China’, (2021) 23 *European Business Organization Law Review* 711, 720

<sup>178</sup> Wu (2016) 272; according to Wu, nearly 7 % of central SOE leaders also serve concurrently on the CCP Central Committee, while a smaller number serve as members of the People’s Congresses. While these dual-hatted SOE executives represent a fairly modest portion, this phenomenon further underscores the political entrenchment of top SOE executives.

<sup>179</sup> Wang (2014) 654; CCP Constitution art. 3 and 10

<sup>180</sup> Center for Strategic and International Studies, ‘Can Xi Jinping’s Anti-Corruption Campaign Succeed?’ (30 March 2024) <<https://chinapower.csis.org/can-xi-jinpings-anti-corruption-campaign-succeed/>> accessed 30 March 2024

<sup>181</sup> Milhaupt and Zheng (2015) 684

#### 4.2.2 Party Influence Codified: The Institutionalization of In-House Cells

As has been mentioned, a key part of Xi's reforms has been the institutionalization of the role of IHCs, primarily through the adoption of corporate charter provisions to that effect. It should be noted that China operates under a very unique system in which the whole country operates under two parallel legal orders, encompassing both state laws applicable to all individuals and entities, as well as internal regulations of the CCP which govern the conduct of CCP members.<sup>182</sup> The rules, outlined above, reflect this dual system; while national law (CCL) requires the establishment of IHCs, their specific functions are by and large dictated by internal CCP regulations.

In practice, however, the distinction between these two legal spheres is often blurred, particularly so when it comes to SOEs. The control over the legal system and its direct involvement in the management of SOEs through IHCs mean that this distinction is not often very relevant. However, the CCP has shown a willingness in the past decade to institutionalize IHCs by integrating them more firmly into the formal legal system.

Most notably this has been done through encouraging amendments to corporate charters to include specific provisions regarding the roles and functions of IHCs in the operation of Chinese companies.<sup>183</sup> As corporate charters are enforceable by law on the company itself, the CCP attempts to ensure that its presence and influence within Chinese companies are legally recognized within the company's governance structure.

Initially, these efforts were focused on state owned enterprises. Initial encouragement was exhibited by Xi in a speech from 2016, in which he encouraged the incorporation of "the legal status of [IHCs] in the corporate governance structure" of SOEs.<sup>184</sup> In 2017, the CCP adopted a party regulation explicitly requiring SOEs to adopt provisions regarding "party building work requirements", as well as to provide "institutional guarantees for the party organization to effectively carry out its work and play its role" in its corporate charter. This requirement applies to all SOEs – both WSOEs as well as those in which the State holds a controlling interest.<sup>185</sup>

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<sup>182</sup> Livingston (2021) 4

<sup>183</sup> Livingston (2021) 4

<sup>184</sup> Sohu, 'Xi Jinping: Upholding the Party's Leadership over State-Owned Enterprises Must Be Consistent' (13 April 2019) <[https://www.sohu.com/a/307762296\\_364628#google\\_vignette](https://www.sohu.com/a/307762296_364628#google_vignette)> accessed 30 March 2024

<sup>185</sup> CCP Central Committee, 'Notice on Solidly Promoting the Requirements of Party Construction in State-Owned Enterprises and Writing them into the Company Articles of Association' (2017) <<https://www.lawdun.com/lawn/d78435.html>> accessed 30 March 2024 (hereinafter "2017 CCP Notice on Amendments to SOEs' AoAs") para 1

In addition, the 2017 regulation placed emphasis on steadily advancing this policy in MOEs, i.e., companies in which the State holds an interest that is not necessarily controlling.<sup>186</sup> Finally, this regulation mandated that an organization's IHC must "strictly review and control" the process of writing the text for the new provisions of corporate charters.<sup>187</sup> In 2017, SASAC and the Chinese Ministry of Finance released model party-building provisions to be adopted by non-financial companies and the financial sector, respectively.<sup>188</sup>

According to research by Lin and Milhaupt (2021), one-third of all companies listed on Chinese stock exchanges had revised their corporate charters to include party building provisions by the end of 2018. This figure included approximately 90 % of all central and local SOEs.<sup>189</sup> Since these figures reflect realities from the initial phases of the party building era, they can be considered slightly dated. Given the ongoing nature of the party building policies of the CCP, it is reasonable to assume that current metrics would record a further increase in adoption. Mere amendments, however, do not tell the full story. For instance, most adopting private companies only adopted provisions that were largely ceremonial.

Conversely, not only did SOEs adopt such symbolic provisions, but a majority of SOEs also adopted provisions which codified practices affording substantial powers to IHCs. These provisions included granting IHCs a formal role in corporate decision-making processes as well as mandating the BoD to consult the IHC before finalizing decisions. Furthermore, a majority of SOEs codified the oversight powers of IHCs over personnel matters and confirmed their control over party cadre management. A majority of SOEs also included provisions about having a disciplinary body under IHC control as well as the joint appointment of top executives and IHC members. In addition, a majority of SOEs included provisions regarding the IHCs role in decision-making,<sup>190</sup>

As can be derived from the discussion above, IHCs are a cornerstone of the political governance exercised by the CCP and have, arguably, become an institutionalized part of the corporate governance of SOEs. IHCs function as the eyes and ears of the CCP within SOEs, while also having substantial sway over the operational and commercial matters of these enterprises.

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<sup>186</sup> 2017 CCP Notice on Amendments to SOEs' AoAs, para 2

<sup>187</sup> 2017 CCP Notice on Amendments to SOEs' AoAs, para 3

<sup>188</sup> Lin and Milhaupt (2021) 194

<sup>189</sup> Lin and Milhaupt (2021) 203

<sup>190</sup> Lin and Milhaupt (2021) 205

However, while IHCs may be the most concrete way in which political influence is exerted on SOEs, it is certainly not the only one.

## 5 Reconciling EU's Formulation of State-Control with Chinese Governance Practices

As has been shown in the examination of the Chinese state-sector in Chapters 3 and 4, the reality of state-control in China is a complex combination of two distinct types of control. On one hand, traditional influence is still wielded by the state through shareholding, but political influence wielded by the CCP has been institutionalized and further strengthened under Xi. This political influence is exerted through various control mechanisms, most notably the IHCs embedded within the Chinese state-sector and beyond.

The notion of state-control in the EU's FDI regime purportedly attempts to pre-empt unwanted influence by third country governments – especially China's – by bringing state-controlled investment, under certain conditions, within the realm of screening. As was demonstrated in Chapter 2.2.2, the notion of state-control within the EU's FDI Regime – both the 2019 Regulation and the 2024 Proposal – is based on two concurrent factors: governmental origin and control. Thus, it should be examined whether the notion of state-control as defined in the EU's FDI regime is compatible with the practical realities of Chinese political governance, as outlined in Chapters 3 and 4.

The notion of state-control within the EU's FDI Regime – both the 2019 Regulation and the 2024 Proposal – is based on two concurrent criteria. The first of the two criteria establishing state-control within the EU's FDI regime is the governmental origin criterion. According to this, control must originate from “the government, including state bodies, regional or local authorities or armed forces, of a third country”.<sup>191</sup> As of yet, there is no case law that addresses ambiguous situations or guidelines from EU bodies which would clarify when control originating from various entities meets the governmental origin criterion. Specifically, it is unclear whether control by a political party such as the CCP may fulfil said criterion.

The second criterion within the notion of state-control as outlined by the Commission in the EU's FDI regime is the control criterion, according to which state-control can be direct or indirect, and it may manifest in various ways, “including through ownership structure, significant funding, special rights or state-appointed directors or managers”. In addition, the 2024 Proposal includes updated text according to which control can additionally be determined

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<sup>191</sup> 2024 Proposal, Art. 5(1)(b)(i)

based on whether the foreign investor is “involved in pursuing policy objectives of third countries to facilitate their military capabilities”.<sup>192</sup>

Beyond the text of the 2019 Regulation and the 2024 Proposal, the contents of which are outlined above, there is no authoritative source that helps establish whether practices regarding political governance employed by the CCP may be included within the notion of state-control. In fact, there is no authoritative source that elaborates on the contents and limits of these criteria in any substantive way.

### **5.1 Possibility for Insights from Established Legal Terminology in EU Law**

There exists a potential avenue for drawing upon other established legal terminology or principles within EU law to provide guidance on the interpretation of state-control criteria in the context of the FDI regime.

For instance, as mentioned in Chapter 2 previous formulations of government influence over enterprises in EU law have often utilized terms such as “public body” or “public authority” to designate the entity exerting influence as a proxy of the state. The usage of a term such as “public body” provides for a broader definition, more clearly encompassing subnational governments as well as other extensions of the state, such as the state banks, it is unclear whether public bodies can still be construed to include political parties. According to the ECJ, as mentioned, a public body is constituted by three concurrent criteria: established for purposes of the general interest, possessing legal personality, and financing or control by another public body.<sup>193</sup>

Further, when analyzing the control criterion, the notion of control is often discussed through the lens of EU competition law. Within the context of the EU’s merger control framework. Defined in Article 3(2) of the EU Merger Regulation (MCR), “control” refers to rights, contracts, or any other mechanisms that, alone or in combination - and considering the factual or legal context - confer the possibility of exercising decisive influence over an undertaking. Specifically, control can be established through either (a) ownership of, or the right to use, all or part of the assets of an undertaking; (b) rights or contracts that grant decisive influence over

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<sup>192</sup> Proposal for FDI Regulation (2024), 25

<sup>193</sup> Case C-516/19, *NMI v EuroNorm* [2020] ECLI:EU:C:2020:754, para 47

the composition, voting, or decision-making processes within an entity's governing bodies.<sup>194</sup> This definition of control has been extended to a myriad of other EU regulatory fields, like air travel and foreign subsidies.<sup>195</sup>

The MCR's notion of control also includes the possibilities of both direct and indirect control. According to Moisejevas and Urbonas (2017), indirect control in the context of the MCR merely refers to control exercised by a parent over a subsidiary of its own subsidiaries.<sup>196</sup>

The key question regarding control, when interpreted through the EU's merger control regime, is whether the mechanisms of political control confer the Communist Party the possibility to exert *decisive influence* over an enterprise. Such decisive influence must be exerted specifically over the commercial policy of the enterprise. Decisive influence is exerted where "the parent company has the power to direct the conduct of the subsidiary to the point of depriving it of any independence in determining its commercial course of action".<sup>197</sup> In other words, decisive influence exists when another entity can determine the strategic commercial behaviour of an undertaking.<sup>198</sup>

However, this avenue encounters significant hurdles for two primary reasons. Firstly, the rationales behind the FDI regime are distinct and very different from those regulations from which interpretation could be drawn from. For instance, in the EU's Merger Control regime, the notion of "control" primarily pertains to the possibility to exercise decisive influence over a company's strategic commercial decisions. This concept of control has been established to ensure that concentrations can be defined and, thus, ensured that they do not lead to a reduction of competition in the internal market of the EU.<sup>199</sup>

In contrast, the purpose of denoting "control" within the context of the EU's FDI Regulation, especially where it relates to state-control, serves a different objective. Here, the emphasis is purely on public order and security, rather than on economic competitiveness. The inclusion of

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<sup>194</sup> Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings, (hereinafter "Merger Regulation") Article 3(2)

<sup>195</sup> Regulation No 1008/2008 on common rules for the operation of air services in the Community, Article 2(9); Regulation (EU) 2022/2560 on foreign subsidies distorting the internal market, Article 20(5)

<sup>196</sup> Moisejevas, Raimundas, and Urbonas, Danielius, 'Problems Related to Determining of a Single Economic Entity under Competition Law' (2017) 10 Yearbook of Antitrust and Regulatory Studies 16, 115

<sup>197</sup> Case C-97/08 P, Akzo Nobel v Commission [2009] ECLI:EU:C:2009:536, para 22-26

<sup>198</sup> Andres Vaquero, Marta, 'The notion of control under the EU Merger Regulation' (Presentation, 18th EU-China Competition Week, 20 March 2019) <[https://competitioncooperation.eu/wp-content/uploads/2019/04/Day-3\\_Session-1\\_Marta-EN-28032019.pdf](https://competitioncooperation.eu/wp-content/uploads/2019/04/Day-3_Session-1_Marta-EN-28032019.pdf)> accessed 8 May 2024, 7

<sup>199</sup> EU Merger Regulation, Art. 2(1), paras 2 and 5

state-control in the FDI Regulation aims to scrutinize foreign investments which may pose security threats, or which may give state-controlled entities undue leverage over crucial sectors. This fundamental difference in objectives means that interpretations of control in one context cannot seamlessly inform the other, as they serve divergent purposes and address distinct risks.

Secondly, the EU's FDI regime operates as a derogation from certain EU fundamental freedoms, notably the free movement of capital. As such, the ECJ has ruled that the requirements included within FDI screening mechanisms must be interpreted strictly.<sup>200</sup> This follows from the principle of EU law where narrow interpretation should be given to derogations from fundamental freedoms such as the free movement of capital.<sup>201</sup> Thus, while other established legal terminology or principles within EU law may offer insights, the strict interpretation mandated for the EU's FDI regime restricts the flexibility to extrapolate meanings from different contexts within EU law.

Thus, it may be most logical to categorize the formulation of state-control within the FDI regime as a distinct legal concept of control, as opposed to merely aligning it with existing legal definitions of control found elsewhere in EU law. As such, it would seem that the exact contents and limits of state-control should be derived from the text of the 2024 Proposal itself. The specific context and purpose of the regulation, as well as the principle of narrow interpretation most likely precludes an expansive search for definitions across other areas of EU law. While legal notions such as that of control in the MCR or terms such as "public body" in EU law could offer insights into interpreting state-control, it's important to note that such arguments would inherently lack an authoritative basis and, thus, would not carry significant legal weight. Therefore, the 2024 Proposal's specific reference to state-control should, therefore, be understood and applied within its own context.

## **5.2 Interpreting Governmental Origin: The Role of the CCP in the EU's FDI Regime**

The first of the two concurrent criteria required to establish state-control is the governmental origin criterion. The text of the 2024 Proposal and the preceding 2019 Regulation provides for some foundational elements that enable a textualist interpretation of said criterion. While they

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<sup>200</sup> Case C-106/22, *Xella Magyarország v Innovációs és Technológiai Miniszter* [2023] ECLI:EU:C:2023:568, para 66

<sup>201</sup> De Cecco, Francesco, 'Fundamental Freedoms, Fundamental Rights, and the Scope of Free Movement Law' (2014) 15(3) *German Law Journal* 383, 390

may not offer an exhaustive level of detail, one can infer insights into their intended meaning and application by closely analysing the language of these documents.

The governmental origin criterion provides for a few examples of entities which may serve as proxies for control originating from the government, namely state bodies, regional or local authorities or armed forces. All included examples have formal authorities and responsibilities which are granted to them by the government and through public law. These entities are directly involved in providing public services and executing state functions. They are all formal government entities which operating directly under the government's auspices. They function as integral components of the government machinery.

SASAC, China's state-shareholder, undeniably fits within the framework. SASAC embodies the essence of a government entity. SASAC's functions align with those indicative examples provided in the Proposal; it operates as a state body with formal authorities and responsibilities bestowed upon it by public law. As an integral component of China's governance structure, SASAC functions under the government's auspices, reinforcing its status as a formal government entity operating within the governmental machinery.

Political parties, however, present a much more nuanced case. Political parties may hold large sway over the government, and this is particularly true in one-party states such as China. Even so, while the CCP wields considerable influence and control in Chinese society as well as holding absolute control over the political processes of the state, it does not neatly fit in with the examples of formal government entities outlined in the Proposal. Political parties, like the CCP, are political organizations rather than formal government entities. It does not hold the formal governmental authority or responsibility to administer public services or execute state functions. Moreover, the CCP's influence over the Chinese government is indirect and mediated through political processes, such as party appointments and policy directives. It operates as a political organization aimed at shaping government policies and decisions rather than directly implementing them.

These are all nominal separations, however. As has been noted by several scholars, international organizations and other observers, the CCP holds absolute control over the Chinese society and

the government under which it operates.<sup>202</sup> However, strictly adhering to a textualist interpretation, one may argue that a political party, such as the CCP, would not typically be classified as a proxy for the government. Textually, the term “government” implies official state entities rather than political parties.

Nevertheless, within the notion of state-control as outlined in the FDI regime, it is highly likely that the Commission intended to include entities that wield significant governmental power and influence, even if they are not explicitly part of the formal governmental apparatus. In the case of the CCP, its pervasive influence over state institutions, including its legislative bodies, makes it a de facto governing entity in China. Ignoring the CCP’s significant role in governance would overlook a crucial aspect of how power is exercised and controlled within the Chinese context.

Therefore, it becomes a question of whether the intent behind the regulation should supersede a strict textualist interpretation. Given the potential security risks and concerns associated with investments linked to entities like the CCP, it is conceivable that the Commission's intent in including state-control criteria extends beyond narrow textual definitions. Instead, the aim may be to capture entities that wield substantial governmental influence, regardless of formal organizational structures.

While recognizing the importance of considering the intent behind regulations, especially within the context of complex geopolitical dynamics, it is crucial to acknowledge that the FDI regime represents a derogation from the fundamental freedoms enshrined in EU law. Thus, its interpretation is guided by the narrow interpretation of its text. As such, a textualist interpretation arguably holds more legal standing within this framework than one based on the regulator’s intent.

### **5.3 Analyzing the Control Criteria: Manifestations of Control in the Chinese State-Sector**

The second of the two concurrent criteria which are required to establish state-control is the control-criterion. This chapter will scrutinize how the various manifestations of control mentioned in the text of the FDI regime, particularly in the 2024 Proposal, are applied in the

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<sup>202</sup> Bucker, Larry Catá, ‘The Party as Polity, the Communist Party, and the Chinese Constitutional State: A Theory of State-Party Constitutionalism’ (2009) 16(1) *Journal of Chinese and Comparative Law* 102, 102; Congressional Research Service, ‘China Premier: China’s Political System’ (29 January, 2024) <<https://crsreports.congress.gov/product/pdf/IF/IF12505>> accessed 28 May 2024

context of China's state-sector dynamics. While mechanisms of political governance is not explicitly mentioned as a manifestation of control in the text of the Proposal, this chapter will examine the named manifestations of control and assess whether they may be used as proxies for political control.

### 5.3.1 Exploring the Control Criterion and Ambiguities within the FDI Regime

According to the control criterion, state-control can be direct or indirect, and it may manifest in various ways, "including through ownership structure, significant funding, special rights or state-appointed directors or managers". In addition, the 2024 Proposal includes updated text according to which control can additionally be determined based on whether the foreign investor is "involved in pursuing policy objectives of third countries to facilitate their military capabilities".<sup>203</sup>

As such, the wording of the 2024 Proposal gives way for both direct and indirect forms of control, and specifically mentions certain manifestations of control. These forms of control are themselves difficult to apply to the complexities of the Chinese economy and its state-sector. Most pressingly for the purposes of this thesis, other forms of control are omitted from the 2024 Proposal's text. Although the Regulation's language suggests that the forms of control mentioned are indicative rather than exhaustive, the lack of an explicit mention of other forms of control raises interpretative challenges.

A notable method of influence, as has been shown in this thesis, is political governance by the CCP. This form of control does not neatly fit into the indicative list of various manifestations of control. Especially within private firms and mixed-ownership entities, the mechanisms of political governance are of particular significance when compared to more traditional forms of control, such as ownership or funding.

It is unclear what the Commission specifically envisages with the usage of the term "control" within the FDI regime. The term "control" is inherently quite ambiguous and, without specific definitions or contextual clarifications, the term may encompass a wide range of activities and relationships that differ significantly in scope and impact.

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<sup>203</sup> Proposal for FDI Regulation (2024), 25

In scenarios where the Chinese state assumes the role of the majority or controlling shareholder of a foreign investor, there exists little ambiguity regarding the applicability of the FDI regime to such instances. The manifestations of control explicitly mentioned within the text of both the 2024 Proposal and the 2019 Regulation include ownership. Thus, the substantial ownership stake held by the state directly brings such instances to the purview of screening under the FDI regime. In these cases, it is primarily the ownership structure that serves as the focal point for triggering screening processes.

However, as outlined in Chapter 3, the landscape of the Chinese state-sector has evolved much since the 2010s. Reforms initiated under the tenure of President Xi are reshaping the dynamics of state ownership and control in the Chinese state-sector. Increasingly, situations are emerging where the state relinquishes its status as the majority or controlling shareholder. Simultaneously, the CCP's role within state-controlled enterprises has only strengthened through the institutionalization of political governance mechanisms. Furthermore, as China's economic landscape has become increasingly intertwined with political imperatives, the delineation between state-controlled and private enterprises has become increasingly blurred.

Given this context, the determination of whether political governance can be considered in isolation, without the presence of controlling shareholding, becomes less straightforward. With the 2024 Proposal, in addition to ownership, the FDI regime is set to explicitly mention four other manifestations of control: significant funding, special rights, ability to appoint directors or managers, and the involvement in pursuing policy objectives.

### 5.3.2 Other manifestations of control as proxies for political control

The FDI Regulation includes several indicators which may be used to determine state-control, namely significant funding, special rights, ability to appoint directors or managers, and the involvement in pursuing policy objectives. It is outside the remit of this thesis to conclusively assess whether these manifestations of control are present in the relationship between the Chinese state and state-controlled entities. Instead, this chapter will focus on whether any of the mentioned indicators can be used as proxies for the mechanisms of political governance exercised by the CCP.

The 2024 Proposal extends the notion of control to include some specific manifestations of such control which are distinct from previous formulations of control. The 2024 Proposal includes updated text according to which control can additionally be determined based on whether such

foreign investor is “involved in pursuing policy objectives of third countries to facilitate their military capabilities”.<sup>204</sup> Inclusion of this language in the proposed update of the FDI Regulation represents a significant step forward in recognizing the multifaceted ways in which state-control may manifest. This language acknowledges the core risk related to state-controlled FDI: that is, the possibility of motives other than purely commercial ones behind investments. Alignment with the policy objectives of the State can often be indicative of control, and this broader definition is able to capture a wider array of FDI transactions.

This delineation, which explicitly only mentions the facilitation of military capabilities, seems like a deliberate choice by the Commission. It suggests that the Commission does not intend for Member States to consider alignment with broader policy objectives beyond those explicitly stated in the Regulation. The entirety of the 2024 Proposal seems to be aiming for a focused and direct approach to identifying and mitigating only the potential threats that are strictly related to security and public order. Thus, such alignment appears logical within the FDI Regulation’s broader framework.

Furthermore, it is settled case-law that only public order and security may serve as justifications for obstacles for the fundamental freedoms of EU law, such as the free movement of capital. Thus, it has been explicitly stated that economic grounds may never serve as such justifications.<sup>205</sup> The delineation made in the 2024 Proposal can, thus, be also seen as stemming from this fundamental principle affecting the FDI regime as a derogation from a fundamental freedom. Given this context, the Commission may have aimed to ensure that FDI screening mechanisms are tightly confined to grounds of public order and security by narrowing the scope to military-related policy objectives.

However, as demonstrated in this thesis, such specific alignment with the facilitation of military capabilities may overlook the various policy objectives of the CCP, the achievement of which the Chinese state-sector is tasked with. The policy objectives of China’s government and the Communist Party are diverse in nature and include a broad scope of goals that are not solely military in nature. This narrow delimitation may restrict the EU’s ability to effectively identify and evaluate when foreign investment is made by a state-controlled entity.

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<sup>204</sup> Proposal for FDI Regulation (2024), 25

<sup>205</sup> Case C-367/98, *Commission v Portugal* [2002] ECLI:EU:C:2002:326, para 52; Case C-54/99, *Association Église de Scientologie* [2000] ECLI:EU:C:2000:124, para 14

Moreover, within the Chinese context, the country's military-civil fusion (MCF) strategy blurs the lines between commercial and military advancements. In China, information sharing between market-oriented and defence industries is highly incentivized.<sup>206</sup> The U.S. Department of Defence, for instance, has specifically linked China's MCF strategy with overseas investments by Chinese entities under such policies like BRI. While these investments may be commercial in nature, they have the potential of indirectly facilitating China's ability better project and sustain military power abroad.<sup>207</sup>

Involvement in pursuing policy objectives is most certainly a manifestation of state-control and its inclusion in the 2024 Proposal no doubt allows for the inclusion of certain FDI activities which may otherwise fall outside the scope of state-control. Further, the inclusion of such language indicates an intent by the Commission to address indirect and non-traditional forms of control. However, the delineation to the facilitation of military capabilities does limit the FDI Regulations ability to capture state-controlled investment where more traditional means of control do not exist.

The 2024 Proposal includes "significant funding" as a criterion that may indicate state control. The 2019 Regulation explicitly included subsidies within the definition of funding in its preamble.<sup>208</sup> This mention has been removed from the 2024 Proposal, ostensibly due to the enactment of the Foreign Subsidies Regulation, which now separately addresses the distortive effects of subsidies from non-EU governments. However, the 2024 Proposal does not indicate that subsidies may not be considered when attempting to determine state-control of a foreign investor where a foreign investment may have adverse effects for security or public order.

Further, it should be noted that it is unclear whether "significant funding" refers to direct state funding of the specific foreign investment under review or if it refers more broadly to the general financial backing of the foreign investor by the state, regardless of the individual transaction.

Research shows that subsidies and other forms of state-supported funding may be significant even in companies where the state does not hold a controlling interest. According to Milhaupt

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<sup>206</sup> European Parliament, 'Security and defence implications of China's influence on critical infrastructure in the European Union' (17 January 2024) P9TA(2024)0028, para 4

<sup>207</sup> U.S. Department of Defense, 'Annual Report to Congress: Military and Security Developments Involving the People's Republic of China' (October 2023) 22 and 31

<sup>208</sup> 2019 Regulation, para 13

and Zheng, there is functionally no difference between SOEs, MOEs or even large POEs when it comes to the receipt of state subsidies. Especially large private enterprises which operate in globally competitive fields often see a large portion of their net profits constituted by subsidies.<sup>209</sup>

These companies may receive below market-rate access to financing and other subsidies, which facilitate individual FDIs. Chinese companies also benefit from subsidized access to various resources such as energy, which is strictly controlled and regulated by the government, and essential raw materials.<sup>210</sup> In particular large enterprises with state-ownership as well as those in strategic sectors and energy-intensive industries enjoy access to energy at below market value.<sup>211</sup> However, with the enactment of the Foreign Subsidies Regulation, it is unclear whether such funding will remain relevant going forward.

If the 2024 Proposal refers to funding of the foreign investor more broadly, such an indicator may indeed in some scenarios serve as a proxy for the political control of the entity in question. This assumption is based on the understanding that state funding might align the interests of a company with those of the state. However, the manifestation of political control is multifaceted, and it does not always operate through financial means.

Particularly in the context of China, the political control imposed by the Communist Party in itself may ensure that state-sector companies align with state policies and objectives, even without direct financial incentives. This control, as evidenced in this thesis, is exerted through a robust party presence within the corporate structures and a pervasive influence over corporate governance. Thus, while significant state funding may indicate potential state-control, the absence of such funding does not necessarily imply independence from state-control.

The FDI regime also recognizes the appointment of directors or managers by the state as a factor that may indicate control. As has been outlined in this thesis, the CCP's control over personnel management is one of the core objectives of the Party under the principle of Party Control of Cadres. Personnel management is a domain in which not only SOEs, but also MOEs and POEs have been increasingly pressured to grant more authority to IHCs.

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<sup>209</sup> Milhaupt and Zheng (2015) 668

<sup>210</sup> Matthes (2020) 43-44; OECD, 'Measuring Distortions in International Markets: The Aluminum Value Chain' (2019) OECD Trade Policy Papers 218, 27 and 120

<sup>211</sup> Matthes (2020) 43

This influence is further institutionalized through the adoption of corporate charter provisions that reinforce the role of IHCs. According to research by Lin and Milhaupt (2021), one of the most commonly adopted provisions under Xi's party-building policy was the codification of the IHC's oversight over personnel matters.<sup>212</sup>

However, as was highlighted in Chapter 4, the directors and managers appointed as a result of state-control are not necessarily appointed by the state. Here, the issue returns to the question of whether a political party, such as the CCP, can be equated to the government or, in this case, the state.

Further, the role of IHCs extends beyond personnel management in certain contexts. The IHCs of the CCP may wield influence over various aspects of governance and decision-making within enterprises, and they may have substantial influence even without oversight over personnel matters. While personnel management serves as a valuable indicator, it cannot fully capture the breadth of state-control.

Finally, the FDI regime includes special rights as an indicator of state-control. Special rights are often more familiarly known as "golden shares", which refer to various mechanisms that governments employ to maintain control over certain decisions in privatized companies. These special rights often enable the government to veto or hinder certain decisions in enterprises.<sup>213</sup> The most common types of special rights are those which grant the government exclusive rights to control changes in ownership as well as those which grant exclusive veto rights to the government on management decisions.<sup>214</sup> These rights are typically linked to tangible economic mechanisms, which ensure that governments are able to protect national interests in strategic sectors.

While the unique political governance methods employed by the CCP, particularly through the in-house cells embedded within enterprises, present a different and more complex form of control as compared to the traditional understanding of special rights, the two share some similarities. The institutionalization of political governance by the CCP under Xi, coinciding with the increased private capital infusion into the state sector, mirrors the retention of golden shares by the European governments during the privatization of their state-owned enterprises.

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<sup>212</sup> Lin and Milhaupt (2021) 205

<sup>213</sup> European Commission, 'Special rights in privatised companies in the enlarged Union—a decade full of development' (2005) Commission Staff Working Document, 1

<sup>214</sup> European Commission (2005) 5

Both instances reflect a shared objective of balancing governmental control with the utilization of private capital for economic growth.

Whether the language related to special rights may be expanded to also include such mechanisms of political governance remains a topic of debate. While there are compelling arguments in favour of such an extension, additional insights are necessary to reach any authoritative conclusion. Clear guidelines or directives from the Commission are required to provide much-needed clarity on this matter.

The examination of indicators of state-control within the EU's FDI regime in the context of China's state-sector underscores the complexities inherent in identifying and assessing such control. The 2024 Proposal introduces an updated list of indicators, namely including the involvement in pursuing policy objectives related to military capabilities, reflecting a recognition of the multifaceted nature of state-control. However, the narrow delineation of this indicator may overlook the broader policy objectives of the CCP, potentially undermining its effectiveness.

Additionally, while indicators such as significant funding, appointment of directors or managers, and special rights offer insights into potential state-control, their interpretation requires a careful balance between avoiding unwarranted expansiveness in definitions while remaining sensitive to the complex nature of political governance in China. Ultimately, explicit guidance from the Commission or case-law from the ECJ is required to reach conclusions on these matters.

## 6 Conclusions

This thesis has systematically explored the complexities and nuances of state-control within the framework of the EU's FDI Regulation, including its 2024 Proposal, and contrasted them against the operational dynamics of state-control in China, particularly through the mechanisms of the CCP's party apparatus, especially IHCs. This analysis has highlighted that the EU's existing regulatory mechanisms, while robust in dealing with traditional forms of state influence, are potentially less equipped to address the more intricate and covert forms of control exercised by the CCP.

The FDI Regulation presupposes a model of state-control which is characterized by visible state involvement. However, as evidenced in the Chinese context, state-control can manifest through deeply embedded political influences that extend beyond governmental ownership or overt financial control. The CCP's strategy of using IHCs to influence decisions not through overt commands but through a form of control that is less transparent and more diffused.

While the 2024 Proposal does attempt to better define the scope of state-control, challenges remain in fully capturing the influence exerted by a political entity such as the CCP. Moreover, reforms of the state-sector under President Xi have the potential of underscoring these challenges, as the state is increasingly taking a backseat as a shareholder and ceding control to the IHCs. These reforms, which have further privatized the state-sector, have also strategically ensured that the CCP retains substantial influence over these enterprises, particularly through the institutionalization of IHCs. The acceleration of these mixed-ownership reforms signifies a deliberate strategy by the CCP to enhance competitiveness of its state-sector without relinquishing political control.

The comparative analysis between EU's formalistic approach to state-control and China's integrated model of political and economic governance reveals a critical gap in the EU's capability to screen and manage foreign investments that are subtly influenced by foreign state actors. This gap calls for a broader understanding of what constitutes control in the context of global economic interactions.

There are compelling arguments that the EU's current formulation of state-control with its existing and explicitly named manifestations of control may, to some extent, consider the realities of Chinese political governance. However, drawing definitive conclusions in this regard is not possible without further guidelines from the Commission or the ECJ.

Given that the 2024 Proposal is still pending implementation, addressing the current text's inadequacy in accommodating Chinese political governance should be a crucial consideration for both the Commission and Member States. Resolving these uncertainties before the regulation comes into effect would be prudent to ensure clarity and the effectiveness in its application.

As the EU continues to navigate the complexities of international trade and investment, the insights from this thesis underscore the need for a more nuanced understanding of state-control that goes beyond traditional metrics. This is imperative not only for enhancing the efficacy of the EU's FDI Regulation, but also for ensuring that the EU remains resilient against the strategies employed by states like China, which blend economic ambitions with political objectives.