CHINESE INVESTMENT IN THE UNITED STATES: IMPACTS AND ISSUES FOR POLICYMAKERS

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED FIFTEENTH CONGRESS
FIRST SESSION

THURSDAY, JANUARY 26, 2017

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2017

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the "Consolidated Appropriations Resolution, 2003," Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of the Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the "Consolidated Appropriations Act, 2008," Public Law Nol. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December); as amended by the Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act for Fiscal Year 2015, P.L. 113-291 (December 19, 2014) (regarding responsibilities of the Commission).

The Commission's full charter is available at www.uscc.gov.

March 9, 2017

The Honorable Orrin Hatch
President Pro Tempore of the Senate, Washington, DC 20510
The Honorable Paul Ryan
Speaker of the House of Representatives, Washington, DC 20515

DEAR SENATOR HATCH AND SPEAKER RYAN:

We are pleased to transmit the record of our January 26, 2017 public hearing on "Chinese Investment in the United States: Impacts and Issues for Policymakers." The Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Pub. L. No. 106-398 (as amended by the Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act for Fiscal Year 2015 § 1259b, Pub. L. No. 113-291) provides the basis for this hearing.

At the hearing, the Commissioners heard from the following witnesses: Thilo Hanemann, Director and Economist, Rhodium Group; Jeff Johnson, President and CEO, SquirrelWerkz; James Stengel, Partner, Orrick Herrington Sutcliffe LLP; Robert Atkinson, President, Information Technology and Innovation Foundation; Patrick Woodall, Research Director and Senior Policy Advocate, Food & Water Watch; Patrick Jenevein, CEO, Tang Energy Group and Chairman, WattStock LLC; Shaswat Das, Senior Attorney, Hunton & Williams LLP; Paul Gillis, Professor of Practice, Peking University's Guanghua School of Management; Peter Halesworth, Managing Partner, Heng Ren Partners LLC.The subjects covered included recent trends in Chinese investment in the United States, the implications of Chinese investments in strategic sectors of the U.S. economy, and the activities of Chinese companies listed on U.S. stock exchanges.

We note that the full transcript of the hearing will be posted to the Commission's website when completed. The prepared statements and supporting documents submitted by the participants are now posted on the Commission's website at www.uscc.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2017 Annual Report that will be submitted to Congress in November 2017. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Leslie Tisdale, at 202-624-1496 or ltisdale@uscc.gov.

Sincerely yours,

Carolyn Bartholomew
Chairman

Hon. Dennis C. Shea
Vice Chairman

cc: Members of Congress and Congressional Staff

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THURSDAY, JANUARY 26, 2017

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CHINESE INVESTMENT IN THE UNITED STATES: IMPACTS AND ISSUES FOR POLICYMAKERS

THURSDAY, JANUARY 26, 2017

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in Room 419 of Dirksen Senate Building, Washington, D.C. at 9:00 a.m., Commissioners Robin Cleveland and Michael R. Wessel (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF COMMISSIONER MICHAEL R. WESSEL HEARING CO-CHAIR

HEARING CO-CHAIR WESSEL: Welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2017 Annual Report cycle. I want to thank all of you for joining us today--and one of our witnesses will be here shortly.

I also want to recommend and invite and welcome our newest commissioner, Mr. Commissioner Jon Stivers, who was appointed late last year, and this is his first hearing. And thank our staff, especially Sean, who set up all of today's events.

Today's hearing comes at an important time. More than ever, China's economic activities are having a clear and direct impact on the lives of average Americans. This impact is clearly evident in the rise of Chinese investment in advanced sectors of the U.S. economy, including semiconductors and biotech, even as the Chinese government continues to restrict the ability of U.S. companies to invest in the same sectors, raising serious concerns for U.S. economic interests and national security.

As our new administration prepares to formulate policy towards China, it is important to separate fact from fiction in our discussion of the key drivers and impacts of China's economic activities in the United States.

According to data from the Rhodium Group, Chinese investment flows to the United States have grown steadily in recent years, reaching nearly $46 billion in 2016, a threefold increase from 2015. The speed of this investment flow growth coupled with a lack of reliable government data, both in China and the United States, has hindered efforts to accurately analyze trends in Chinese investment while also masking some of the risks and benefits these investments present to the United States.

Even with limited official information, however, it is clear that Chinese investment is targeting sectors of strategic importance to the United States economy.

Firms like the Rhodium Group, which prepared a recent report for the Commission and is represented by Thilo Hanemann here today, have contributed a great deal to the debate with their investment tracking efforts. However, we are still lacking the kind of granular data and long-term analysis needed to thoroughly understand what's happening with Chinese firms operating here.

Do they operate like Western firms? What happens with management, their inputs, R&D activities, wage and compensation policies, and so many other metrics that are regularly measured and analyzed for other foreign-invested enterprises?

And as we will hear today, are Chinese entities engaging in activities to diminish the market value of our companies as they put them in their sights, then scoop up their assets for a song? How do these companies access our financial markets and how do they finance their operations?

These and many other questions and concerns must be addressed in light of China's growing presence here in the U.S. and its rise on the world stage.

Our hearing will begin with an analysis of key trends in Chinese investment in the United States. Special attention will be paid to investments in key economic sectors, such as information and communications technology, agriculture and biotechnology, and manufacturing. The impacts of investments in these sectors along with recent cases of Chinese state-owned companies claiming sovereign immunity in U.S. courts and duress acquisitions of U.S. entities by Chinese firms will be discussed and debated by our expert witnesses.

We will hear testimony from the first two panels this morning before adjourning for a lunch break at 12:30. We will reconvene in this room at 1:30 for the final panel.

And let me now turn to my co-chair, Commissioner Robin Cleveland, for her opening remarks.

PREPARED STATEMENT OF COMMISSIONER MICHAEL R. WESSEL HEARING CO-CHAIR

Hearing on "Chinese Investment in the United States: Impacts and Issues for Policymakers"

Opening Statement of Commissioner Michael R. Wessel
January 26, 2017
Washington, DC

Good morning, and welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2017 Annual Report cycle. I want to thank you all for joining us today.

Today's hearing comes at an important time. More than ever, China's economic activities are having a clear and direct impact on the lives of average Americans. This impact is clearly evident in the rise of Chinese investment in advanced sectors of the U.S. economy, including semiconductors and biotech, even as the Chinese government continues to restrict the ability of U.S. companies to invest in the same sectors, raising serious concerns for U.S. economic interests and national security. As our new administration prepares to formulate policy toward China, it is important to separate fact from fiction in our discussion of the key drivers and impacts of China's economic activities in the United States.

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Let me now turn to hearing co-chair Commissioner Robin Cleveland for her opening remarks.

OPENING STATEMENT OF COMMISSIONER ROBIN CLEVELAND HEARING CO-CHAIR

HEARING CO-CHAIR CLEVELAND: Thank you, Commissioner Wessel, and thank the staff for an extraordinarily well-prepared briefing book. Good morning and thank you all for coming.

In the initial stages of reform and opening up, the Chinese government invited foreign companies to help stimulate domestic growth. Now we are witnessing the start of a new period with Chinese companies beginning to expand abroad.

Unable to access sufficient capital from China's state-owned banking system and undersized bond market, Chinese companies increasingly are relying on foreign investors to keep their businesses operating and growing.

Today, around 135 companies are listed on major U.S. stock exchanges. Among them, the Chinese giants Alibaba, Tencent and Baidu. However, the complex legal structures of these U.S. listings and the shroud of China's secrecy laws and opaque auditing practices allow companies to shield themselves from U.S. legal and regulatory jurisdiction. As a result, these listings may pose risks for unsuspecting U.S. investors who buy U.S.-listed companies.

For the last decade, U.S. negotiators have sought to protect investors in U.S. capital markets by ensuring that all public accounting firms adhere to U.S. auditing standards. Public statements about the status of the ongoing negotiations between auditors and their U.S. counterparts, however, have shown little progress in securing more transparent accounting practices in China.

In today's hearing, we will evaluate the activities of Chinese companies listed on U.S. stock exchanges and the regulatory mechanisms that govern their activity and protect U.S. investors. To this end, we will be joined by a number of experts from the business, legal, and academic fields in our third panel of the day.

I do want to note that, Mr. Hanemann, I hope you speak to this, while there are risks, I think in your report to the Commission, you note that the vast majority of trade theft and espionage that we are most concerned about are not tied to these foreign direct investments.

So with that, do you want to introduce the panel or would you like me to?

PREPARED STATEMENT OF COMMISSIONER ROBIN CLEVELAND HEARING CO-CHAIR

Hearing on "Chinese Investment in the United States: Impacts and Issues for Policymakers"

Opening Statement of Commissioner Robin Cleveland
January 26, 2017
Washington, DC

Thank you, Commissioner Wessel, and good morning, everyone. Thank you all for being here. I would also like to thank the Senate Committee on Foreign Relations and its staff for helping to secure today's hearing venue.

In the initial stages of reform and opening up, the Chinese government invited foreign companies to help stimulate domestic growth. Now, we are witnessing the start of a new period, with Chinese companies beginning to expand abroad. Unable to access sufficient capital from China's state-owned banking system or undersized bond market, Chinese companies increasingly rely on foreign investors to keep their businesses operating and growing.

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First, however, I will kick off our first panel by introducing the three experts here to discuss Chinese investment activities in the United States.

PANEL I INTRODUCTION BY COMMISSIONER ROBIN CLEVELAND

HEARING CO-CHAIR CLEVELAND: So we'll start today by examining the key trends and impacts of Chinese investments in the U.S. We have three seasoned--that makes you feel old, doesn't it--

[Laughter.]

HEARING CO-CHAIR CLEVELAND: --leaders in business, investment and law to discuss their research and expertise.

Welcome, Mr. Hanemann. You're the Director and Economist at the Rhodium Group where you lead the firm's work on global trade and investment issues. Your most recent work focuses on evolution of Chinese international investment position, including a report, “Chinese Investment in the U.S.: Recent Trends and Policy Agenda,” which we sponsored.

You were educated at the Free University in Berlin, Nanjing University, a lovely town, and Columbia in New York. I think you recently testified in 2013.

Next we do not yet have Mr. Johnson, the President and CEO of SquirrelWerkz Cyber, Competitive, and Economic Treat Intelligence Management Solutions.

Mr. Johnson draws upon his 30 years of successful cyber, intelligence, and financial services experience to deliver innovative cross-discipline cyber and economic risk management solutions. He previously served as an Executive Director at Ernst & Young where he led the development and implementation of their Cyber Economic Risk Solution Model. He graduated from Excelsior College.

Finally, we welcome Mr. Stengel, who is here, a partner in the law firm Orrick. Mr. Stengel has substantial experience in litigating, trying, and resolving cases involving cross-border or multi-jurisdictional elements and has represented Chinese companies in litigation in the U.S. courts.

Most recently, he successfully argued for the sovereign immunity of a top-level state-owned enterprise under the Foreign Sovereign Immunities Act.

You hold your J.D. from the University of Michigan and your B.A. from the University of Illinois.

I welcome you both. Each witness has about seven minutes to deliver your statements, which will be challenging because your prepared testimony was excellent and very thorough. So give it your best shot to keep it to seven.

We'll start with you, Mr. Hanemann.

**OPENING STATEMENT OF MR. THILO HANEMANN
DIRECTOR AND ECONOMIST, RHODIUM GROUP**

MR. HANEMANN: Co-chairs and members of the Commission, thank you for the opportunity to testify today.

The United States has a long history of welcoming foreign investment with only minimal restrictions based on national security considerations. However, U.S. investment policy has periodically been updated and adjusted in response to changes in the nature of global FDI flows and the emergence of new investors, for example, Japanese companies in the 1980s or sovereign funds from the Middle East in the 2000s.

In all those instances, policy adjustments were carefully designed to address specific concerns and lawmakers were mindful not to put at risk the many, many benefits that the U.S. has been receiving from its general openness to foreign investment.

I do believe that the recent increase of Chinese investment does warrant a discussion about the adequacy of U.S. FDI policy because China is different in many ways: it has a vastly different economic system with heavy state intervention; it has a nondemocratic political system without rule of law; and, last but not least, it is a geopolitical competitor of the United States.

At the same time, it is my conviction that it is important that this debate that we're having is guided by facts and by data, not by emotions and special interests.

As an economist at Rhodium Group, I have been closely following Chinese outbound investment for the past decade. We have built a unique database that captures all Chinese direct investment transactions in the U.S. economy since 1995, giving us a very detailed perspective on the activities of Chinese companies in the U.S. economy.

My colleagues and I have published numerous studies on the topic of Chinese investment, and, as you know, most recently we produced a report for the Commission that summarizes and describes the recent trends and analyzes the implications for U.S. policy.

In my remarks today, I would like to present the most important data points and the policy recommendations that we draw from our research.

Starting with the data highlights, first, and I think Commissioner Wessel already mentioned, that official statements are a poor measure for the scale and patterns of Chinese FDI in the U.S. This is not because Chinese companies are trying to fly below the radar but because statistical agencies in both China and the U.S. are primarily tasked with capturing financial flows based on balance of payments considerations.

Alternative data sets based on collecting and aggregating individual transactions are therefore indispensable for properly understanding the latest trends of Chinese investment.

Looking at transactions data, we see that Chinese FDI in the United States has grown rapidly with a particularly sharp increase in 2016. We have gone from an annual average of less than $500 million before 2008 to about $15 billion in 2015 and almost $46 billion in 2016. By the end of 2016, the cumulative value of Chinese FDI transactions in the U.S. totaled $109 billion. So the stock, if you want.

More than 90 percent of that capital--9-0--has entered the U.S. through acquisitions and not greenfield FDI.

Third, Chinese companies are investing in a broad range of U.S. industries with a particular focus on technology, modern services, and safe haven assets. Before 2013, the majority of Chinese capital was flowing into natural resource extraction. Since then, investment in energy has dropped sharply and flows are now driven by interest in technology, modern services, and commercial real estate.

Fourth, Chinese investment is not just focused on the rich coastal economies but it is spread widely across the country. By the end of 2016, 47 out of 50 U.S. states had received significant investment from China. The top five recipient states of Chinese capital were California, New York, Illinois, Kentucky and Virginia.

Fifth, the mix of Chinese investors in the U.S. is diverse. But in recent years flows have been dominated by privately-owned enterprises. State-owned enterprises were responsible for the majority of investments from 2009 to 2013. Since 2014, private companies have been the main drivers, accounting for 79 percent of investments over the past three years.

That said, private companies can have strong ties to the Chinese government through financing arrangements and executives. So any policies based on nominal ownership are, in my view, problematic.

Sixth, most investments can be explained by commercial considerations, but Chinese government policy is an important variable as well. Beijing influences investment patterns through both administrative measures allowing or discouraging certain types of flows, as well as economic and industrial policies that set incentives for companies to invest in specific industries, geographies, and technologies.

I hope these initial data points provide a useful starting point for this first panel, and I would like to conclude my testimony with just a few of our recommendations for U.S. policymakers.

In our view, the U.S. system for screening inbound FDI has generally handled the inflow of Chinese investment well, permitting the benefits while at the same time managing concerns appropriately.

In response to the latest increase and the changes that we observe in the patterns of Chinese FDI, we recommend the following priorities to U.S. policy:

First, Congress should ensure that the Committee on Foreign Investment in the United States, CFIUS, as well as regulators and law enforcement have sufficient resources to fulfil their mandates and to monitor new developments and patterns that could impact U.S. national security.

Second, now is the right time for us to explore options to address concerns about economic risks without sacrificing the many benefits. Two key concerns are the discrepancy between market access for Chinese investors in the U.S. and U.S. investors in China and the potential spillover of market distortions based on state ownership, subsidies and other non-market elements in the Chinese economy. Policymakers should explore mechanisms to address those concerns without resorting to abstract concepts such as a "net benefit test."

Third, the expansion of local presence and assets in the U.S. through FDI should increase the accountability of Chinese companies in U.S. courts.

Lawmakers should review and, if necessary, close potential loopholes that allow companies to escape that accountability.

Finally, and this may go against the current spirit in Washington, but it is my conviction and it indispensable that the U.S. coordinates with partners and like-minded market economies on policies with a regard to Chinese investment. Debates about security and economic risks arising from Chinese investment are happening in many or most other OECD economies and coordination with those countries would increase U.S. leverage and the effectiveness of policies.

Thank you for your attention, and I look forward to answering any questions that you may have.

PREPARED STATEMENT OF MR. THILO HANEMANN
DIRECTOR AND ECONOMIST, RHODIUM GROUP

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

Thilo Hanemann

Director and Economist

Rhodium Group

Co-chairs, members of the Commission: thank you for the opportunity to testify today.
As director and economist at the Rhodium Group, I have been closely following Chinese outbound investment for the past decade. I have built a unique database that captures all Chinese direct investment transactions in the United States since 1995, which gives me a very granular perspective on the activities of Chinese companies in the U.S.

Over the past decade, I have published numerous studies on Chinese investment in the US with the goal of contributing to a data- and facts-driven public debate about the benefits and risks of this new dimension of US-China economic relations.

In 2016, I co-authored a report for the U.S.-China Economic and Security Review Commission ("Chinese Investment in the United States: Recent Trends and the Policy Agenda"), which describes recent patterns of Chinese foreign direct investment (FDI) in the U.S., analyzes the policy environment in the US and China, and puts forward our view on the implications for policymakers.

This written statement summarizes the findings of that report, provides an update on the full year 2016 numbers, and discusses recent policies in China that tighten the administrative control over capital outflows. Charts pertaining to the statement can be found in the Appendix.

1. Patterns and Growth of Chinese Direct Investment in the United States

Public attention on Chinese FDI in the United States is at unprecedented levels, but available official statistics do not offer a coherent perspective on the level and recent patterns of these inflows. Figures 1 and 2 in the Appendix summarize available data points. Estimates of the total stock of total Chinese FDI in the United States range from $21 billion, according to the US Bureau of Economic Analysis (BEA), to $47 billion, according to China's Ministry of Commerce (MOFCOM).[1] Data points that try to capture the flows of China's U.S. FDI in the

[1] FDI stock refers to the cumulative value of FDI flows at a given point of time, either at historical value or adjusted for market prices.

last 5 years also differ greatly and are sometimes contradictory. BEA's balance of payments (BOP) figures show annual flows fluctuating between $1 and $5 billion during 2011-2015; MOFCOM shows a steady increase from $1.3 billion in 2010 to $7.6 billion in 2014.

Given these discrepancies and other shortcomings, alternative datasets based on aggregating individual transactions are indispensable for properly understanding the latest trends of Chinese investment and metrics relevant for policy. These datasets record a higher stock of Chinese FDI in the U.S. and greater levels of investment in recent years than official statistics. The most detailed dataset available is Rhodium Group's China Investment Monitor (CIM), which includes more than 1,200 individual investments from 2000 to 2015, together amounting to $64 billion.[2]

The CIM dataset also offers a timely perspective on the growth of Chinese inflows in recent years. The combined value of Chinese FDI transactions in the U.S. has grown from an annual average value of less than $500 million before 2008 to $15.3 billion in 2015. In 2016, Chinese corporations spent a new record of $45.6 billion on acquisitions and greenfield projects in the United States. This is three times as much as in 2015 and pushed total cumulative Chinese FDI in the U.S. from $64 billion to $109 billion. Figure 3 in the Appendix displays the recent growth trajectory of Chinese FDI in the U.S., relaying on Rhodium Group's transactions data.

2. Industry Composition and Geographic Distribution

Chinese FDI is increasingly headed toward advanced manufacturing, services and safe haven assets. China's U.S. investments have broadened from trade facilitation and natural resource extraction to a more diverse set of activities. Since 2013, investment in unconventional oil and gas extraction has declined substantially from previous years. This drop was balanced by rapid growth of investment in technology and innovation-related activities and modern service sector assets. Chinese companies seeking to move up value chains, access U.S. markets directly, and capitalize on the U.S.'s research and development capabilities have led this charge. In recent years, we record fast expansion of investment in U.S. subsidiaries engaged in research and development as well as manufacturing.

In the past three years, Chinese investors have also ramped up their investments in commercial real estate and other safe haven assets that allow them to diversify away from China. Figure 5 in the Appendix provides an overview of Chinese FDI by sector for three different periods of time. Most Chinese capital is still entering the U.S. through the acquisition of existing assets, but greenfield FDI is growing fast and numerous large projects are currently under construction.

This investment is now spread widely across the U.S. Figure 4 in the Appendix shows cumulative Chinese FDI in each state since 2000, logged by the location of greenfield projects and headquarters of acquired companies. By the end of 2016, 47 out of 50 states had received investment from China. The top five recipients of Chinese capital were California, New York, Illinois, Kentucky, and Virginia.

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[2] http://rhg.com/interactive/china-investment-monitor.

3. Characteristics of Chinese Investors

The shift in investment patterns has also transformed the mix of Chinese investors in the U.S. economy (Figure 6 in the Appendix).[3] Before 2005, the mix of Chinese investors in the U.S. consisted of large state-owned investors as well as small privately-owned trading and manufacturing companies, but investment values were tiny. In 2005, then state-owned firm Lenovo made the first sizable investment in the U.S., which dominated cumulative investment until 2009. From 2009 to 2013, Chinese capital inflows were predominantly state-related, as state-owned enterprises (SOEs) in energy and a handful of other sectors expanded their footprints. At the peak in 2011, SOEs accounted for 53% of cumulative Chinese FDI in the U.S. Since then SOE investment has continued, but growth has been largely driven by privately owned companies. In 2015 and 2016, privately owned companies accounted for 78% and 79% of total investment, respectively. By the end of 2016 the share of state-owned entities in cumulative investment fell to 27%, and privately owned companies accounted for 73% of the total.

A table of the largest Chinese investors in the U.S. (Table 1 in the Appendix) shows that all of the top five and 12 out of the top 20 investors are private. The largest private investor is HNA, the parent of Hainan Airlines, and owner of Ingram Micro, a distributor of information technology products, as well as real estate and hotel assets. Second is Wanda, an entertainment and real estate conglomerate with major investments in the U.S. film industry. Insurance company Anbang is in third place through its investments in real estate and hospitality. Shuanghui (now WH Group), which acquired pork producer Smithfield in 2013, is fourth. Lenovo, an early investor in 2005 with two more major deals in 2014 (acquisitions of IBM's x86 server division and Motorola Mobility) is a close fifth. The largest SOE investors are oil companies Sinopec and China National Offshore Oil Corporation (CNOOC), Aviation Industry Corporation of China (AVIC), China Life, the insurance company, and China Investment Corporation (CIC), China's primary sovereign wealth fund.

While privately owned companies now dominate, recent Chinese restructuring plans suggest that SOEs will remain an important part of China's FDI flows in years ahead. More importantly, it is difficult to properly classify SOEs and the distinction between private and state-owned companies for policy analysis based on nominal equity ownership is problematic. China's state-dominated financial system and the lack of rule of law means that state involvement can be pervasive, even if a firm is nominally privately owned.

[3] The category of state-owned investors includes central SOEs under the State-Owned Assets Supervision Administration and Commission, local SOEs controlled by provincial or municipal governments, sovereign investors, and any other entities that have more than 20% combined government ownership. The category of private investors includes companies that are at least 80% owned and controlled by non-state-related investors. We chose the 80% threshold because most listed companies have small, passive stakes from state-related entities such as commercial banks, which makes a 100% threshold for the category of private ownership problematic for our analytical purposes.

4. Chinese Outbound Investment Policy

Chinese government policies are important variables for explaining the patterns of China's global outbound investment and its FDI footprint in the United States. For most of the first two decades of China's economic reform period, Chinese companies were forbidden from investing overseas unless they had direct approval from the government. This restrictive stance changed only gradually starting in the early 2000s when the Chinese government began to liberalize and encourage outbound investment. In the past five years, China has further liberalized its outbound investment approval regime, so that most investments now only need to be registered with the two main regulators, MOFCOM and the National Development and Reform Commission (NDRC). This streamlined process, which is summarized in Figure 7 of the Appendix, has made it much easier for private companies to invest overseas, which partially explains the surge in private outbound investment.

In the past 18 months, outward FDI has grown so rapidly that Chinese leaders felt compelled to slow down outflows. Since mid-2014, China's balance of payments conditions have changed substantially with the financial account shifting from a surplus to a deep deficit. Net capital outflows accelerated after the one-off yuan depreciation in mid-2015, with more than $150 billion of net outflows per quarter in 3Q and 4Q 2015. The post-election spike in the U.S. dollar sent the RMB/USD exchange rate below the 6.90 level and further accelerated outflows in late 2016. Additional pressure looms with expectations of further Fed rate hikes in 2017. In response to these changing BOP dynamics, Chinese authorities have re-tightened administrative controls for outbound FDI. In early 2016, China's central bank began to ask banks to increase scrutiny on foreign exchange conversion. In November 2016, the State Council issued guidance that discourages outbound transactions with certain characteristics, among them large deals and investments that principally seek financial returns. At the same time, leaders and regulators reaffirmed support for legitimate outbound FDI transactions. The situation is currently in flux and new formal rules that bring greater clarity on which transactions are considered "illegitimate" are expected in the first quarter of 2017.

In addition to administrative measures allowing and discouraging certain types of transactions, the Chinese government also influences the patterns of outbound investment through broader economic policy as well as incentives and policies aimed at promoting overseas investment in specific industries, technologies and geographies. However, current data do not allow clear-cut conclusions about causality between industrial policy and outbound investment patterns. Examining Chinese investment into the U.S., it is impossible to determine whether investments in targeted sectors are directly driven by a specific policy, or whether they are the result of Chinese companies' own business interests. Additionally, Chinese industrial policy support is so broad as to render it difficult to classify. We do not find compelling evidence that Chinese industrial policy broadly explains outbound FDI in the U.S., but there are individual cases in which the relationship is qualitatively and anecdotally apparent.

The surge in global takeover offers in the semiconductor industry is the most notable example of the industrial policy-outbound investment nexus. Since 2014 Chinese private and state-affiliated players have hastened to explore US semiconductor asset acquisitions following a central government initiative to strengthen China's domestic semiconductor capabilities. Cumulative Chinese investment in the US semiconductor industry amounted to only $200 million before 2014, but investment activity soared in 2014 and 2015, with more than $800 million of completed transactions (and several failed takeover attempts) in those two years (see Figure 7 in the Appendix).

5. U.S. Policy to Review Inbound Investment

The current U.S. system for screening inward FDI has generally handled the influx of Chinese investment well thus far, simultaneously permitting the benefits while addressing concerns. The U.S. government has identified and blocked acquisitions that could have threatened national security interests while allowing the vast majority of investments to proceed. Importantly, review by the Committee on Foreign Investment in the United States (CFIUS) is not the last opportunity to regulate the behavior of Chinese firms. Recent cases illustrate that the expansion of local presence and assets through FDI means that Chinese companies can be held accountable in U.S. courts in cases of non-compliance with laws or commercial disputes, which is good news for U.S. regulators and businesses.

While the U.S. system has generally worked well in the past, investment from China may require a re-assessment of traditional risks related to FDI because China is different than most other countries that have significant FDI stocks in the U.S. economy: it has a vastly different economic system with heavy state intervention, it has a non-democratic political system without rule of law, and it is emerging as a geopolitical competitor of the United States in the international system.

There is no prima facie reason to presume that FDI originating from China is not, on net, beneficial, due to these factors. Utilizing our database, we find little to no deleterious side effects thus far. However, atypical Chinese characteristics, such as state-directed collusion among firms in some concentrated sectors, may require new approaches to screening inward investment if those characteristics do not subside.

6. Priorities for Policymakers

Based on my understanding of Chinese investment patterns and related benefits and risks, I recommend Congress to focus on the following priorities:

First, national security screening and law enforcement need adequate resources. I do not see immediate urgency to change the CFIUS mandate or processes, but our data and case studies point to two important dimensions to ensure the efficiency of the current approach. For one, the Treasury Department and CFIUS as a whole need to have sufficient resources to fulfill their mandates. The increase of Chinese FDI means that the number of reviewed transactions has grown rapidly in recent years, requiring additional resources to ensure an efficient process. Moreover, the growing local presence of Chinese companies and citizens means that U.S. regulators and law enforcement need to have the appropriate resources to monitor new developments and assess their implications for U.S. national security, for example local R&D cooperation with Chinese-owned companies, technology licensing by U.S. firms to local subsidiaries of Chinese companies, or early stage technology financing.

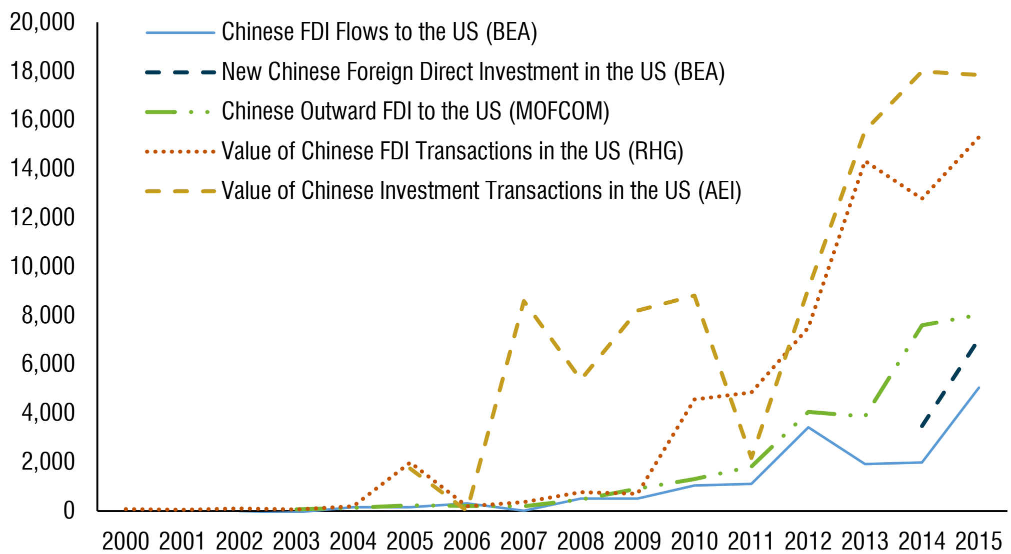
Second, lawmakers should explore options to address concerns about economic risks**.** The discrepancy between market access for Chinese investors in the U.S. and U.S. investors in China, and the potential transmission of distortions caused by state-owned enterprises, subsidies and other non-market elements in the Chinese economy are the two key concerns. Simple calls for reciprocity are misguided but we recognize the need for greater symmetry in the two-way U.S.-China FDI relationship as a bulwark against further erosion of mutual trust and perceptions. We also share concerns about competition policy fundamentals and the potential for market distortion if Chinese FDI continues to grow without clearer separation between political authorities and commercial entities at home. If the scale of China's participation in the U.S. reaches the levels we forecast, and the comingling of commercial and political motives is not resolved, then a new chapter in U.S. – and global – competition policy activism may be required.

I also strongly believe that a bilateral investment agreement with China offers significant opportunities. A robust bilateral investment treaty (BIT) that gives U.S. investors pre-establishment rights in China limited only by a narrow list of restricted industries would help to level the playing field, which would contribute to avoiding the politicization of two-way FDI flows and thus sustaining the benefits of Chinese inflows into the United States for the long-term. At the same time, a BIT with China will not dilute existing U.S. authority to scrutinize Chinese investment for legitimate purposes.

Finally, recent attempts by Chinese SOEs to claim immunity have predictably triggered efforts to tighten loopholes, while firms place higher risk premiums on dealing with Chinese investors, showing that the system is functional. Lawmakers should further review and, if necessary, close potential loopholes that allow companies to escape accountability.

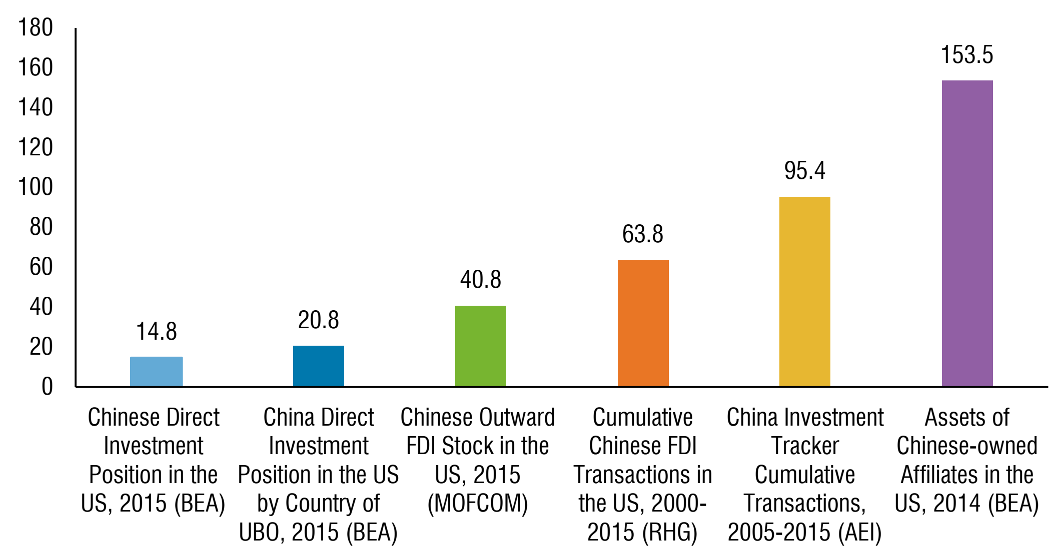
Appendix: Figures and Tables

Figure 1: Comparison of Available Data for Chinese FDI Flows to the US, 2000-2015
USD million



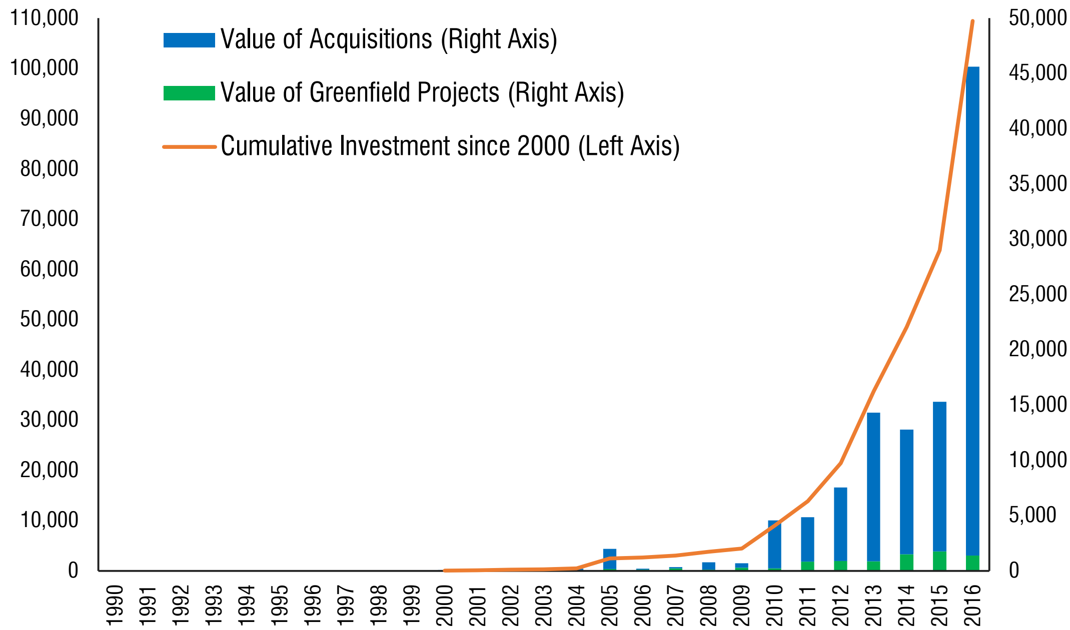
Source: "Balance of Payments and Direct Investment Position Data", Bureau of Economic Analysis, "China's Outward Foreign Direct investment", Ministry of Commerce, American Enterprise Institute, Rhodium Group.

Figure 2: Comparison of Available Data for Chinese FDI Stock in the US, 2015
USD million



Source: "Balance of Payments and Direct Investment Position Data" and "Data on Activities of Multinational Enterprises", Bureau of Economic Analysis, "China's Outward Foreign Direct investment", Ministry of Commerce, American Enterprise Institute, Rhodium Group.

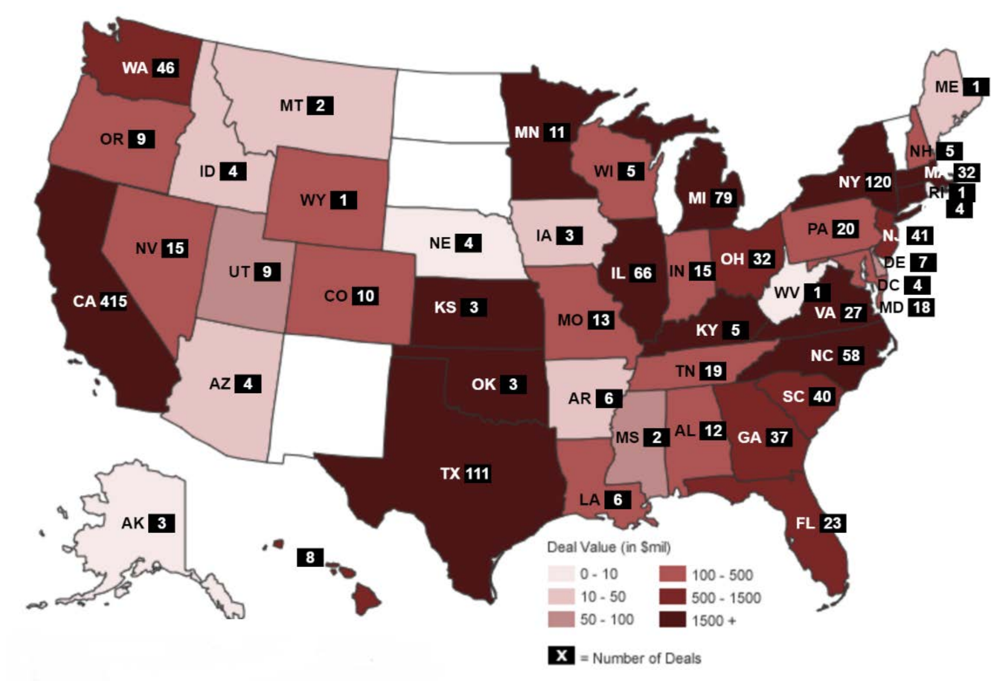
Figure 3: Chinese FDI Transactions in the U.S., 2000-2016
USD million



Source: Rhodium Group.

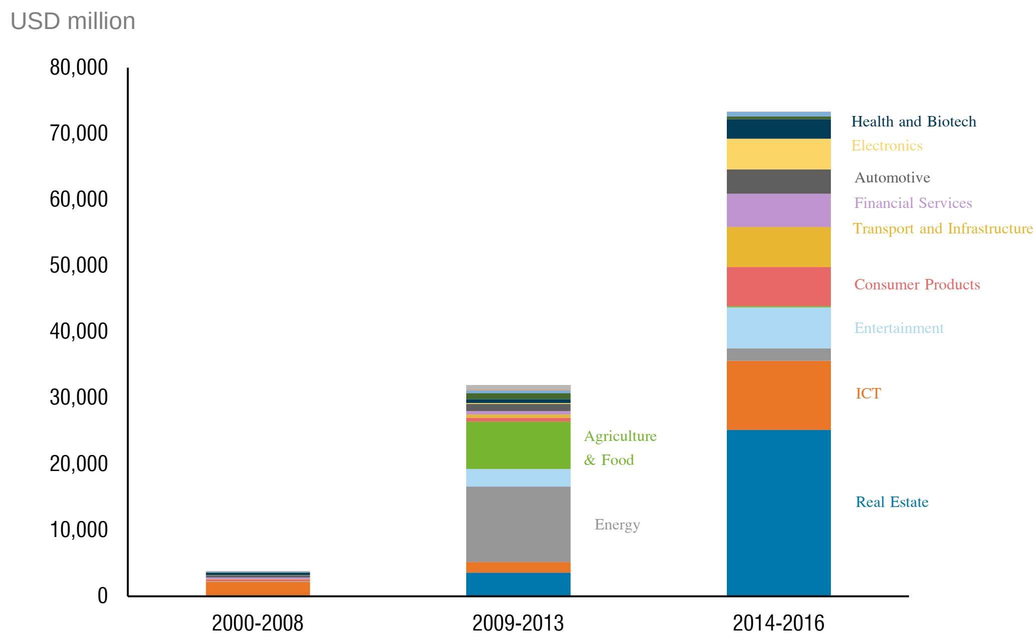
Figure 4: Geographic Distribution of Chinese Investment in the U.S., 2000-2016

USD million; number of transactions



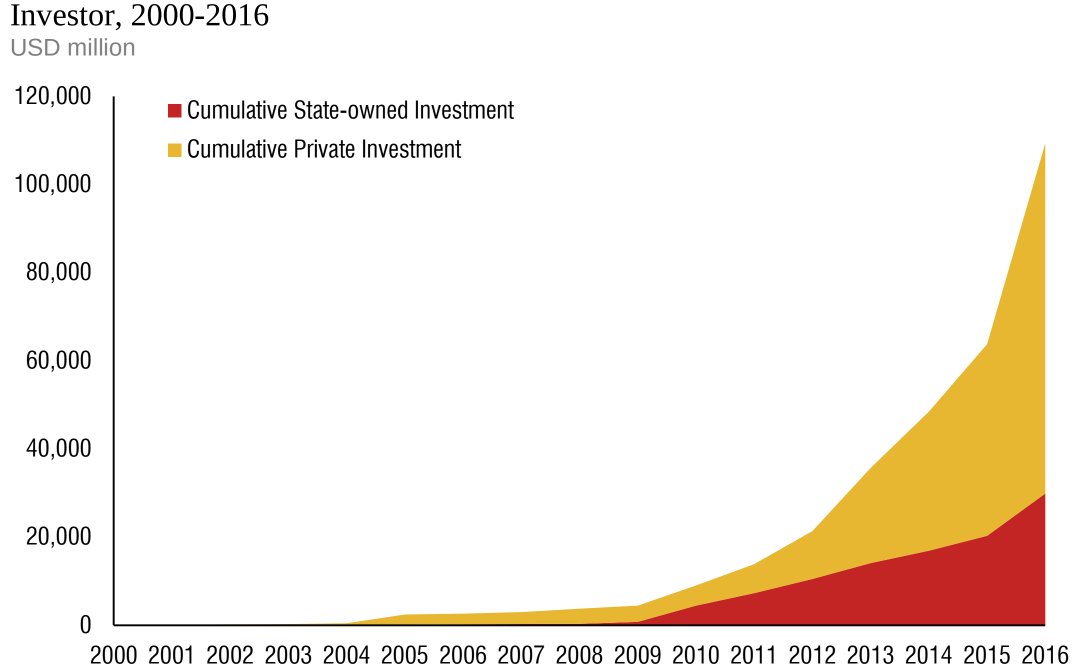
Source: Rhodium Group

Figure 5: Value of Chinese FDI Transactions in the US by Industry, Different Periods, 2000-2016



Source: Rhodium Group.

Figure 6: Cumulative Value of Chinese FDI Transactions in the US by Ownership of Investor, 2000-2016



Source: Rhodium Group.

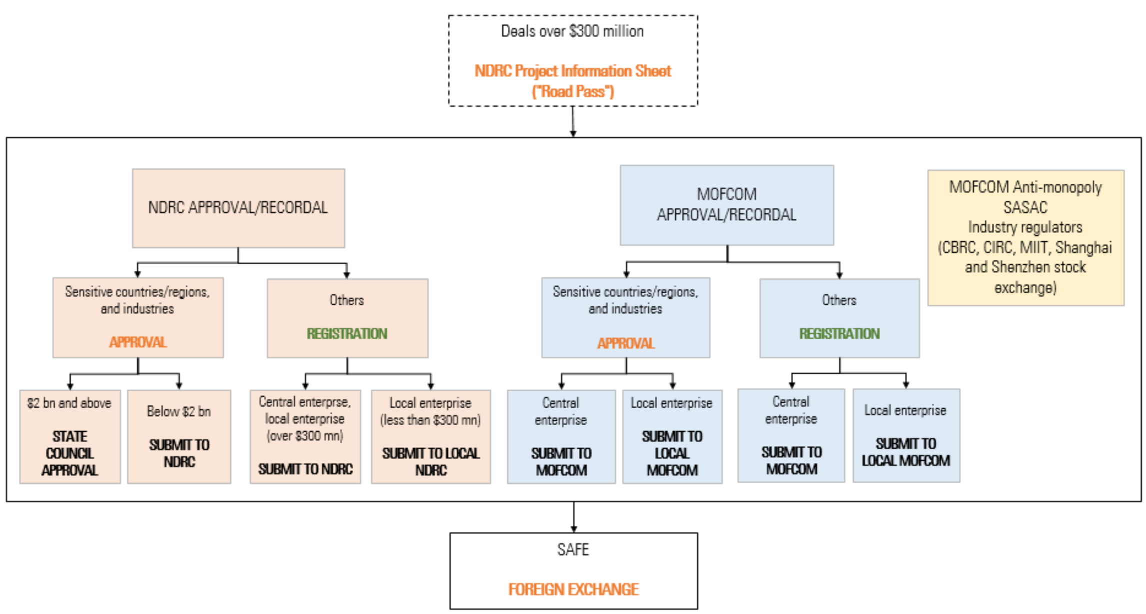
Table 1: Ranking of the Biggest Chinese Investors in the United States

By cumulative investment from 2000–2016, USD billion

Rank	Investor	Ownership	Total Investment
1	HNA	Private	$10.0
2	Wanda	Private	$8.5
3	Anbang	Private	$7.9
4	Shuanghui/WH Group	Private	$7.1
5	Lenovo	Private	$7.0
6	Haier	Private	$5.7
7	Fosun	Private	$4.0
8	Apex Technology	Private	$3.7
9	Sinopec	State-Owned	$3.6
10	China Life	State-Owned	$3.3
11	China National Offshore Oil Corporation (CNOOC)	State-Owned	$3.3
12	China Investment Corporation (CIC)	State-Owned	$3.3
13	Aviation Industry Corporation of China (AVIC)	State-Owned	$2.2
14	Hua Capital consortium	State-Owned	$1.9
15	Yantai Xinchao	Private	$1.3
16	Zhang Xin family	Private	$1.3
17	Huaneng	State-Owned	$1.2
18	Wanxiang	Private	$1.2
19	Tencent	Private	$1.0
20	Greenland	State-Owned	$1.0

Source: Rhodium Group. This table is based on transactions since 2000 only and does not take into account divestitures.

Figure 7: China's Regulatory Regime for Outbound FDI, June 2016

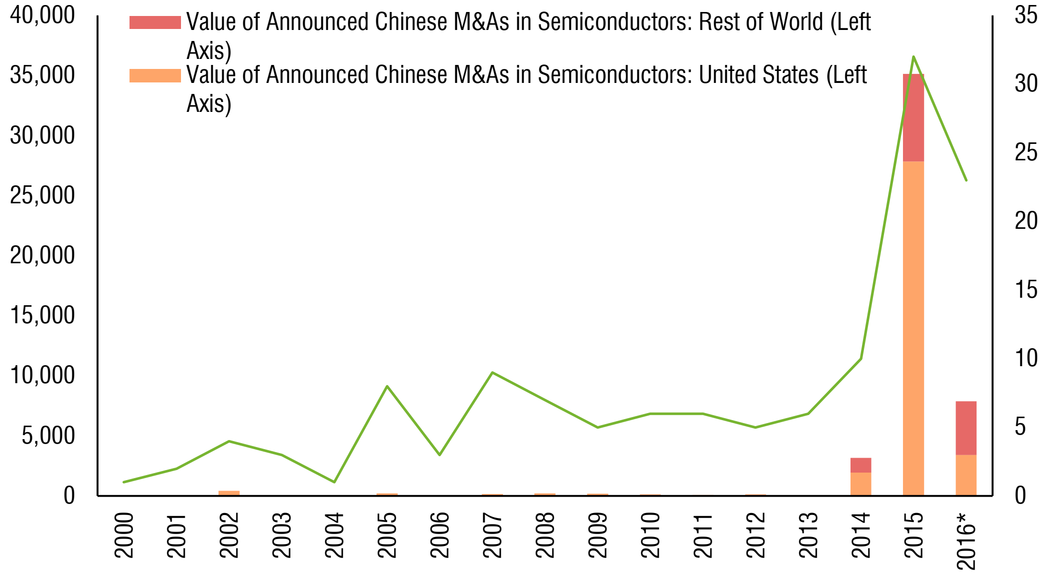


Source: Authors' compilation based on policy documents and expert interviews (June 2016).

Figure 8: Value of Announced and Rumored Chinese M&A in the Semiconductors

Industry, 2000-2016*

USD million; number of transactions



Sources: Bloomberg, Rhodium Group. * 2016 through August.

OPENING STATEMENT OF MR. JAMES STENGEL PARTNER, ORRICK

MR. STENGEL: Good morning, members of the Commission. I'll be approaching this from a somewhat different angle. I'm not a policy expert. I'm a practicing lawyer. I'm going to share my views on experience in actually representing Chinese state-owned enterprises in litigation in the United States.

I don't have a policy recommendation other than at the end to say I think the existing legal structure works quite well. It's fair, it's balanced, and it's applied appropriately by federal courts throughout the country.

To understand the significance of the interaction between Chinese state-owned enterprises and the Foreign Sovereign Immunity Act, which is the sole source of sovereign immunity in the civil courts in the United States, both state and civil, you have to understand that sovereign immunity has been a central precept of international law widely accepted for hundreds of years, first accepted in the United States in an official way by Chief Justice Marshall in 1812.

At that point until the 1950s, sovereign immunity was an absolute. If an entity was identified as a sovereign, that was the end of the inquiry. It was immune from litigation, it was immune from process, immune from collection of a judgment.

The United States and other nations began to qualify or take a more restrictive approach to sovereign immunity, which is our current structure. The original structure involved the State Department being asked by courts in individual case basis to weigh in. That led to, as you might expect, lobbying of the State Department and widely varying results depending on the defendants.

In response to that, in 1976, the Foreign Sovereign Immunity Act was passed by the United States Congress. And we've operated under the restrictions of the FSIA since that time, more than 40 years of experience.

Now I was asked to address specifically the issue of Chinese state-owned enterprises under the context of sovereign immunity having litigated that issue in federal court. The Chinese SOE experience is a relatively modest part of the FSIA experience with sovereign entities. True, China has a higher prevalence of state-owned enterprises than probably most other systems although any formerly communist or currently communist regime will have a similar structure.

State-owned enterprises are common throughout the world, probably least so here in the United States, but common throughout the rest of the world, and much of litigation involving FSIA does involve state-owned enterprises.

There are two reasons why, and as a practicing attorney it pains me to say this, this issue is not that important from a policy perspective. The law works reasonably well. The immunity that's available to state-owned enterprises is restricted in important ways by the structure of the act and how it's been interpreted by the United States Supreme Court.

First of all, the Court decided in a case called Dole v. Patrickson that to qualify as an agency or instrumentality of a sovereign nation and to be sovereign itself, the enterprise has to be majority owned directly by the state. That is subsidiaries of state-owned enterprises do not involve, do not enjoy immunity under the act. That takes out as a practical matter a vast range of state-owned enterprises, indirect state-owned enterprises doing business in the United States.

For example, the Bank of China, which you would normally think of, I think, as a state-owned enterprise, is actually owned by the Chinese Sovereign Investment Fund. Because of that, it does not qualify as a sovereign immunity under the FSIA. So you're talking about a relatively restricted strata of companies in the first instance.

In my direct experience in the Chinese drywall litigation in Louisiana, in the federal court there, we successfully asserted sovereign immunity for the senior-most entity. That was the directly owned by the PRC, but there are 11 or 12 remaining subsidiary defendants that are still actively litigating the litigation.

No plaintiff will go uncompensated because of the assertion of sovereign immunity, and, not surprisingly, Chinese entities tend to do business on a multinational basis much the way American corporations do, for cabining of risk reasons through subsidiary structures, and I think you'll see in most of the reported cases, and there are relatively few reported cases involving Chinese enterprises, they are operating in a multi-tiered structure with only the senior-most entity having access to immunity under the FSIA.

The other, and probably the most litigated exception to sovereign immunity, is the commercial activity exception, and the commercial activity exception takes most of the activity that would give rise to litigation in the United States outside the bounds of an assertion of immunity.

That is, even if a directly-owned Chinese enterprise enters into a contract with an American entity, any claims arising in a contract would be presumptively outside the scope of the immunity because it's a commercial activity, and commercial activity has been reasonably broadly interpreted by U.S. courts.

The other exception to sovereign immunity, and there are nine enumerated exceptions, many of which are not really relevant to your purposes, but sovereign immunity can and is often waived. It can be waived explicitly. It can be waived on an implied basis, and in an investment context, the issuance of debt, for example, it is common for investors to require a waiver of sovereign immunity.

Sovereign immunity can also be waived by provisions which allow for an assertion of jurisdiction in a U.S. court, an arbitration provision. So there are substantial holes in the protection of the Sovereign Immunity Act.

So in base, what the Commission needs to understand, and this does pain me as a practicing lawyer to say this, this is really not that important an issue. It's very important obviously to the individual litigants in a piece of litigation, but as a policy matter, the FSIA has functioned well for 40 years and continues to do so.

The exceptions contained, the limitations on which entities are identified as sovereign entities and thereby protected by the provisions of the act, are limiting by design and practical effect. So this is not a sinister situation. It's not a situation where the Chinese, the defendants, are getting an unfair advantage. They're not enjoying a legal regime that is in any way biased or changed specifically for their interests. It is a uniformly applied piece of federal legislation that applies to Latin American countries, European countries, and the Chinese with equal application.

With that, if there are any questions, I think you should all understand that some of the heat that I've seen or heard about the assertions of immunity by state-owned enterprises, particularly Chinese enterprises, I think arises out of misunderstanding of what is required to assert immunity and, maybe more importantly, what the perceived scope of that immunity may be.

Thank you.

PREPARED STATEMENT OF MR. JAMES STENGEL
PARTNER, ORRICK

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

James Stengel[1]

Partner

Orrick

The Foreign Sovereign Immunity Act of 1976 ("FSIA"), 28 U.S.C. § 1602 *et seq.*, governs all litigation in both state and federal courts against foreign states and governments, including their "agencies and instrumentalities." It "contains a comprehensive set of legal standards governing claims of immunity in every civil action against a foreign state or its political subdivisions, agencies, or instrumentalities,"[2] and "provides the sole basis for obtaining jurisdiction" over these entities in U.S. courts.[3]

The FSIA serves to codify in U.S. law protections equivalent to those that U.S. entities enjoy in foreign courts as a matter of international law.[4] Sovereign immunity has long been acknowledged as a matter of comity among nations. The recognition in foreign courts of the United States' immunity from suit has long been of vital importance to U.S. interests.[5] It has only become more so in recent years, given the increasing prevalence of transnational commerce. In enacting the FSIA, Congress recognized that, by adhering to these widely held international norms, the United States furthers its own long-term interests.[6]

Although, in some circumstances, Chinese state-owned enterprises ("SOEs") are entitled to immunity in U.S. courts under the FSIA, the instances in which Chinese SOEs have availed themselves of that protection are few in number and make up only a small proportion of the overall number of cases in which a foreign state or its SOE asserted immunity under the FSIA. To the extent that Chinese entities have from time to time successfully asserted sovereign immunity in U.S. courts, those judgments reflect an unexceptional application of this decades-old statutory framework for adjudicating claims against foreign sovereigns—a framework that effectively and appropriately balances

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[1] The views offered here are mine alone and not those of any other firm, entity, or organization
[2] *Verlinden B.V. v. Cent. Bank of Nigeria*, 461 U.S. 480, 488 (1983).
[3] *Argentine Republic v. Amerada Hess Shipping Corp.*, 488 U.S. 428, 439 (1989).
[4] *See* H.R. Rep. No. 94-1487 at 9 (1976) (hereinafter "House Report").
[5] *Id.*
[6] *First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba (Bancec)*, 462 U.S. 611, 628 (1983) (quoting House Report at 29-30) ("If U.S. law did not respect the separate juridical identities of different agencies or instrumentalities, it might encourage foreign jurisdictions to disregard the juridical divisions between different U.S. corporations or between a U.S. corporation and its independent subsidiary.").

litigants' right to recovery for harms caused by certain governmental activities with the United States' interest in maintaining conformity with central and long-established principles of international law.

I. Brief History of the FSIA

The FSIA rests on a long-established policy of granting foreign sovereigns immunity in U.S. courts. Indeed, for more than 200 years, the United States has recognized that foreign sovereigns are generally immune from suit. In *Schooner Exchange v. McFaddon*,[7] Chief Justice Marshall observed that, "as a matter of grace and comity," "the international community had implicitly agreed to waive the exercise of jurisdiction over other sovereigns in certain classes of cases."[8] In keeping with that observation, courts consistently deferred to the Executive Branch's recommendations about whether to exercise jurisdiction over actions against foreign sovereigns and their instrumentalities.[9]

Up until 1952, "the United States generally granted foreign sovereigns complete immunity."[10] In 1952, the State Department adopted a more restrictive view of sovereign immunity, whereby foreign governments were immune from suits involving their public acts, but not from suits involving their commercial or private conduct.[11] But because the "restrictive theory" was not enacted into law, initial responsibility for deciding questions of sovereign immunity continued to fall primarily upon the Executive Branch. The State Department made formal suggestions of immunity to the courts, and the courts largely abided by those recommendations.[12] Foreign states, however, often "attempt[ed] to bring diplomatic influences to bear upon the State Department's [immunity] determination[s],"[13] leading to inconsistent application of the sovereign immunity doctrine.[14]

In 1976, Congress enacted the FSIA, with input from the State Department, Justice Department, bar associations, and the academic community. [15] A primary goal of the FSIA was to enhance "uniformity in [immunity] decision[s], which [wa]s desirable since a disparate treatment of cases involving foreign governments may have adverse foreign relations consequences."[16] To that end, the FSIA codified the restrictive theory of foreign sovereign immunity and assigned primary responsibility for deciding foreign sovereign immunity claims to the courts, instead of the State Department.[17]

The basic premise of the FSIA is that foreign states and governments—including their

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[7] 11 U.S. 116 (1812).
[8] *Republic of Austria v. Altmann*, 541 U.S. 677, 689 (2004).
[9] *See id.* at 688.
[10] *Verlinden*, 461 U.S. at 486.
[11] H.R. Rep. No. 94-1487 at 6 (1976) (hereinafter "House Report").
[12] *Altmann*, 541 U.S. at 690.
[13] House Report at 7.
[14] *See Samantar v. Yousuf*, 560 U.S. 305, 311 (2010).
[15] House Report at 7.
[16] *Id.* at 13.
[17] *Samantar*, 560 U.S. at 313.

political subdivisions, agencies, and instrumentalities—are immune from suit in the United States unless the action falls under one or more of the FSIA's specific exceptions.[18] If the claim does not fall within one of these enumerated exceptions, the defendant is entitled to immunity and the courts lack both subject-matter and personal jurisdiction.

The protections and benefits the FSIA provides to foreign governmental agencies "[r]eflect the particular sensitivities of litigation against [such] entities."[19] The FSIA thus provides "extended time for answering complaints, a right of removal from state to federal court, entitlement to a non-jury trial, limitations on award of punitive damages, and constraints against attachment of and execution against government property."[20] Moreover, "FSIA immunity is immunity not only from liability, but also from the costs, in time and expense, and other disruptions attendant to litigation."[21] Consistent with that understanding, the FSIA requires courts to address immunity at the very outset of a case,[22] and an order denying immunity is immediately appealable under the collateral order doctrine.[23]

In short, in keeping with the long-standing recognition of foreign sovereign immunity, and undergirded by principles of comity and respect, "[t]he FSIA seeks to avoid affronting other governments by making it hard for private litigants to haul them into court." *Patrickson v. Dole Food Co.*, 251 F.3d 795, 806 (9th Cir. 2001), *aff'd in part, cert. dismissed in part*, 538 U.S. 468 (2003).

II. Definition of "Foreign State"

The FSIA does not distinguish between a "state" and its "government." "Thus, the statute applies whether the named defendant is, for example, China, the People's Republic of China, the Government of China, or one of its integral governmental components (such as the National People's Congress, the People's Liberation Army, or the Ministry of State Security)."[24] The FSIA's definition of "foreign state" includes a "political subdivision of a foreign state,"[25] meaning that a suit against one of China's provinces, autonomous regions, or municipalities would be treated the same as a suit against China itself. The definition of "foreign state" also includes "an agency or instrumentality of a foreign state."[26] In turn, § 1603(b) defines "agency or instrumentality of a foreign state" to include any entity that is (1) "a separate legal person, corporate or otherwise," that is (2) "neither a citizen of a State of the United States … nor created under the laws of any third country," and (3) either "is an organ of a

[18] *See Saudi Arabia v. Nelson*, 507 U.S. 349, 355 (1993).
[19] David P. Stewart, *The Foreign Sovereign Immunities Act: A Guide for Judges*, Federal Judicial Center, 2-13 (2013).
[20] *Id.*
[21] *Kelly v. Syria Shell Petroleum Dev. B.V.*, 213 F.3d 841, 849 (5th Cir. 2000).
[22] *See Verlinden*, 461 U.S. at 495 n.20 ("[E]ven if the foreign state does not enter an appearance to assert an immunity defense, a District Court still must determine that immunity is unavailable under this Act.").
[23] *Terenkian v. Republic of Iraq*, 694 F.3d 1122, 1130 (9th Cir. 2012).
[24] Stewart, *The Foreign Sovereign Immunities Act*, at 6.
[25] 28 U.S.C. § 1603(a).
[26] *Id.*

foreign state or political subdivision thereof" or an entity "a majority of whose shares or other ownership interest is owned by a foreign state or political subdivision thereof."

The first element "is intended to include a corporation, association, foundation, or any other entity which, under the law of the foreign state where it was created, can sue or be sued in its own name, contract in its own name or hold property in its own name."[27] For example, an "agency or instrumentality of a foreign state" could include "a state trading corporation, a mining enterprise, a transport organization such as a shipping line or airline, a steel company, a central bank, an export association, [or] a governmental procurement agency."[28]

The FSIA does not elaborate any further on what makes an entity an "organ" of the foreign state. However, in *California Department of Water Resources. v. Powerex Corp.*,[29] the Ninth Circuit explained that "[a]n entity is an organ of a foreign state (or political subdivision thereof) if it engages in a public activity on behalf of the foreign government."[30] In the Ninth Circuit's view, to determine whether an entity satisfies this test, courts should consider (1) "the circumstances surrounding the entity's creation"; (2) "the purpose of its activities"; (3) "its independence from the government"; (4) "the level of government financial support"; (5) "its employment policies"; (6) and "its obligations and privileges under state law."[31]

By contrast, whether an entity meets the definition of "instrumentality" based on ownership is comparatively straightforward. A foreign corporation incorporated in, and at least 50% owned by, a foreign state (or a political subdivision of that state) will typically qualify as an "agency or instrumentality."[32] Accordingly, a foreign country's SOEs often will fall within the definition of "instrumentality of a foreign state," and thus within the protections of the FSIA. But that is not to say that an entity will *always* be considered an instrumentality of a foreign state based on a claim of state-owned enterprise status. For instance, an entity wholly owned by a corporate parent, which is in turn wholly owned by a foreign sovereign, might reasonably be called a "state-owned enterprise," but such an entity is not entitled to benefit from the sovereign's immunity: Under *Dole Food Co. v. Patrickson*,[33] an entity qualifies under § 1603(b)(2)'s majority ownership clause only if the foreign state (or political subdivision) *directly* owns a majority of the entity's shares.[34]

III. Exceptions to Sovereign Immunity

The FSIA creates a number of exceptions to immunity, including (1) waiver, (2) commercial acts, (3) expropriations, (4) rights in certain kinds of property in the United

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[27] House Report at 15-16.
[28] *Id.*
[29] 533 F.3d 1087 (9th Cir. 2008).
[30] *Id.* at 1098.
[31] *Id.*
[32] Stewart, *The Foreign Sovereign Immunities Act*, at 33.
[33] 538 U.S. 468 (2003).
[34] *Patrickson*, 538 U.S. at 474.

States, (5) non-commercial torts, and (6) enforcement of arbitral agreements and awards. For U.S. companies doing business with Chinese SOEs, the FSIA's broad exception to sovereign immunity for "commercial activity" and the exception for waiver of immunity are likely to be of particular importance.

A. Commercial Activity Exception

Section 1605(a)(2)'s commercial activity exception is the FSIA's "most significant" [35]—and most frequently litigated—exception to sovereign immunity. The commercial activity exception provides that a foreign state is not immune from suit in any case in which the action is based upon (1) "a commercial activity carried on in the United States by the foreign state"; (2) "an act performed in the United States in connection with a commercial activity of the foreign state elsewhere"; or (3) "an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere[,] and that act causes a direct effect in the United States."

"Commercial activity" is defined as "either a regular course of commercial conduct or a particular commercial transaction or act."[36] This definition was intended to cover "a broad spectrum of endeavor…. A 'regular course of commercial conduct' includes the carrying on of a commercial enterprise such as a mineral extraction company, an airline or a state trading corporation." "If an activity is customarily carried on for profit, its commercial nature c[an] readily be assumed."[37] But even "a single contract," falls within the definition of commercial activity "if of the same character as a contract which might be made by a private person."[38]

As the Supreme Court explained in *Republic of Argentina v. Weltover, Inc.*, "whether the foreign government is acting with a profit motive or instead with the aim of fulfilling uniquely sovereign objectives" is irrelevant.[39] "Rather, the issue is whether the particular actions that the foreign state performs (whatever the motive behind them) are the type of actions by which a private party engages in trade and traffic or commerce."[40] Thus, "a contract to buy army boots or even bullets is a 'commercial' activity, because private companies can similarly use sales contracts to acquire goods."[41] Indeed, any contract between a foreign state and a private party for the purchase and sale of goods and services is presumptively commercial.[42]

Recent cases discussing the commercial activity exception have held a contract made by the Ukrainian government for asset recovery services was a commercial activity,[43] as was

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[35] *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 611 (1992).
[36] 28 U.S.C. § 1603(d).
[37] House Report at 16.
[38] *Id.*
[39] 504 U.S. at 614.
[40] *Id.* (internal quotation marks omitted).
[41] *Id.* at 614-15.
[42] *Practical Concepts, Inc. v. Republic of Bolivia*, 811 F.2d 1543, 1549 (D.C. Cir. 1987).
[43] *Universal Trading & Investment Co. v. Bureau for Representing Ukrainian Interests in International & Foreign Courts*, 727 F.3d 10, 12 (1st Cir. 2013).

a Hungarian bailment agreement to return plunders of war, [44] but Monaco's hiring of an individual to perform intelligence services was not a commercial activity because contracting for intelligence services is "not the type of employment private parties can undertake."[45]

B. Waiver Exception

Section 1605(a)(1) provides an exception to immunity when the foreign state has waived its immunity "either explicitly or by implication." Explicit waivers are typically found in contractual provisions, but they could also arise from independent statements. They are normally construed narrowly, in favor of the sovereign.[46]
Implied waivers have been found when a foreign state has agreed in the provisions of a contract or lease agreement that the agreement is to be governed by the law of a particular country,[47] and when a foreign state has filed a responsive pleading in a case without raising the defense of sovereign immunity.[48]

IV. State-Owned Enterprises

Throughout the world, governments participate in commercial activity through SOEs.[49] They exist in European countries, such as Germany, France, Italy and Sweden, Central and South American countries, such as Brazil, Colombia, Mexico, and Venezuela, and Asian counties, such as India, Japan, Malaysia.[50] Their formation may occur for a number of reasons but often "because markets were imperfect or unable to accomplish critical societal needs such as effectively mobilizing capital or building enabling infrastructure for economic development."[51]

China has approximately 156,000 SOEs (SOEs).[52] Approximately one-third of these are owned by the central government, with the remaining companies owned by local governments.[53] The State-owned Assets Supervision and Administration Commission (SASAC), and thus the central government, directly controls and runs 106 SOEs; 66 of these companies are listed on stock exchanges.[54] SOEs account for 20% of China's employment and 30% to 40% of its GDP.[55]

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[44] *de Csepel v. Republic of Hungary*, 714 F.3d 591, 594 (D.C. Cir. 2013).
[45] *Eringer v. Principality of Monaco*, 533 F. App'x. 703, 704-05 (2013).
[46] *See, e.g.*, *World Wide Minerals, Ltd. v. Republic of Kazakhstan*, 296 F.3d 1154, 1162 (D.C. Cir. 2002) ("A foreign sovereign will not be found to have waived its immunity unless it has clearly and unambiguously done so.").
[47] *See, e.g.*, *Themis Capital, LLC v. Democratic Republic of Congo*, 881 F. Supp. 2d 508, 516-17 (S.D.N.Y. 2012) (contract); *Joseph v. Office of Consulate Gen. of Nigeria*, 830 F.2d 1018, 1022-23 (9th Cir. 1987) (lease).
[48] *Haven v. Polska*, 215 F.3d 727, 731-32 (7th Cir. 2000).
[49] PriceWaterhouseCoopers, *SOEs, Catalysts for public value creation* (April 2015).
[50] *Id.* at 9.
[51] *Id.* at 14.
[52] U.S. Dept. of State, Bureau of Economic and Business Affairs, *Investment Climate Statements for 2016*, online at http://www.state.gov/e/eb/rls/othr/ics/investmentclimatestatements/index.htm?year=2016&dlid=254271.
[53] *Id.*
[54] *Id.*
[55] *Id*.

V. Chinese-Manufactured Drywall Litigation

The recent dismissal of a Chinese entity from an ongoing products liability litigation involving Chinese-manufactured drywall[56] is a perfect illustration of the proper application of the FSIA with respect to SOEs. As background, between 2005 and 2008, the housing boom and rebuilding efforts necessitated by Hurricanes Rita and Katrina led to a shortage of construction materials. To meet that demand, gypsum wallboard manufactured in China ("drywall") was brought into the United States and used in the construction and refurbishing of homes. Subsequently, a number of homeowners filed suit in state and federal courts, alleging that the drywall was defective. They named a range of defendants, from the homebuilders and developers, to the suppliers, importers, exporters, distributors, and manufacturers of the drywall (e.g., Taishan) and the parent and grandparent companies of those manufacturers.

Among the latter cohort was China National Building Materials Group (CNBM Group). The parties agreed that CNBM Group is a state-owned enterprise directly and wholly owned by the People's Republic of China. As such, CNBM Group qualified as an "agency or instrumentality of a foreign state" under the FSIA, and therefore was presumptively immune from suit. Accordingly, it moved to dismiss the claims brought against it on sovereign immunity grounds. The plaintiffs alleged, however, that CNBM Group fell within both the FSIA's commercial activity exception and the tortious activity exception. The district court disagreed and granted CNBM Group's motion to dismiss.

The court explained that § 1605(a)(5)'s exception to sovereign immunity for tortious activity applies only when alleged injury and the foreign state's tortious conduct occurred within the United States. CNBM Group, which was merely a shareholder of the manufacturers, had not engaged in *any* drywall-related conduct in the United States.

Turning to the commercial activity exception, the court explained that this exception applies only if the plaintiffs' claims are "based upon" an act or activity by the foreign state defendant. The commercial activity that formed the basis of the plaintiffs' claims was the manufacture, sale, and export of allegedly defective drywall. But, again, CNBM Group's involvement was limited to that of a shareholder of a shareholder of the manufacturers; CNBM Group itself had never manufactured, inspected, sold, supplied, distributed, marketed, exported, or delivered any drywall.

The plaintiffs also argued that CNBM Group exercised such a significant degree of control over the manufacturers that the manufacturers' conduct should be attributed to CNBM Group on an "alter ego" theory. The court rejected this argument. It concluded that to the extent CNBM Group exercises control over the manufacturers, it is no different than the type of control any corporate investor has in the company it holds shares in. Such control, the court recognized, is inadequate to find an alter ego relationship between CNBM Group and the manufacturers. Ultimately, the court dismissed CNBM Group because the company is not directly engaged in any commercial

[56] Order Granting Motion to Dismiss, *In re: Chinese-Manufactured Drywall Products Liability Litigation*, No. 09-02047, Dkt. 20150 (E.D. La. Mar. 9, 2016).

activity in the United States. And owning shares in a company that *does* engage in commercial activity in the United States is not, the court explained, a sufficient basis for subjecting a sovereign to suit.

Notably, if CNBM Group itself had been engaged in selling allegedly defective drywall to the United States, those sales would likely fall within the commercial activity exception to sovereign immunity and CNBM Group would therefore likely have been subject to the court's jurisdiction, notwithstanding CNBM Group's state-owned enterprise status. And if CNBM Group had exercised a great deal of control over the day-to-day activities of its subsidiary companies—including the manufacturers—those companies' commercial activities would have been attributable to CNBM Group under an "alter ego" theory.[57] Because CNBM Group was the only entity that asserted immunity, the litigation now continues against the remaining defendants.

Perhaps the most important takeaway from the Chinese Drywall litigation is how closely the court adhered to settled law. The dismissal of a parent company from a suit where the alleged harms arose from actions taken by a subsidiary is an everyday occurrence in this country. Under ordinary principles of corporate law, a corporate parent is not liable for the acts of its subsidiary, except in cases of fraud or other exceptional circumstances that warrant "piercing the corporate veil."[58] In the Chinese-manufactured drywall litigation, then, CNBM Group would ultimately have been dismissed from the lawsuits, irrespective of the operation of the FSIA. However, in recognition of the respect the United States has long accorded to foreign sovereigns and their instrumentalities, the question of sovereign immunity is to be decided at the very outset of any litigation. In other words, by bringing its motion under the FSIA, CNBM was simply able to secure its dismissal from the suit at an earlier stage in the litigation.

VI. Other Recent Cases

Global Technology, Inc. v. Yubei (XinXiang) Power Steering System Co.[59] is another recent court of appeals decision in which a Chinese state-owned enterprise invoked a sovereign immunity defense under the FSIA. There, Global Technology, a Michigan-based sales representative and global business consultant, agreed to assist Yubei in its attempted acquisition of an automotive-steering company, Nexteer. After Yubei's bid failed, Nexteer was purchased by a different Chinese company, Pacific Century. Subsequently, Yubei's grandparent company, Aviation Industry Corporation of China ("AVIC"), one of China's largest SOEs, acquired a controlling stake in Pacific Century. Global Technology then sued Yubei and AVIC for breach of contract.

AVIC (but not Yubei) moved to dismiss on sovereign immunity grounds. In denying AVIC's motion, the district court assumed the truth of Global Technology's allegations and therefore concluded that AVIC's activities fell within the commercial activity exception. AVIC brought an interlocutory appeal, and the Sixth Circuit vacated the

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[57] *See Bancec*, 462 U.S. at 629, 632.

[58] *See United States v. Bestfoods*, 524 U.S. 51, 61 (1998) ("It is a general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries."); *Patrickson*, 538 U.S. at 475.

[59] 807 F.3d 806 (6th Cir. 2015)

district court's judgment.[60] The Sixth Circuit reasoned that because AVIC's assertion of sovereign immunity amounted to a factual attack on the district court's jurisdiction, the district court was obliged to make factual findings necessary to determine its jurisdiction. The court explained that because the parties agreed that AVIC was a foreign state within the meaning of the FSIA, the burden of production fell on the plaintiff to rebut the presumption of immunity by showing that an enumerated exception applies. "If the plaintiff succeeds," the court explained, "the burden shifts to [the defendant] to demonstrate that its actions do not satisfy the claimed exception."[61] And, the court noted, AVIC, as the party claiming immunity, "retains the burden of persuasion throughout this process."[62] On remand, the parties settled. As a result, the case establishes only the procedure by which the court makes its "critical preliminary determination" of immunity.[63]

Though the cases discussed above involve Chinese SOEs, it should be noted that SOEs exist the world over. In fact, a survey of recent cases involving SOEs claiming sovereign immunity under the FSIA demonstrates that SOEs claiming immunity in federal court are predominantly owned by foreign states other than China. For instance, as compared to cases involving Chinese SOEs, cases involving South American SOEs comprise an outsized share of the federal judiciary's recent FSIA docket.[64] Likewise, many FSIA cases involve actions directly against foreign governments, as distinct from the SOEs they own.[65]

And a review of recent SOE cases demonstrates the vigilance with which courts have reinforced the FSIA's limited but sensible reach. For instance, they have stayed true to *Dole Food*'s recognition that the definition of "agency or instrumentality of a foreign state" extends only to those with a "direct ownership of a majority of shares by the foreign state" and not those entities indirectly owned by foreign states.[66] And where it can be said that foreign states or instrumentalities are operating as alter egos of companies that otherwise would be subject to U.S. jurisdiction, courts have expressed a willingness to subject them to jurisdiction, while, at the same time, reinforcing the same principles that underlie U.S. corporate laws and refusing to hale into courts entities that satisfy *Bancec*'s test for corporate separateness.[67] Finally, where SOEs satisfy a FSIA

[60] *Id.* at 809-10.
[61] *Id.* at 811.
[62] *Id.*
[63] *Id.* at 813.
[64] *See, e.g.*, *Absolute Trading Corp. v. Bariven S.A.*, 503 F. App'x 694, 697 (11th Cir. 2013); *Crystallex Int'l Corp. v. Petróleos De Venezuela, S.A.*, No. 15-1082, 2016 WL 7440471 (D. Del. Dec. 27, 2016); *Marrero-Rolon v. Autoridad de Energia Electrica de P.R.*, No. 15-1167, 2015 WL 5719801, *3 (D.P.R. Sept. 29, 2015); *Pine Top Receivables of Illinois, LLC v. Banco de Seguros del Estado*, No. 12 C 6357, 2013 WL 440839, at *1 (N.D. Ill. Feb. 5, 2013).
[65] *See, e.g.*, *Chevron Corp. v. Ecuador*, 795 F.3d 200, 203-08 (D.C. Cir. 2015); *Petersen Energia Inversora, S.A.U. v. Argentine Republic*, No. 15-CV-2739, 2016 WL 4735367, at *4 (S.D.N.Y. Sept. 9, 2016); *Hoban v. Sovereign Republic of Peru*, No. 15-81105-CIV, 2016 WL 4718174, at *2 (S.D. Fla. Aug. 31, 2016); *Dentons U.S. LLP v. The Republic of Guinea*, 134 F. Supp. 3d 5, 7-10 (D.D.C. 2015).
[66] *See e.g.*, *First Inv. Corp. of the Marshall Islands v. Fujian Mawei Shipbuilding, Ltd. of People's Republic of China*, 858 F. Supp. 2d 658, 671 (E.D. La. 2012).
[67] *See, e.g.*, *First Inv. Corp. of Marshall Islands v. Fujian Mawei Shipbuilding, Ltd*., 703 F.3d 742, 753 (5th Cir. 2012), *as revised* (Jan. 17, 2013).

exception, courts have not hesitated to subject them to jurisdiction.[68]

VII. Conclusion

Generally speaking, when U.S. companies are engaged in business dealings with foreign states or SOEs, those transactions will often fall within the commercial activity exception to sovereign immunity. That holds true in the context of Chinese SOEs. If engaged in business in the United States, they will be subject to litigation here. And if they are not, then, just as the United States would not want a foreign country haling a U.S. company into foreign courts, then a SOE will not be subject to suit here. As recent litigation involving these issues reveals, Chinese SOEs receive the same treatment as American companies. The only difference being that respect for sovereigns and principles of comity afford them the opportunity to exit the litigation slightly earlier than their U.S. counterparts.*

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[68] *See, e.g.*, *Rote v. Zel Custom Mfg. LLC*, 816 F.3d 383, 388 (6th Cir.), *cert. denied sub nom. Direccion Gen. de Fabricaciones Militares v. Rote*, 137 S. Ct. 199 (2016); *Hansen v. PT Bank Negara Indonesia (Persero), TBK*, 601 F.3d 1059, 1062-63 (10th Cir. 2010); *Vinum Tokaj Int'l, LLC v. Tokaj Kereskedohaz Zrt,* No. 14-1509, 2015 WL 12660399, at *3 (C.D. Cal. May 18, 2015), *aff'd sub nom. Vinum Tokaj Int'l, LLC v. Grand Tokaj Zrt*, No. 15-55822, 2016 WL 4651421 (9th Cir. Sept. 7, 2016).

PANEL I QUESTION AND ANSWER

HEARING CO-CHAIR WESSEL: Thank you both. When Mr. Johnson, who I believe has been held up in traffic, gets here, we will allow him to testify. We'll ask him to abbreviate it.

But for the first question, Mr. Shea.

VICE CHAIRMAN SHEA: Well, thank you and thanks to the two co-chairs for putting on a great hearing and welcome, Jonathan, to the Commission.

I'm going to leave you alone, Mr. Stengel. So I'm going to just--

[Laughter.]

VICE CHAIRMAN SHEA: --talk to--

MR. STENGEL: Thank you.

VICE CHAIRMAN SHEA: Okay--talk to Mr. Hanemann, and thank you for your great work on that report that you did for the Commission, and you are the expert on this issue, on Chinese FDI into the United States. Maybe Derek Scissors would disagree, but you are definitely one of the top people.

I agree with you that the discussion around Chinese FDI should be motivated by facts and data, and that policies based on nominal ownership alone are problematic. And I just want to sort of probe the way you have in your written testimony just very nicely pegged certain companies as private and certain companies as state-owned enterprises.

I mean you do say there's a little murkiness here, but in your charts and in your written testimony, you say these companies, namely, HNA, Hainan Airlines, Wanda, Anbang, Shuanghui, Lenovo, Haier, are private companies. And I'm wondering, just as a matter of research, are you able to confidently say that you know the ownership structure of these companies? The equity ownership? Are you confident that you know this?

MR. HANEMANN: Yeah. First of all, thank you for giving us the opportunity to work with the Commission on the latest report and for giving me the credits that you just gave me.

VICE CHAIRMAN SHEA: Sure.

MR. HANEMANN: And I don't know if Mr. Scissors will be very happy about what you said--

[Laughter.]

MR. HANEMANN: --but I certainly appreciate that. Going back to your question, and I think from an analytical point of view, I strongly believe that the distinction between state-owned and private enterprises is irrelevant for many of the policy questions that we're looking at from a national security perspective.

VICE CHAIRMAN SHEA: But I'm saying if it's irrelevant but it sets a perception that the private is okay and the state-owned is not okay, just as a matter--I have just a few minutes--but are you confident that you know the equity ownership of these companies as a researcher, the leading researcher in this field?

MR. HANEMANN: For the majority of companies, we're confident that we know what the nominal equity ownership is, and the threshold we use for private companies is at least 80 percent or more of the equity in the company or the corresponding voting interest needs to be owned by private entities.

There are some instances, for example, Anbang or other smaller companies--

VICE CHAIRMAN SHEA: Right. But are you confident that you have the insight into the data to say I know the equity ownership arrangement of Wanda, Anbang, Lenovo, HNA, which you've characterized as private companies? Are you confident as a research matter that you know who owns those companies?

MR. HANEMANN: In the majority of cases, we are. There are cases where we aren't certainly.

VICE CHAIRMAN SHEA: Okay. So I mean would you agree that the U.S. notion of what a private company is and the Chinese notion of what a private company is are different?

MR. HANEMANN: Yeah, I would agree with that statement.

VICE CHAIRMAN SHEA: Okay. I mean Wanda, for example, a lot of the children of the leaders of China, past and present, have enormous stakes in these companies. Lenovo, you listed as private, but I thought Lenovo was 35 percent owned by state-owned Legends Holding Group and the Chinese Academy of Sciences.

MR. HANEMANN: The ownership structure changed--

VICE CHAIRMAN SHEA: Oh, it did.

MR. HANEMANN: --a few years ago.

VICE CHAIRMAN SHEA: Okay.

MR. HANEMANN: Which pushed the state ownership below 20 percent.

VICE CHAIRMAN SHEA: Okay. Thank you for clarifying that. I guess what I'm saying is maybe you should get out of this binary approach of private and state-owned and come up with a third category, and I was thinking on the way over here maybe call these OPSIEs, maybe ostensibly private but state-influenced companies. Just because you're the leading person in this field and when you put, label things as "private," you are leading people to make certain assumptions about that, that they're motivated by commercial and market-based reasons when, in fact, there may be other things going on.

So I would suggest to you that you come up with a third category, and I'd called them OPSIEs, or ostensibly private, state-influenced companies. But I'll leave that to you. You want to comment on that?

MR. HANEMANN: Yeah, we'll take that recommendation for the next report that we're going to write for the Commission.

VICE CHAIRMAN SHEA: Okay.

MR. HANEMANN: Thank you very much.

VICE CHAIRMAN SHEA: All right. Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

Mr. Stengel, I won't leave you alone, and looking forward to getting educated a bit, and please do so since we're not a constitutional law committee, you know, don't go broadly into theory, but explain to me the recent vitamin C case, which according to press reports doesn't seem to fit within your fact pattern in the sense that as reported, those entities were given immunity here because they were operating under some kind of state direction.

Is that accurate in terms of the reporting? Can you give a very short discussion of whether that is, in fact, a precedent-setting case that we should be concerned with, an outlier, or what really happened there?

MR. STENGEL: Well, just by way of background, the vitamin C litigation was an antitrust case which had been pending for over a decade now I believe, and what it reflected was, as China has tried to push its enterprises into a market economy, there have been sort of an evolution of how they've controlled the operation of the entities and through what are called chambers of commerce, which is a very different thing in China than it is in the United States, they were setting prices, and to get export approval for vitamin C, these companies had to prove that they were charging at or above a price set by the chambers of commerce.

And what the court in the Eastern District of New York found, and this is a very different doctrine than sovereign immunity, and it's a common law doctrine of comity although it's rooted in international law. What the judge essentially found was these companies were--and this is a very unusual situation because the Chinese government actually showed up in court and talked about what the legal requirements of China were, which was unprecedented. They've never done that before.

But the judge said, look, I accept that U.S. antitrust law makes this conduct presumptively illegal. I also accept based on representations of the Chinese government that these companies had no choice but to comply with domestic Chinese law. They would not be authorized to export their product without that compliance. That creates an irreconcilable conflict for the defendants here. They couldn't move one way or the other without violating one body of law, and I'm going to, under the doctrine of comity, which is a longstanding judicial doctrine, find that these entities did not, will not be held accountable for a violation of U.S. antitrust law because they were in compliance with domestic Chinese law.

Now whether that proves to be an outlier or a growing body of law remains to be seen. That argument has been rejected repeatedly. There have been jurisdictional battles, probably most notably in the fights involving the accounting firms who found themselves caught between the Chinese financial regulatory bodies and the SEC. But I don't know. In that one instance, that's what that court ruled.

HEARING CO-CHAIR WESSEL: So it was not an assertion. It was not an FSIA.

MR. STENGEL: It was not an FSIA assertion.

HEARING CO-CHAIR WESSEL: It was a comity issue. Are they able to argue in the alternative in the sense that some, another firm in the future could do, seek FSIA immunity or a, you know, waiver because of comity?

MR. STENGEL: It would be unusual. Well, first of all, just procedurally, because sovereign immunity goes to the court subject matter jurisdiction.

HEARING CO-CHAIR WESSEL: The first jurisdiction. Right. Okay.

MR. STENGEL: Whether this matter should even be before the court, it would be typical to assert sovereign immunity, and if that assertion because of a lack of ownership, a commercial activity exception, were found unavailing, I suppose a party could--and this is all hypothetical--

HEARING CO-CHAIR WESSEL: Understand.

MR. STENGEL: --could divert to an assertion of a comity defense.

HEARING CO-CHAIR WESSEL: Separate question. As it relates to CFIUS and mitigation agreements or how companies seek to have, Chinese companies seek to have their transactions approved, do you think it would be appropriate to ask entities to waive their FSIA immunity as a condition of getting approved so that we would know that if you operate--if you come here, you get CFIUS approval, you waive the immunity, and therefore we know we will be able to reach their activities in U.S. courts of law?

MR. STENGEL: Well, first, I don't purport to be an expert on CFIUS and I'm a litigating attorney, not a transaction attorney. I'm familiar with the way the regulatory scheme generally works.

To the extent CFIUS violations give rise to criminal penalties, I don't think FSIA applies anyway.

HEARING CO-CHAIR WESSEL: Right.

MR. STENGEL: It's a civil situation. The extent to which an individual company would waive to get approval, I presume that would be feasible, but I can't speak to it as a matter of policy.

HEARING CO-CHAIR WESSEL: Okay. Thank you. I see my time has expired.

Mr. Johnson, thank you. Could you summarize your comments since we are already in the midst of our activities? Welcome. Everyone's testimony will be entered in the record. If you could summarize your comments quickly.

COMMISSIONER TALENT: Mr. Chairman.

HEARING CO-CHAIR WESSEL: Yes.

COMMISSIONER TALENT: Could I just--I understand your desire to continue with the questions, but I thought Mr. Johnson's testimony was really important and differs in very substantial respect. So I hope he'll be permitted to give his full--

HEARING CO-CHAIR WESSEL: Fine. Please, your full seven minutes, yes.

COMMISSIONER TALENT: It is, of course, your hearing. I'm not trying to suggest otherwise.

[Laughter.]

HEARING CO-CHAIR WESSEL: As we, for a different kind of comity, I will accede.

MR. JOHNSON: And my apologies. Sometimes the best laid plans to make a 24-hour turn-around trip to California don't work as well as you'd hoped.

But I'll summarize very quickly background related to the firm so I can get to some of the material of my testimony.

HEARING CO-CHAIR WESSEL: Please don't leave material out. As Senator Talent has indicated, it is important testimony.

OPENING STATEMENT OF MR. JEFF JOHNSON
DIRECTOR AND ECONOMIST, RHODIUM GROUP

MR. JOHNSON: Okay. So I'd like to say thank you to the Commission for having me back this year and to discuss this in more of a public forum. My firm and the analysts that work with us put a lot of work into trying to provide input that was tangible and specific to this year, to include providing specific threat entities so that we can take a little bit more action instead of keeping it at the higher level.

Before I go into it, I'd like to say that over the last four years, we've had an opportunity to really investigate these cases from what I consider to be the right perspective. Four years ago, we started looking at cyber breaches more from what we now refer to as cyber economic lenses. When we would go into a case and determine that it was a nation-state actor, what we would do is look at that case from that point forward from the perspective of the adversary, not NIST, not ISO, or some specific standard for cyber incident response. Instead of focusing solely on how you analyze the technical evidence, let's try to determine why they're there.

So we would start from the perspective of why they say they're there. What's in their five-year plan if it's China or some other nation- state, and then why would they be in this petrochem company or why would they be in this ag company, and then that led to the studying of the financials for those companies, the 10-Ks, the risk statements, and from there we were able to develop more of a targeting plan from the adversary's perspective. What would--we'd probably be targeting this company to take it over, to create duress, to manipulate the market, or commit fraud. And then we would take the standard scenarios for these crimes and go look and see if the evidence showed up in those other areas because the technical evidence typically ends at certain points because of concealment techniques.

And then we would find more evidence at each one of those points, whether it was a sales system, R&D, supply chain, but it was almost like they were targeting almost every line of the financial statement with some type of scheme.

So that's how we've been, that's how we've been reviewing these cases for the last four years. As far as I know, we're the only team that performs this type of analysis, and in each case when we presented the results to our clients, they validated the results. So that was always good news. In cyber, a lot of times, you get a lot of things called false positives, and we don't really see a lot of them because you're looking for business indicators.

So when something is so far out of whack that it can't be explained, there's normally something wrong, you know. You can't spend more money than you have, for example. The only way you could do that is if you were getting credit or a subsidy of some sort, and so if you continue to look at the money, the evidence starts to roll out. And then you're able to merge it with the cyber data, and it makes more sense.

So that's the background of how we went into our cases. Now there's been over 20 different industries involved in our cases and more than 40 different countries.

The one that I was with yesterday validated their cases examples once again every single time that we start to discuss some of the points.

So those were the key background points. Now in terms of what helps our team is we always look at an investigation from a legal perspective such as the WTO or Sherman Antitrust Laws, or market manipulation laws. This way, when we're collecting the evidence, it's not that subjective.

You're looking for evidence that matches precedents of cases that have been in our courts as well as the WTO, and you're looking for leading indicators of something that's about to happen or trailing indicators of something that has happened.

So I mentioned in my written testimony that for the most part a lot of the evidence that we'll present will link back to either barriers to entry, antidumping, subsidies, countervailing measures, and then we also have the U.S. laws for market manipulation and fraud.

So that kind of sets the tone for how we go in and how we collect the evidence and then how we even make predictions. Now in terms of our own laws, too, you'll note in my written testimony that I recommend that a lot of times it's just following what we currently have. We have a lot of great laws in place, but because we're stovepiped in the way that we're looking at the issue, and sometimes we fight our own instincts on what's happening, we don't necessarily apply those laws the way that we might to optimize them, and then sometimes we apply biases to a case, which steer us down the wrong path.

But what we've seen in the past is most of our laws, if used properly, would allow us to address this, but there is a gap, okay, and the gap is really at the nation-state level. If you review the antitrust laws, like the Sherman Act, it's really written within the context of company-to-company or person-to-company complaints. It doesn't really address if a nation-state actor is actually ChinaCo, and the CCP sits at the top as the chairman. What happens when the leader of such an organization has an organization in place, and he's directing traffic--okay--and he's bringing together all these different schemes? How do our laws apply?

You may not have direct evidence of Company A talking to Company B and coordinating because the coordination is taking place at the NDRC level, at the universities, at the research parks. So you have to tie those together. You have to be able to figure out how to apply the law to the nation-state actors.

But for the most part, there's so much evidence about what the companies are doing, and it's often overwhelming, at least for the top 100 to 200, that you don't have to put too much effort into that either, but at least that is one of the key gaps.

So in terms of some of the questions that we reviewed coming into this, one of the first questions was: what are the main drivers of the Chinese investment in the United States? And at the front of that question are the more obvious answers: economic growth and the standard types of things that you do in any developing nation to increase your economic strength. So protecting the Communist Party is one of the highest priorities on their agenda along with job creation, economic workforce development, and gaining increased levels of diplomatic influence.

So those are the more obvious. But also what is in their own documents, and most of what I'm covering is based on their own documents. Our team is just helping investigate cases and tie the pieces back to what they already say. The other not so obvious objectives, though, are things like gaining monopoly-like control of key industries. And they'll go on record saying they want that monopoly-like control. Gaining increased control of each company's value and supply chain so they can control the economic drivers. Materially infiltrating key financial, corporate, research and government entities. Gaining enhanced insider access to sensitive intellectual property and technology, otherwise considered off limits or beyond their current capability. Gaining increased dependence on Chinese financial resources for financial and economic growth. Gaining control of the western investment syndicates in order to redirect their outbound FDI toward China-preferred investments. Decreasing risk associated with the exposure of their illicit financial operations. Increasing control of domestic and overseas Chinese individuals. Increasing levels of political influence and control within the U.S. and other nations.

These objectives are all referenced in their own documents. Okay. They refer to these at the Ministry of Planning, Ministry of Education, Ministry of Science and Technology and all the way to the top to the State Council. And then the policies float down to organizations such as the United Front and others.

So then the next question then on do Chinese invest--

HEARING CO-CHAIR WESSEL: Mr. Johnson.

MR. JOHNSON: Yes.

HEARING CO-CHAIR WESSEL: We're going, as I said, make all of your testimony part of the public record.

MR. JOHNSON: Okay.

**PREPARED STATEMENT OF MR. JEFF JOHNSON
PRESIDENT AND CEO, SQUIRRELWERKZ**

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

**Testimony before
The U.S.-China Economic and Security Review Commission**

January 26, 2017

Jeff Johnson

President and CEO

SquirrelWerkz

Thank you for the opportunity to testify before the esteemed members of this commission. The works and research associated with this commission have long served as a valuable resource to those of us in the cyber, competitive and economic threat intelligence and risk management profession. Through today's testimony I plan to present new insights into the Chinese affiliated cyber-economic (CE) campaigns and how the government of China leverages a number of direct and indirect entities and methods to illegally finance, and/or subsidize, these complex industry-wide efforts.

Before I begin the formal portion of my testimony, I would like to state that I assess our biggest challenge to be identical to that described by the 9/11 Commission when they described the root cause of the intelligence failure related to the terrorist attacks on our nation's economic and military epicenters in 2001. They stated that our nation experienced a ***"failure of imagination, policy, capabilities and management."*** In a similar regard, despite the volumes of evidence and damage assessments presented annually about the nature and impact of the Chinese threat to our economic and national security, we attempt to rationalize and forgive our adversary's actions and behaviors because we tend to "hope" we'll ultimately change China into a market-driven economy and a nation accepting of fair trade, transparency and the rule-of-law as we know it.

From a background perspective, I've had the privilege of leading two teams over the past four years in the development, refinement and automation of what's referred to as cyber, competitive and economic threat intelligence. This is a form of predictive intelligence used to expose the breadth, depth, activities, entities and objectives associated with nation-state affiliated cyber-economic campaigns. These campaigns consist of state-sponsored and supported criminal cartels focused on leveraging cyber-enabled espionage and sabotage to execute industry-wide fraud, market manipulation and anti-trust schemes designed to accelerate China's entry and domination of each key global industry. In effect, these campaigns are designed to selectively bypass traditional barriers-to-entry that would otherwise prevent weaker competitors from earning a market leadership position within a free-market – especially within the more complex technical and scientific markets.

These cyber-economic campaigns are persistent, intense, patiently executed and include the simultaneous execution of such a large and diverse set of legal and illegal methods, individuals and organizations, there's little chance the targeted U.S. competitors can effectively defend or compete in the future without significant support of the U.S. government. If we begin with a mutual appreciation of this basic premise, we will be able to better understand how China's so-called private investment strategy, and related CE activities, fit within the broader context of China's strategic economic and military plans and activities while also addressing the one-sided, "in-the-trenches," battles being fought every day and how to begin turning back the tide.

Nearly every issue we will discuss today is a practice forbidden by US law and the WTO – an enforceable agreement China entered into in 2001. The sections of the WTO agreement pertaining to these issues include: 1) Annex 1, Section 17, **Barriers-to-Entry**, 2) Annex 1, Section 19, **Anti-Dumping** and 3) Annex 1, Section 24, **Subsidies and Countervailing Measures**. Rather than addressing the practices giving rise to these allegations, China has aggressively pressured governments for recognition as a market economy, a move which would limit the severity of the penalties implemented on China through the WTO's dispute settlement mechanism.

If we are to stop the type of behavior described throughout my testimony and protect our economic and national security, these laws and/or agreements must be applied to the fullest extent of the law and we must proactively manage the proper defense, enforcement and punitive efforts in a unified, centrally controlled, manner. And, we must do so in a manner that is consistent with what's required to counter our adversary's significantly superior cyber-economic capabilities. The U.S. may be superior in the execution of traditional business, commerce, financial, production, education, innovation, enforcement, military defense and intelligence processes. But, in the case of cyber-economic conflicts, our strengths are our greatest weaknesses because each is treated as a separate and distinct function and our laws and organizational structures prevent us from identifying and acting upon nation-state threat actor's intent on exploiting these weaknesses through the execution of a centrally controlled national strategy designed to achieve economic, military and diplomatic superiority. Chinese leaders refer to this as "Unrestricted Warfare."

Our own laws and corporate risk statements become the starting point for their targeting plans. For example, one need only Google the terms fraud, market manipulation and anti-trust to view a host of laws, regulations, reports, guidelines and case studies that describe, in detail, how to execute schemes associated with each category of crime and how to legally defend oneself if detected. Then, download just one corporate annual report from each industry and review the “Risk Factors” section. Any current or former “Targeting” or “Mission Planning” analyst will confirm just how valuable this information would be to a cyber-economic campaign planning professional – especially if the adversary believes the targeted nation(s) or corporation(s) are unable to detect, and unwilling to act upon, the national level aspects of the crimes.

But, we need not change who we are nor implement policies that result in less transparency or unintentional trade/currency wars. Nor should we open ourselves to charges of engaging in our own form of protectionism. Our focus simply needs to be improving our strengths while also improving our ability to expose and act upon nation-state adversary weaknesses and their illegal activities. We place our focus on improving fair and open competition and put Chinese owned, controlled and highly infiltrated companies on notice that we know what they have done, how they’ve done it and we will not tolerate it in the future. We place the emphasis on the beneficiary entities the same way we would if we discovered a U.S. company or investor was involved in fraud, market manipulation and anti-trust schemes. And, we also hold all entities materially contributing to these efforts equally accountable. We can simply refer to it as maximizing our ability to compete, as a nation, in the 21st century.

I would also like to say, for the record, that my testimony is my own personal opinion based on my direct experiences over the past 35 years within the intelligence, information warfare, information security, fraud control and financial services communities. All examples and evidence presented are provided for information purposes only and the commission, and public, are encouraged to review the same and come to their conclusions as to the validity of my findings and recommendations.

What are the Main drivers of Chinese investment in the United States?

The underlying political, economic and military drivers associated with China’s cyber-economic campaigns, and the associated financing methods, appear to be heavily driven by fear – and justified fear at that. Following the Chinese Cultural Revolution and Chairman Mao’s death, the Communist Party Elite reportedly felt a desperate need to catch up to the West as they realized that they were falling further and further behind in technological and economic strength and this placed the Communist Party, and its leadership, at risk. This feeling of desperation to improve its education, infrastructure, technological and economic leadership position appears to have escalated to new heights after China’s Communist Party leadership studied the 1990-1991 U.S. Gulf War (Desert Storm). Reports indicate many of China’s most senior leaders were stunned when the U.S. technological superiority resulted in the near destruction of the world’s 6th largest army in just 100 hours - with only 147 coalition forces killed-in-action compared to 20,000 to 35,000 Iraqis. In addition, the Iraqis lost approximately 3,700 tanks, 2,400 APCs, 2,600 artillery pieces, 110 aircraft and 19 naval ships. This, along with growing internal issues associated with sustaining and controlling a poverty stricken population of approximately 1.3B people and the seemingly insurmountable challenges of overcoming the miserable state of its public and private infrastructure, potable water, agriculture, livestock, medical and healthcare, education and the effects of the “one child” policy, created the drivers and justification for the ongoing cyber-economic campaigns and the corresponding surge in Chinese Outbound Foreign Direct Investment (FDI).

The more traditional and obvious objectives associated with China’s cyber-economic campaigns are:

1. Protection and strengthening of the communist party
2. Job creation
3. Economic and workforce development
4. Gaining increased levels of diplomatic influence

But, China’s objectives also extend well beyond western norms, and in many cases, our imagination. Chinese outbound FDI is but one piece of a much bigger, and more complex, strategic mosaic. This bigger puzzle is, to quote a former White House official, “a Pandora’s Box.” It has been intentionally designed as a Pandora’s Box to discourage us all from fixing it. You may recall that the real Pandora’s Box was actually a jar containing all the evils of the world and Pandora let everything out except for “hope.” Our adversary would like to create the same conditions – conditions of hopelessness. Only then will their enemy submit “without firing a shot.”

The more aggressive and unique objectives of these campaigns and investment activities include:

1. Gaining monopoly-like control of key industries and the global economy.
2. Gaining increased control of each company’s value and supply-chain.
3. Materially infiltrating key financial, corporate, research and government entities.
4. Gaining enhanced insider access to sensitive IP and technology otherwise off-limits or beyond their current capability
5. Gaining increased dependence on Chinese financial resources for financial and economic growth.
6. Gaining control of the western investment syndicates in order to redirect their O-FDI toward China’s preferred investments.
7. Decreasing risk associated with the exposure of their illicit financing operations.
8. Increasing control of domestic and overseas Chinese individuals (hereditary – not just current Chinese citizens).
9. Increasing levels of political influence and control within the U.S. and other nations.

Do Chinese investments and activities present economic or business challenges for the United States?

Foreign investment in to U.S. entities by the Government of China and its proxies is our 21st Century Opium and, if not managed and controlled, it will likely lead to the eventual loss of our strategic competitive advantage in banking, finance, innovation and productivity. China's investments are made within the context of the aforementioned cyber-economic campaigns – not traditional Return-on-Investment (ROI) principles. Based on my experience with the various industry cyber-economic campaigns, I believe China's primary investment related objectives fit within the following categories:

1. Concealment of illegal government subsidies in support of building national champions or top tier, controlled, competitors
2. Concealment of government financing of covert, U.S. based, Chinese controlled entities serving in various cyber-economic campaign support roles such as:
   - Technology transfer
   - Espionage support
   - Sabotage support
   - Support the insertion, through mergers, of Chinese teams or business units within strategic U.S. companies for the purposes of technology transfer, espionage and sabotage
   - Capacity building
3. Concealment of government investments in companies to:
   - Enhance private equity syndicates and raise capital for strategic Chinese investments
   - Gain access to sensitive insider information (sales, performance, risk, legal, investment, etc.)
   - Manipulate foreign industry leaders
   - Gain access to sensitive technology and related IP
   - Support corruption (bribes and money laundering)

The following summarizes the national and economic issues/challenges associated with these efforts:

1. <u>Concealment of illegal government subsidies in support of building national champions or top tier, controlled, competitors:</u> When an illegitimate Chinese investor (private equity or corporations) provide financing to an illegitimate Asset/Company (i.e., unqualified and state supported entity) they artificially increase the competitiveness (price and options) and market share of an entity that would otherwise be considered a non-performing asset. Conversely, this weakens the legitimate competitors and reduces their market share, cash and liquidity position, growth capital and ultimately results in: a) insolvency, b) being acquired by the Chinese champions or c) being acquired by other weakened survivors. In each case, removal of the legitimate competitors and the free-market dynamic will typically prevent the recovery of the former market leaders and ultimately discourage investor participation in the stock market thus placing the de facto state-owned-enterprises in permanent monopoly positions.

2. <u>Concealment of government financing, and control, of covert, U.S. based, Chinese entities serving in various cyber-economic campaign roles:</u> This method is typically used in support of corruption, money-laundering, concealment, deception and to develop corporate or other forms of CE Campaign support entities that can more easily, including as trusted insiders, interact with U.S. based entities, investors and customers. This approach allows China controlled business and investor entities to gain highly trusted insider access to companies that compete with the Chinese national champions as well as their customers and other value-chain entities. This provides an enormous competitive advantage to the entire Chinese affiliated corporate and investor cartel.

3. <u>Concealment of government investments in companies:</u> This method includes outbound investments from Chinese entities with the intent of: a) creating strong personal relationships with U.S. investors, b) increasing China's overall industry influence and access, c) buying privileged access to private/confidential corporate decision making information with intent of sharing with China competitors or for use within cyber-economic schemes, c) gaining control of the U.S. asset and its products and IP for use within cyber-economic schemes, and d) gaining control of the U.S. asset to gain access to critical supply and/or value chain entities. Evidence suggest this method is also used to generate revenue/capital required to "self-fund" some level of the cyber-economic campaigns. Methods used to entice or force a target company to accept the terms of the Chinese investor include coercion and duress.

How can these challenges be mitigated?
This is not an insurmountable problem and it is one we have much more control of than China would like us to believe – at least as of 2017. They prefer we accept the hopelessness of defense and just enjoy the opium of foreign investment – a narcotic ultimately to be withheld when the house-of-cards collapses or they've achieved their stated objectives. The U.S. is still the strongest nation in the world in terms of innovation, consumer strength, education and a motivated workforce – and despite losing 77 spots on the Fortune 500 between 2002 and 2015, the U.S. is still the leader with 128 companies listed. Unfortunately, China grew from 3 to 106 during the same period.

I believe the solution to these cyber-economic campaigns is based upon two primary principles: 1) Enhancing current laws and regulations to address nation-state cyber-economic threats vs. drafting new laws and regulations and 2) Enhancing our government/industry command and control structure to address ***cyber-enabled economic warfare***.

As for the more detailed recommendations, I believe that if the following were formalized and acted upon, we would see a remarkable reversal of the current campaigns while at the same time balancing the need to cure the disease without killing the body. In this case, China is a major part of the global economy, the body, and any step taken to correct the cyber-economic related issues must correct the issue without causing the complete collapse of China's economy or government. Therefore, I recommend the following:

1. Optimize government and industry awareness of the current state of each nation-state cyber-economic campaign (by industry)
2. Optimize government and industry awareness of the CE campaign strategies, methods, activity, communications and coordination
3. Empower a joint cyber-economic task force to act upon nation-state cyber-economic campaign activity within the context of a strategic national threat
4. Enhance audit, due diligence and procurement practices and standards to include cyber, competitive and economic threat intelligence methods and techniques
5. Eliminate current audit community conflicts-of-interest introduced by rogue nation-state involvement in cyber-economic campaigns (i.e., rogue nation-state introduced obstructions to growth and regulatory retaliation in response to adverse findings)
6. Create a model CE procurement risk management program using the FAR/DFARS procurement processes
7. Create a model CE investment portfolio risk management program using the top U.S. government pension programs (e.g., Civil Service Retirement and Disability Fund, Thrift Savings Plan, Military Retirement Fund, Congressional Pension Fund)
8. Create a model CE insider threat management program by focusing on the Defense Industrial Base and Defense Security Services (DSS)
9. Optimize the U.S. immigration and visa programs to reduce the number of high-to-severe risk insiders supporting CE espionage, sabotage and support related activities
10. Identify and revoke the visa's associated with the Top 5-10 U.S. based CE threat entities per industry campaign
11. Leverage existing US, China and Taiwanese laws to jointly pursue prosecution of the top 100 CE threat actors (people) within China, Taiwan and the U.S. involved in the most material campaign schemes over the past 5-10 years.

If these measures do not result in a significant shift away from the use of cyber-economic campaign methods, then include:

1. Place the highest risk and confidence Chinese industry, academic and government CE leadership entities (threats, accomplices and beneficiaries) on the official U.S. OFAC and travel restrictions lists
2. Pursue trade sanctions and significant civil awards in support of the CE victim companies, shareholders, universities and research organizations

Can you explain the private equity, private corporation and SOE investor roles and activities within the context of what you believe are the most significant Chinese government affiliated industry campaigns?

Priority #1 – IT Industry Overview:

I've divided the IT Industry Campaign into seven sub-campaigns: 1) Raw Materials, 2) Component Makers, 3) Telecom/Wireless Service Provider, 4) Network & Communications, 5) End-User Platform and Mobile, 6) IT Security and 7) Digital Content.

The net result of this campaign is that Huawei, ZTE, Lenovo, Tsinghua Holdings, Xiaomi, Netscreen, Fortinet, NSFocus and Hillstone Networks appear to be the primary beneficiaries of the earliest phases of this campaign. Conversely, Nortel, Alcatel, Lucent, 3Com, RIM/Blackberry and Motorola have been sidelined while Ericsson, Cisco, Nokia, Juniper and IBM have been degraded but remain on the leader board.

Each segment continues to be targeted but the more intense current cyber-economic activity appears to be associated with: 1) completing control of the mobile device segment, 2) expanding control of the information technology segment, 3) achieving control of the IOT related segments, 3) leveraging Chinese and Taiwanese resources and assets to execute the microchip campaign and 4) expanding and merging the media and entertainment campaign to control the gaming, content and digital delivery technology segments.

Huawei/ZTE Only CE Campaign Highlights (2005-2014):

Financial Impact
1. Estimated total victim company lost/diverted revenue: $160B
2. Estimated total victim company lost/diverted profit: $8B
3. Estimated total government tax (payroll and corporate) income lost: $19B
4. Estimated total victim company lost/diverted CAPX and R&D investment: $11B

The Telecom/Wireless, Network & Communications and End-User Platform/Mobile cyber-economic campaigns were primarily led by Huawei/ZTE but were joined by other government subsidized mobile competitors in the 2011-2013 timeframe. This particular campaign is considered a generation one China-based brute-force CE campaign. The new campaigns are significantly more refined.

During the 10-year period from 2005 to 2014, the top 3 western Telecom/Wireless and Network/Communications competitors grew an average of 4% per year while Huawei/ZTE averaged 24% per year. During this period, Huawei/ZTE developed competitive products that fit within four separate, highly competitive and costly, segments: 1) Telecom/Wireless, 2) Network & Communications, 3) End-User Platform and Mobile and 4) Integrated Circuits. The Western leaders associated with each segment were Ericsson, Cisco, Samsung (RIM/Blackberry for a time) and Intel. Each of these market leading companies invested an average of $6B per year in R&D during the

2005 to 2014 timeframe to earn the leadership position, develop a market leading product portfolio, generate the necessary patents to protect their return-on-investment and optimize growth. This represents an estimated 10-year total of $240B invested in R&D by the top competitors associated with these four segments. If a new market entrant were to enter the market and attempt to compete with each, it would be expected to invest an equal, or higher, amount to catch up and overcome each of the leaders.

During the 2005-2014 period, Huawei and ZTE invested approximately $40B. <u>This represents an investment gap of at least $200B within the R&D category alone</u>. This gap also represents the likely value of the illegal R&D subsidies provided by the Chinese Government. Evidence suggest, the $200B value is divided between: 1) illegal cash subsidies to the beneficiary company R&D efforts, 2) illegal cash subsidies to accomplice companies, research institutes, tech transfer organizations, and universities that funnel their IP to the beneficiary, 3) investments in corporate espionage programs and 4) the acquisition of technology and IP.

Despite this disparity, Huawei/ZTE closely mirrored three of the segment leaders product launch rates while exceeding their patents filed rates. The only segment with a material lag in development has been within the microchip segment but this began to accelerate over the past few years. Huawei and ZTE, combined, currently rank #1 in total patents filed in the world. As individual companies, ZTE ranks #2 and Huawei ranks #3. Only IBM filed more patents during this period.

During this same 2005-2014 timeframe, the four western leaders invested an estimated total of $32B in CAPX (facilities, manufacturing lines, IT etc.) required to support growth and annual enhancements to productivity and quality. Huawei/ZTE invested an estimated total of $6.5B. <u>This represents an investment gap of at least $25.5B</u>. As with the R&D investment gap, this shortfall represents the likely value of the illegal CAPX subsidies provided by the Chinese Government.

The likely R&D and CAPX subsidy value of $225.5B over 10 years, or an average of $22.55B per year, is staggering and truly highlights the true magnitude of the issue.

Intelligence information and artifacts analyzed during the analysis and reporting portion of the Huawei/ZTE campaign, included indicators of cyber and traditional forms of espionage, IP theft and conversion, sales manipulation, major levels of concealed subsidies, collusion, exclusive dealings, tying products, predatory pricing, financial statement fraud, coercion, dumping, bid rigging, stock bashing and the introduction of barriers-to-trade. The evidence relates to events within China, Canada, U.S., Europe, Australia, Africa, Latin America, Caribbean and Southeast Asia.

<u>Information Security Segment Campaign Highlights (1995-2016):</u>

The IT Security Campaign is a very different form of cyber-economic campaign. Same objectives and progress but this campaign likely included significant U.S. based Chinese command and control, corporate, investor and insider threat entities.

The campaign began in the 1997-2000 timeframe. The individuals associated with likely leadership roles entered the U.S. during the late 1980's and early 1990's. They were ***children of the Chinese Cultural Revolution*** and their parents and teachers were children of WWII, the Communist Revolution and the Great Leap Forward.

In 1975, Deng Xiaoping wrote Mao Zedong and stated "University Graduates were not even capable of reading a book in their own fields when they left the university." In addition, in 1993, only 10% of Chinese had a phone, only 1% had a computer at home and their first permanent internet connection was completed in 1994. Compared to the U.S., approximately 93% had a phone, 50% had a computer, 50% had access to the internet and 30% had a cellphone. This is important context for understanding the leaders and strategic insiders associated with the cyber-economic campaigns.

Three of the four suspected leaders of the IT Security Campaign attended Tsinghua University during the 1981-1989 timeframe. The fourth attended Tsinghua University between 1987-1994. The academic quality associated with this timeframe was far from western standards and each would have likely arrived in the U.S. at a considerable disadvantage in terms of educational building blocks and experience within the subjects of business, finance, management and internet related technologies and security – and even more so in regards to microchips and internet-based encryption.

The suspected leaders of the IT Security Campaign took slightly different paths to NetScreen once they arrived in the U.S. During the years leading up to the 1997 founding of NetScreen, one founder took a position with Intel (Microchips) while another worked at Cisco (an IT network and security pioneer). The initial NetScreen prototype solution used to gain initial funding was allegedly designed and built within a 30-day period while the two individuals continued to work at Cisco and Intel. The original investors included U.S. and Taiwanese venture financing yet traditional due-diligence models would have likely flagged such an investment as a high risk venture.

Post Company Founding Campaign Highlights are as follows:

1998: NetScreen leadership co-found Hua Yuan Science and Technology Association (HYSTA) – the suspected primary U.S. based IT Industry cyber-economic command and control entity.

2000: Two Netscreen co-founders prematurely depart NetScreen to found Fortinet, a direct competitor to NetScreen, yet maintain equal ownership of NetScreen. Once again, the founders receive significant private financing despite the growing number of high-end industry competitors such as Cisco and Checkpoint.

2001: Successful IPO in months following 9/11 when the majority of IPO's were cancelled and IT and IT security related sales plummeted due to frozen CAPX budgets during this period. NetScreen's financials included a significant number of anomalies associate with potential sales fraud executed from 1997 to their acquisition by Juniper in 2004.

2002: During the post IPO and pre Juniper acquisition period, Juniper was able to close the duress acquisition of OneSecure. OneSecure, an Israeli affiliated company with links to market leading Checkpoint, provided NetScreen with technical credibility required to increase sales within the U.S.

2003: The surprise duress acquisition of Neoteris in October 2003. Neoteris was a leading niche SSL/VPN company and the objective and value of this acquisition is not clear. Neoteris had an anomalous senior technical employee, another child of the Chinese Cultural Revolution, and a late 1980's Nanjing University Graduate. He was listed as a co-inventor of the SSL/VPN technology yet his education and career, till Neoteris, provided little access to the knowledge and experience one would normally associate with encryption technology development.

2004: NetScreen was acquired by Juniper for $4.1B. This valuation was based on extremely high compound quarterly growth rates ranging from 14% to 80% during the preceding year. Its competitors such as Nortel, Nokia, Checkpoint and SonicWall were averaging negative growth rates during the same period. NetScreen's success was reportedly based on major deals provided by the Government of China through its key SOE's – including a portion of the Great China Firewall.

2004-2006: 1) NetScreen became Juniper's primary security product's business unit, 2) NetScreen's founding executives led efforts to move NetScreen R&D to China, 3) Juniper's CEO signed a strategic partnership with Tsinghua University, 4) NetScreen's founding executives co-founded Northern Light Ventures (a high risk China/US venture firm), 5) a segment of NetScreen/Juniper leaders and employees founded Palo Alto (a competitor to Juniper), 6) a segment of NetScreen/Juniper leaders founded Sigma-RT (funded by Northern Light), 7) a segment of NetScreen/Juniper leaders founded Hillstone Networks (funded by Northern Light), 8) a key NetScreen founder became President of HYSTA (command and control entity) and 9) the same key NetScreen founder became co-chairman of Tsinghua Executive Entrepreneur Club (TEEC) in Silicon Valley.

2008: NetScreen/Juniper engineers adopt an encryption model for their SSL/VPN solution known to be susceptible to hacking and implement it in a manner that further weakens it.

2009: A key NetScreen founder is selected for membership in the China Entrepreneur Club – the most significant and elite, China Government led, cyber-economic command and control entity. Fortinet experiences 19% growth during the 2008-2009 global economic crisis.

2012-2013: 1) Key NetScreen and Fortinet founder becomes President of HYSTA, 2) ScreenOS Encryption Backdoor embed occurs and 3) ScreenOS Privileged Access Backdoor embed occurs

2014: 1) Juniper awarded unusual level of contracts within China despite the "Snowden-Effect" impact on peer U.S. competitors, 2) Juniper CEO mysteriously fired due to conduct in customer negotiation (some references to "intrigue") and 3) Fortinet and Palo Alto leap over Juniper to take the #3 and #4 market positions respectively – while China-based, Northern Light Venture funded, Hillstone Networks experiences market leading growth rates despite a mature market

2015: Juniper releases an announcement regarding the recent detection of unauthorized code embedded within the Juniper ScreenOS that enabled two covert backdoors – one of which provided full administrative access while the other provided the ability to decrypt VPN connections. These backdoors provided the responsible threat with fully covert and unencrypted access to the encrypted traffic transmitted through a large number of internet service providers used by millions of private and commercial customers – including the DC, New York and Chicago regions. The system-development-lifecycle for ScreenOS has been controlled by Chinese employees from 1997 to the time of this incident. The quality assurance process may have been led by former Netscreen employees working for Sigma-RT – a Northern Light Venture company.

The IT Security campaign has expanded well beyond the entities noted above. And, the challenges of decoupling the legitimate entities and activities from the illegitimate becomes more and more difficult each month.

<u>Microchip Segment Campaign Highlights (2001-Current):</u>

The Microchip Segment Campaign is an example of a more sophisticated cyber-economic campaign that appears to be leveraging all the benefits of the historical IT industry campaigns as well as the lessons-learned. **This is China's current #1 priority campaign.**

This campaign, more so than any other technology segment, appears to involve a material level of support and coordination between Chinese operating from China's Mainland, Taiwan, U.S. and Europe. China has boldly communicated their objectives and provided a significant level of detail about their plans and involved entities.

This campaign is appears to be divided into sub-campaigns targeting the various categories of microchip technology. This includes microprocessors, chipsets, memory, CMOS, analog and power, mixed signal etc. This campaign appears to include an industry unique objective that, if understood by U.S. oversight organizations such as CFIUS, may help shed light on the risk of certain Chinese led investments and acquisition efforts that would otherwise appear low risk. China appears to be executing a cyber-economic campaign strategy designed not only to gain market leadership for its national champions but capture as much IC industry "capacity" as possible. Capacity refers to each competitor's share of the industry's manufacturing facilities, suppliers and raw materials. Some experts have indicated that there's only so much capacity available and this is why we'll often see market leading IC industry competitors acquire failing competitors that provide no obvious financial value.

This past August, China announced the formation of The "High End Chip Alliance (HECA)." This alliance would be considered an anti-trust cartel if it were within U.S. borders. The government's industry spokesperson from TrendForce stated "This alliance of government, academia (government), and industry aims to create a complete ecosystem for domestic semiconductor manufacturers. If successful, the alliance will create a chip industry chain starting from chip architecture to chip production, operation systems, devices, platforms and finally to the IT service market." And then, Jian-Hong Lin stated "The mission of China's high-end chip alliance is to develop highly localized and vertically integrated relationships among industry players. The ecosystem they built will be exclusively for domestic manufacturers and design houses." This exclusive cartel consists of 27 members – including Tsinghua Unigroup, SMIC, Yangtze River Storage Technology, Lenovo, ZTE, Beijing University, Tsinghua University, Chinese Academy of Sciences, Baidu and Alibaba. The Director of this Cartel will be Ding Wenwu, President of China's National Semiconductor Industry Investment Fund. The Deputy Cartel Director is Tsinghua Unigroup Chairman Zhao Weiguo. These are two Chinese government representatives.

This industry segment campaign relies heavily on the following methods/tactics:

1. "Power Buyer" coercion and leverage gained as a result of the market share and leadership positions gained as a result of their IT Industry Campaign within rare earth materials (90%), telecom, enterprise communications, mobile, PC, servers and the Internet of Things (especially automotive)
2. Aggressive investments in, or acquisitions of, industry capacity
3. Aggressive "cross-straits" (Taiwan) recruiting, infiltration, investments and acquisitions
4. Embedded insider threat actors working within all the western microchip manufacturers and investment entities
5. NDRC assisted duress on western competitors operating within China
6. Additional leverage gained as the result of HNA Group's acquisition of Ingram Micro

<u>Media & Entertainment Segment Campaign Highlights:</u>

The Media and Entertainment Segment Campaign substantially overlaps with the IT Industry Campaign. As with other strategic campaigns substantially launched after President Xi assumed leadership of ChinaCo, an industry reference used to capture the notion a Chinese National Conglomerate consisting of all commercial entities, this is a more sophisticated cyber-economic campaign than those launched in the late 1990's. It too appears to be leveraging all the benefits of the historical IT industry campaigns as well as the lessons-learned. This campaign also appears to have much great significance to China than most policy makers understand due it's links to the Ministry of Propaganda initiatives. This segment campaign includes:

1. Mobile and online games
2. Internet browsers
3. Media content (archived movies, television shows, online distribution services etc.)
4. Data streaming and content delivery
5. Automatic Content Recognition (ACR)
6. Production studios
7. Movie theaters
8. Resorts and Theme Parks
9. Cruise lines
10. Sports and Sport Media

The cyber-economic methods and schemes associated with this campaign mirror those noted earlier. The most significant beneficiaries and investors associated with this campaign include: 1) Wanda Group, 2) Alibaba (YF Capital, Alibaba Digital Media and Entertainment, and Alibaba Pictures), 3) Tencent, 4) Tang Media Partners, 5) China Media Capital, 6) Huayi Brothers, 7) Fosun Capital, 8) CITIC, 9) Flagship Entertainment, 10) Shanghai Giant Network Technology, 11) Hunan Television & Broadcast 12) Leyou Technologies, 13) Shandong Hongda, 14) LeVision, 15) LeEco/Vizio, 16) PCCW Media and 17) Crunchyroll

The large number of elite Chinese Government controlled investors is a clear indicator of the importance and priority associated with this campaign.

<u>Financial Industry (FinTech)</u>

The Financial Industry (FinTech) Segment Campaign substantially overlaps with the IT and Media and Entertainment Industry Campaigns. It too represents a more sophisticated campaign. As with the microchip segment campaign, if the current cyber-economic risk scenarios associated with this campaign come to fruition, the impact on the U.S. economy and national security are quite severe.

To understand the quality of the banking and financial services industry campaign strategy, we must view the strategy within the context of the last four campaigns described to this commission as well as the insurance industry segment campaign. "ChinaCo" increasingly controls the servers, laptops, mobile devices and software we use to manage our financial processes, play online games, watch online news, movies and television shows, secure our mobile devices and secure our browsers.

The current U.S. financial services and asset management industry leaders are incredibly strong but also incredibly vulnerable to unexpected changes driven by emerging and disruptive technologies. ChinaCo's cyber-economic campaign strategy for this industry appears to be based on a four-prong attack. Each prong (CE risk scenario) is described below and our assessment is based on the evidence collected over the past four months:

1. **Industry Infiltration & Degradation**: Traditional investment, joint-venture and insider infiltration strategy supported by unique Chinese resource management organizations such as UniCareer
2. **FinTech Vertical Monopoly**: Alibaba, Tencent, Baidu, Ping An, JD.com and Xiaomi have launched FinTech capabilities in nearly all vertical FinTech categories. This would typically be considered a vertical monopoly and anti-trust violation.
3. **FinTech Horizontal Monopoly:** Huawei, Lenovo and Xiaomi have launched major FinTech infrastructure solutions designed in a manner consistent with a horizontal monopoly structure. When coupled with the advantages gained as a result of the vertical monopoly, ChinaCo gains an incredible amount of industry advantages and an ability to block all competitors from challenging its FinTech position.
4. **Digital Transaction Monopoly:** ChinaCo appears to be executing an aggressive IP theft and conversion campaign, as well as a state-sponsored acquisition strategy to corner the bitcoin and blockchain market and introduce the first major disruptive innovation in the financial transaction and asset management industry in recent memory. This technology is already being integrated with some of Chinese FinTech vertical and horizontal solutions. Successful execution of this strategy will undermine all current leaders in the industry. Key high risk entities associated with this campaign include all organizations subordinate to Financial Blockchain Shenzchen Consortium (FBSC) and the Chinese representatives to the R3 Blockchain Consortium. The Zhongguancun Science Park and the following universities are key to China-based R&D and conversion activities: 1) Tsinghua University, 2) Peking University, 3) CAS/CAE, 4) Renmin University and 5) Beihang University.

In your opinion, which Chinese, or Chinese Controlled, Investors present the highest risk to U.S. interest?

Our efforts indicate the following investors are the highest risk to U.S. national interest: 1) Alibaba syndicate, 2) Wanda Group syndicate, 3) Tsinghua syndicate, 4) Fosun syndicate, 5) Tencent syndicate, 6) Legend syndicate, 7) Huawei syndicate, 8) CITIC syndicate, 9) Northern Light Ventures syndicate, 10) Summitview syndicate, 11) Shanghai Semiconductor syndicate and 11) China Integrated Circuit Industry Investment Fund (CICIF) syndicate.

In addition, I believe special attention should be paid to: 1) China Entrepreneur Club, 2) HYSTA and U.S. based investors and companies with close relationships with the investor syndicates and suspected command-and-control entities described above.

What other activities have the Chinese been involved in that might advance their interests to the disadvantage of U.S. companies?

China's most effective means of gaining tactical and strategic advantage over U.S. companies is something most American's are just not prepared to listen to or address. But, it is also the method that could be the Achilles Heel of the entire Chinese cyber-economic campaign strategy.

The method used is so detestable to our personal sensitivities that it is just as controversial to speak of it as it is to speak about the differences between torture and acceptable forms of interrogation.

The method I am referring to is the use of a massive human intelligence, open-source intelligence and technology transfer networks to infiltrate and exploit foreign competitors, R&D organizations and universities for the purposes of IP theft, espionage, sabotage and capacity building.

Considering the stated goals and objectives of the United Front and Overseas Chinese Affairs Office, it appears likely China intends to target and leverage as many overseas Chinese, and persons of Chinese descent, as possible in order to achieve their long-term national objectives. The advantage this provides far exceeds that of traditional, externally focused, cyber access. It provides trusted insider access as well as control and influence within the targeted competitors.

According to the U.S. Census Bureau, as of 2013, 2,018,000 Chinese immigrants lived within the U.S. 1,634,000 of these immigrated to the U.S. after 1980 and most were raised within the Communist led academic, legal and social environment while a small percentage were raised in Hong Kong. In addition, according to the Wall Street Journal, in 2015, there were 331,371 Chinese students studying within the U.S. – more than double that from India. Conversely, the number of Americans living on the Chinese mainland reached a mere 71,493 in 2010 – many of which are of Chinese descent (Chinese census bureau figures). As noted within Chinese sourced policy documents, much of the Ministry of Science & Technology, Ministry of Personnel, Chinese Academy of Sciences, Ministry of Education, National Natural Science Foundation (NSFC), State Administration of Foreign Expert Affairs (SAFEA), Overseas Chinese Affairs Office and United Front efforts are focused on optimizing the impact of these overseas Chinese as well as optimizing the Chinese Returnee contributions upon return to the mainland.

Another unique advantage Chinese corporations and investors have over their U.S. counterparts is their apparent immunity to Foreign Corrupt Practices Act (FCPA) restrictions. Chinese corporate leaders are able to make "major investments" in opportunities with little or no expectation of receiving a traditional ROI because the cost lines within their budgets mean little when the government provides covert subsidies, loans, grants and even debt relief. This allows any number of Chinese corporate leaders to invest in deals that benefit U.S. political leaders, their families or allies in anticipation of a quid-pro-quo on future policies impacting China or Chinese investments. Two such anomalous investments involved Shandong Tranlin Paper Co. Ltd (aka Quanlin Paper) and Shandong Sun Paper Industry Co. Headlines indicated these investments were to be at the $2B and $1.36B level and for the purposes of establishing pulp plants in Virginia and Arkansas. Neither investment appears to conform with traditional ranges for such investments, Virginia and Arkansas are not in the top tier for straw production required to support operations, and the U.S. pulp market is experiencing a negative annual rate. These investments may have been attempts to influence the U.S. political process as the U.S.

Another unique advantage provided to China's industry leaders comes from China's unique use of a small number of key billionaires that appear to act as a direct agent or conduit to and from President Xi. Two of the most noteworthy, included within the SquirrelWerkz case studies, include Jack Ma (Alibaba) and Jianlin Wang (Wanda). Considering the campaigns led by these two individuals, it would be difficult to identify two more significant Chinese threats to U.S. economic and national security interests than these two individuals.

Finally, China's National Development and Reform Commission (NDRC) has introduced yet another material advantage to China's industry players. The NDRC now appears to play an active role in applying strategic duress on foreign competitors that extends well beyond normal regulatory and enforcement support. In addition, its unique role in investigating foreign companies for perceived anti-trust violations provides yet another mechanism for accessing and sharing sensitive IP seized during these same investigations.

Are there concerns that Chinese government-affiliated entities, through private equity investments, may gain access to U.S. companies that produce advanced materials or technologies that have dual-use applications?

<u>Example #1: Undersea Cable Industry</u>
Evidence supports a conclusion that China poses a significant threat to the U.S. Navy and its allies due to its long-term efforts to gain incremental control of the foreign companies associated with the undersea cable industry and the potential enhancement of these cables to support undersea monitoring and command and control. Despite direct control of less than 10% of the current total market through Huawei Marine, China has gained considerable control/influence over the top providers including: 1) Nokia's Alcatel-Lucent Submarine Networks (ASN) Division, 2) TE Connectivity Inc/SubCom and 3) NEC.

<u>Example #2: Navy Shipbuilding Industry</u>
Evidence supports a conclusion that China is leveraging its cyber-economic methods and entities to access classified and sensitive engineering documents, plans and specifications. Chinese shipbuilders such as CSIC, CSSC, CSTC and SinoTrans/CSC

appear to be leveraging ChinaCo's broader campaign relationships, access and leverage points to gain access to these types of documents, technology and the skilled resources through companies based within allied nations such as Taiwan, France, Turkey, Germany, Pakistan, Saudi Arabia, Egypt, UAE and India. In addition to the aforementioned Chinese shipbuilders, the following Top 5 Chinese entities appear to be involved in the conversion efforts: 1) Harbin Institute of Technology, 2) Harbin Engineering University, 3 Beijing Institute of Technology, 4) University of Science and Technology of China and 5) Beihang University).

One Navy related example includes the apparent use of sales related incentives and dis-incentives to manipulate Rolls-Royce to, wittingly or unwittingly, provide access to sensitive propulsion-related engineering IP. In excess of 10% of Rolls-Royce revenue comes from China and Rolls-Royce is also a major provider of advanced propulsion systems for the U.S. Navy. The PLAN has improved its own submarine fleet's propulsion systems using IP provided through Rolls-Royce. In addition, China has sold no less than two attack submarines and two destroyers to Pakistan with the same advanced propulsion systems.

Other concerning defense related cyber-economic campaign indicators are associated with the following: 1) autonomous vehicles (automobiles, trucks, aircraft, shipping and submersibles), 2) drones, 3) advanced rocket propulsion systems, 4) private space industry, 5) virtual reality and 6) aerospace and aerospace supply-chain.

<u>Key Space Industry Activities and Entities:</u>

1. China's OneSpace was founded in June of 2015 with direct support from the National Defense Science and Industry Bureau and is the Chinese competitor of U.S. based SpaceX. Its core investors include Legend Holdings (Lenovo), Harbin Institute of Technology (HIT), Chun Xiao Capital and Land Stone Capital
2. Other emerging space industry entities include Landspace (Tsinghua, CN), Shenzhen Yu Long Aerospace Science and Technology (CN), Expace (CN), Link Space (US), Space Vision (UK) and Blue Origin (US)
3. The China Academy of Launch Vehicle Technologies (CALT) leads China's public and private sector investments and development associated with spaceplanes
4. The Kuang-Chi Group syndicate is highly involved in space related investments including a $1.5B futuristic tourism and space theme park. Kuang-Chi is China's answer to Elon Musk and his organization already ranks #7 in patent applications
5. AVIC acquired California based Align Aerospace in 2015. Align is a global aerospace supply chain company providing a wide variety of proprietary and non-proprietary products and hardware required for aircraft manufacturing and maintenance. This acquisition provides AVIC direct buyer and technology partner access to GE, Pratt, Bell, Sikorsky, Honeywell, Triumph, Boing and Bombardier.

What do public and private sector policy leaders need to understand to gain a greater appreciation of the threat to U.S. interest caused by China's outbound investment strategy?

During the past four years, I've met privately with more than 300 senior executives representing more than 20 industries. During these meetings, we've reviewed the China led cyber-economic campaign having to do with either their company or industry. In nearly every case, the executives have agreed with, and often validated, the findings and evidence. And, in nearly every case, these same executives provide their own examples of incidents and indicators and express a desire to take action. But, there are two consistent mental obstacles that tend to prevent or minimize their response:

1. They have no meaningful reference point to help them understand how big, complex, effective and persistent the Chinese Cyber-Economic Threat really is so they begin to believe they can just hunker down and the storm will pass
2. They are fearful that if they take meaningful action, the Chinese threat actors will retaliate in ways that destroy their business, reputation and ability to recover

Addressing the first issue could be accomplished through a government led effort to educate the public and private sector on the true nature of the two primary nation-state cyber-economic threats (China and Russia). This education process should include U.S. universities and research organizations and include a review of the following:

China's Economic and Science and Technology (S&T) Intelligence Requirements, Collection and Conversion Process consist of six stages: 1) Communist Party Defines/Documents Key Themes, Main Task and Strategic Priorities for S&T/Economic Growth, 2) Consumers of S&T/Economic Intelligence Define Requirements to satisfy Communist Party objectives, 3) S&T/Economic intelligence collection managers task collection resources, 4) S&T/Economic intelligence collection resources collect and transfer raw intelligence to analysis and processing resources, 5) S&T/Economic intelligence analysis and processing resources prepare information for use and distribution to consumers and 6) S&T/Economic intelligence consumers further sanitize and convert IP into economic advantage.

***Communist Party Defines/Documents Key Themes, Main Task and Strategic Priorities for S&T/Economic Growth**:*

1. All S&T/Economic goals, objectives and budget approvals are defined within the context of China's Five Year Plans (FYPs)
2. The State Council, the most powerful decision authority in China, is led by the President/Premier and includes 32 ministry leaders
3. State Council Departments support and/or assists in the development of the specific industry/product segment plans and budgets
4. National Development and Reform Commission (NDRC) is the most influential FYP leadership organization

5. NDRC has recently assumed an additional role that includes an authority to levy anti-trust claims and penalties against corporations for activity, which it currently or historically has been authorized – This provides the NDRC with a powerful economic weapon

Consumers of S&T/Economic Intelligence Define Requirements to satisfy Communist Party objectives.

1. The State Council Steering Committee of S&T and Education Coordinates the National S&T Policy (including the National Innovation System Policy)
2. The State Council Steering Committee of S&T and Education members represent the top five national S&T planning, intelligence process management, conversion and capacity building organizations/programs
   - Ministry of Science & Technology (MOST)
   - Chinese Academy of Sciences (CAS)
   - Ministry of Education (MOE)
   - Ministry of Personnel (MOP)
   - National Natural Sciences Foundation
3. The military S&T/Economic information governing body interacts directly with the President and State Council to ensure the highest priorities are assigned to their requirements

S&T/Economic intelligence collection managers task collection resources. There are three primary categories of S&T/Economic Intelligence Collection Managers:

1. PLA (Military Intelligence)
2. Ministry of State Security (Foreign Intelligence Service)
3. Civilian (Economic and Corporate Espionage)

The PLA has four primary units tasked with the collection and exploitation of Foreign S&T/Economic Intelligence. The Ministry of State Security (MSS) has three primary units tasked with the collection and exploitation of Foreign S&T/Economic Intelligence. There are no less than eight civilian ministries or departments tasked with the collection and exploitation of Foreign Economic and S&T Intelligence. Each of the three primary intelligence managers relies heavily upon overseas Chinese and their "insider" status to accelerate and optimize S&T/Economic Intelligence collection, analysis, storage and transmission to the processing and storage resources.

S&T and Economic Ministries plan, fund and support the S&T and Economic Intelligence exploitation and processing requirements – including the human resources and capacity building efforts.

The Ministry of Science & Technology (MOST) acts as the overall "Project Manager" for the collection, whitewashing, and conversion of Foreign S&T/Economic Intelligence through:

1. National S&T Programs
2. State Key Laboratories
3. National Engineering Research Centers
4. High-Tech Development Zones

The **Chinese Academy of Sciences (CAS)** acts as the single most significant R&D, white paper and patent conversion entity. The **Ministry of Personnel** acts as the primary organization for short and long-term capacity building, recruiting talent for domestic and overseas positions, motivating overseas Chinese to support the motherland and ultimately return to the mainland. The **Ministry of Education** serves to prepare specific individuals for overseas assignments, manage international exchange programs, manage intelligence storage/database operations and support the whitewashing and conversion processes. The **National Natural Science Foundation (NSFC)** serves a critical role between the ministries, academic environment and industry by funding and providing oversight for strategic research efforts and institutions.

Chinese source documents indicate that as of 2005, China funded and operated no less than 353 major S&T and economic intelligence institutes nationwide. This infrastructure and associated resources should be considered an illegal subsidy and a significant component of the criminal cartel involved in cyber-economic campaign activity. These brake down into:

- ~35 attached to the technical ministries
- ~33 subordinate to provincial and municipal governments
- ~285 considered local institutes
- ~15,782 direct employees

In addition to this, there are ~3,000 basic cells serving in key requirements generation and conversion positions. Chinese source documents refer to approximately 60,000 employees in grassroots units such as “companies” and “labs.” These resources are assigned duties defined as “investigating, collecting, sifting, analyzing, synthesizing and repackaging data in response to specific requirements.” SquirrelWerkz assumes, based on its own evidence, these resources serve within the intelligence liaison and management role within key Chinese companies (e.g., National Champions) and assist with the conversion of stolen IP and open-source intelligence into competitive advantage and competing products for these companies.

S&T and Economic Intelligence Collection Resources collect and transfer raw intelligence to analysis and processing resources through a wide variety of transfer methods – both overt and covert.

- Overt: Performed with little effort to conceal the actual collection activities
- Covert: Performed within a clandestine environment with the intent of concealing the collection activity or the true-nature of the collection activity

The China-PRC National Innovation System and “Information/Intelligence” Processing and Dissemination Programs follow the former Soviet Model for planning and collection but have been enhanced to incorporate the strengths and cultural nuances of China

- Layered approach to intelligence collection (Mattis) ranging from traditional service-driven operations with modern tradecraft to “amateur espionage” entrepreneurs
- Maximize numbers of “agents” or resources instead of a smaller, trusted, cadre of collectors
- Train the millions of “amateur agents” or resources to focus on denial versus tradecraft – get lost in sheer volume

Chinese and U.S. source documents indicate the Chinese government goals and objectives include a desire to control and manage all Chinese – including mainlanders, overseas, and even those with no direct family ties – through active insertion into foreign communities, associations, and control of local community organizations (Tongs) and Triads.

Economic and S&T Analysis and Processing Resources prepare Information for use and distribution to consumers.

China’s National S&T/Economic Civilian Intelligence (Information) Governing Body includes three key and inter-related entities:

1. Ministry of Industry Information & Technology (MIIT)
2. State Administration of Science, Technology and Industry for National Defense (SASTIND)
3. Civil Military Integration Promotion Department (CMIPD)

China’s National Economic and S&T Civilian Intelligence (Information) Governing Body includes seven subordinate member organizations. There are reportedly three National S&T/Economic Intelligence Analysis & Processing Organizations (mega-libraries):

1. China Defense Science & Technology Information Center (CDSTIC)
2. National Science & Technology Library (NSTL)
3. Patent Documentation Library

There are no less than thirteen subordinate S&T and National Economic Intelligence Analysis & Processing Organizations.

PLA source documents indicate there are three primary differences between these Libraries and western notions of libraries: 1) the Chinese system is run by intelligence experts, 2) they directly and actively support end-users and 3) they have a mission to provide an R&D shortcut by leveraging foreign intelligence

Other source documents indicate that in 2005, there were 50,534 networks used to host and distribute S&T information, 27,000,000 users and 1,000,000+ Chinese accessing “overseas” networks through the Intelligence Institutes to gather foreign S&T materials.

S&T/Economic Intelligence Consumers (aka, cyber-economic campaign beneficiaries) further sanitize and convert stolen confidential information and intellectual property into economic, competitive and military advantage.

Chinese source documents indicate there are three primary conversion environments used to transform (re-innovate) the S&T and Economic Intelligence into usable forms that provide Chinese entities with an economic advantage (indigenous innovation).

1. Academic: Used to whitewash the stolen or improperly attributed IP and to gain international competitive advantage for purposes of increasing tuition revenues, patent royalty revenues, entice foreign student registration, entice overseas Chinese to return and attract otherwise undeserved Inbound-Forward Direct Investment (I-FDI) related to ongoing research and development efforts (illicit subsidies)
2. Commercial: Used to produce competitive products and gain industry advantage without the corresponding cost-of-goods, R&D or capital expenditures (illicit subsidies)
3. Military: Used to produce competitive aerospace and defense systems and strategic advantage as well as to counter foreign systems and advantages

China’s National Innovation System (NIS) and Economic and S&T Intelligence Network is massive in size and scope, yet is managed in a highly effective manner due to the investments made to shape and control the collectors and conversion process within the context of China’s broader, long-standing, institutional, academic, research and economic development structures.

PANEL I QUESTION AND ANSWER (CONTINUED)

HEARING CO-CHAIR WESSEL: Appreciate it. We're going to return to questions. Senator Talent.

COMMISSIONER TALENT: Mr. Stengel, on the sovereign immunity issue, you made a point at the end, which I just barely knew before you made it, that this is, it goes to the issue of the court subject matter jurisdiction, and therefore can be raised, can't be waived, can be raised at any point in the litigation and, in fact, the court is supposed to raise the issue sua sponte; right?

MR. STENGEL: That is correct.

COMMISSIONER TALENT: Now given the fact that it's so difficult, it's often difficult to know the extent of Chinese government control of a company that you're dealing with if you're an American company doing business with them, and the fact that, in other words, you can't waive this so you can do business with a company, one of these Chinese companies, for years, get into litigation with them, and then two-thirds of the way through raise it if you want to; right?

Do you think it would make sense to amend the law to require that in countries where there is so much difficulty determining often who's running a company that, if you want, if you're going to raise sovereign immunity as a defense in any litigation or you're going to rely on it as a defense in any litigation arising out of a commercial transaction, that you have to indicate that at the time you form the relationship or engage in the transaction?

And that if you fail to do so, and Congress could, of course, change the law, so to grant, in other words, to make it not a subject matter jurisdiction issue, but a waivable issue, and then provide that if you don't indicate up-front that you're going to assert it, you can't assert it in subsequent litigation? So that the companies you're dealing with are on notice that you are going to claim sovereign immunity and can take that into account when they, when they negotiate the terms of the contract the relationship.

It would seem to me to make sense, in particular in dealing with Chinese companies--I don't think the law would have to say it's just Chinese companies--but I'd like your view on that.

Otherwise, I'm going to wait as far as Mr. Johnson and Mr. Hanemann to hear what some of the other people say and maybe in a second round. But I'd like your answer to that, Mr.--and one of the reasons is we make recommendations to the Congress in our report, and this would seem to me to be a subject we ought to explore and possibly make a recommendation on.

MR. STENGEL: Well, thank you, Senator.

Let me clarify something because the sovereign immunity since it's something that belongs uniquely to sovereign is unusual in terms of subject matter jurisdiction in that it can be waived by the party--

COMMISSIONER TALENT: Right.

MR. STENGEL: --and that's recognized. So there's no reason why, if I were doing business with a Chinese company and didn't know its ownership situation, I would try to protect myself and get a waiver contractually. That would be effective to create subject matter jurisdiction.

In other contexts, of course, parties can't create subject matter jurisdiction. It either exists or it doesn't, but this is a unique aspect of sovereign immunity in that if the sovereign waives subject matter jurisdiction if it otherwise exists is restored. So I don't know that specific legislation is required on this because I think the way the law already operates, there is a recognition certainly of explicit waivers of sovereign immunity.

That's functionally recognized by courts, very common obviously in the foreign debt context, sometimes to the sorrow of people who didn't get waivers. The courts are more restrictive on implied waivers, and there is no waiver--once you're in litigation, you can, as clients sometimes do, not appear, default, come in and say uniquely sovereign immunity and subject matter jurisdiction objections are retained.

But you, for example, can waive sovereign immunity by not raising it in a responsive pleading in federal court. So it is waivable. I don't know that--I mean the legislation might clarify to actors in these scenarios that there was an availability of such a protective device, but I don't know that the law requires that for it to be effective right now. I think parties can protect themselves.

COMMISSIONER TALENT: And you said you're not a transaction lawyer. Is it your sense, though, I mean obviously you litigate these cases, you know about the underlying transactions, I mean are companies regularly advised about this problem before they do business with these companies? I mean is it your view that they're conscious of this?

MR. STENGEL: Well, if they're sentient, yes. I mean any time you're dealing with a non-U.S. entity, companies through their lawyers ought to be thinking very long and hard, even apart from China and sovereign immunity, if they don't have assets available in the United States, how do we protect ourselves.

So I think parties are sensitive. I think that's why you see such a prevalence of consent to jurisdiction I mean again assuming bargaining position. I routinely advise U.S. clients dealing with non-U.S. entities to have a consent to jurisdiction and to litigation in a New York court, and that's--

COMMISSIONER TALENT: So your view is this is working pretty well now the way it is; litigation takes a long time sometimes, so it may look like one of our companies is being treated unfairly, but actually people are aware of the legal framework and can guard against it?

MR. STENGEL: Whether companies are adequately protecting themselves may be an open question. Whether there's a need for a subsequent or additional legal structure to help them, I think that's the part I don't quite get to. I think the existing legal structure is adequate, and it's up to the parties to take advantage of it.

HEARING CO-CHAIR WESSEL: Before Commissioner Slane, just as a--if you could answer later, just send us something, the question about that's in a transactional sense, the question of-- and I understand the monopoly, anti-monopoly issue was a comity issue--whether there are areas where it falls outside of the transaction, that there may be entities who have no idea that there is no waiver or there is no jurisdiction, et cetera, those kind of things. Is there a way of dealing with that?

Commissioner Slane.

COMMISSIONER SLANE: Thank you.

Mr. Hanemann, I wanted to follow up on Commissioner Shea's question. As I see it, there are three types of companies in China: state-owned; state-controlled; and private. Take Shuanghui. Shuanghui appears to be a private company, but the senior management is appointed by the Chinese Communist Party. When Shuanghui purchased Smithfield, it took the Bank of China 24 hours to approve a $4 billion loan. And the

Bank of China is not really a bank but an arm of the Chinese treasury.

So it gets very confusing in our country trying to implement what appears to be a private company but is not really a private company. I mean can you talk about that?

MR. HANEMANN: Yes, I so agree that the notion of a private enterprise is a very different concept in China, and just to be on the record, in an authoritarian country like China, I do believe that we should assume that any company, whether it's nominally state-owned or private, can be influenced and to some extent controlled by the Chinese government and ultimately by the Communist Party.

And I put that very clearly--we put that very clearly in all of our research, but for analytical purposes, we do believe it does make sense to have these distinctions between centrally state-owned companies, locally state-owned companies, hybrid firms and privately-owned enterprises. Maybe not for national security issues, but, for example, if you look at the jobs impact, the management capabilities, corporate governance issues, I think those distinctions matter.

And so we do put it in our research because a lot of people are interested in looking at these different categories, and for some policy and economic questions, commercial questions, it does actually play a role whether the company is state-owned or privately-owned nominally.

COMMISSIONER SLANE: And I don't know whether I missed this, but did you say you're opposed or you support the net benefit test?

MR. HANEMANN: I think the net benefit test is a problematic concept because there are no objective criteria for deciding whether an investment is beneficial to a country.

There's different viewpoints, and so I think having a net benefit test as opposed to a very narrowly defined national security test opens the process to politicization, to special interests, and in my view dramatically reduces the certainty for investors in terms of regulatory decisions. And so I do believe that this is not a solution that the U.S. should implement, yes.

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you. Thank you, gentlemen.

Mr. Hanemann, I'd like to ask you a question. Your hope is that we as a people are guided by facts and data. You described the significantly increased foreign direct investment of China in the U.S. You also mentioned that 90 percent of that foreign direct investment is acquisitions, with maybe eight percent greenfield investments.

Would you say fact-wise that it's largely the greenfield investments that bring jobs to America, or are those other acquisitions adding jobs too? I'd like to hear your opinion on that because I think that's what our citizenry would want to understand. I want to know how Chinese investments in the U.S. adds jobs.

MR. HANEMANN: So economists generally assume that greenfield FDI is more beneficial on net in terms of jobs impact because it creates new things. So in most instances, it involves hiring people as opposed to acquisitions, which is legally speaking a transfer of ownership.

Having said that, if you actually look at the numbers, and we've done a lot of research looking at the impact of Chinese investments of different forms, I would argue that it is important to look at the post-acquisition impact in terms of jobs with regard to Chinese companies, and if you actually look at Chinese companies' acquisition track record, I would say what we found looking at the last 25 years, in the overwhelming majority of instances, Chinese companies have increased staff count at companies that they have acquired.

So there is this fear that Chinese acquisitions could lead to a transfer of jobs back to China. It's what we used to call the "headquarters effect," that an acquirer buys a valuable asset and then moves the high-value-added jobs back to the headquarters. We have found no evidence whatsoever that this is the case for now Chinese-owned companies, but in most instances there is an increase in especially the higher qualified staff so engineers and white collar workers.

COMMISSIONER TOBIN: And are you publishing on that?

MR. HANEMANN: Yes. In fact, we do. We have a separate line of work that looks at local impacts of Chinese investment where we very diligently track jobs connected to these investments. It's called New Neighbors. We're doing this together with the National Committee on U.S.-China Relations, and the next update is going to come out in April-May this year.

The last year's numbers, we had about 100,000 jobs that were directly connected to Chinese-owned enterprises in the U.S. Again, about 90 percent of those jobs were acquired, but we couldn't find any evidence that acquisitions had a negative net impact on employment in the U.S.

COMMISSIONER TOBIN: Thank you. Could we get--

MR. HANEMANN: Maybe just--

COMMISSIONER TOBIN: Go ahead.

MR. HANEMANN: Quick preview on the 2016 numbers. There have been a lot of acquisitions of very labor-intensive companies in the U.S. in 2016 so I would estimate that the jobs count as of now is somewhere between 130 and 140,000 jobs directly owned, directly employed Americans with Chinese-owned enterprises.

COMMISSIONER TOBIN: I'll just close by saying I think the more visible that information can be to U.S. citizens, the better. Thank you.

HEARING CO-CHAIR WESSEL: Senator Dorgan.

COMMISSIONER DORGAN: Thank you very much.

I wanted to ask a question similar to Commissioner Slane's question on the issue of state control. We had a hearing last year in which we had a lot of discussion about state-owned enterprises versus state-controlled enterprises. And you mentioned, Mr. Hanemann, with the exception of the national security issues, it might not make much of a difference. But national security issues are what we're really, really concerned about.

And, you know, when you go from $15 billion to $40 billion a year, 90 percent of which is for acquisition, it reminds me again that the dark shadow over all of this discussion is that if American businesses put together a capital fund of $40 billion, 90 percent of which was destined for acquisition in China of majority ownership of Chinese companies, they wouldn't get to first base.

Is that--so let me just, having said that, isn't there a real significant interest and need for us to understand that it is not just state-owned enterprises? It is state-controlled enterprises, which almost always have fealty to what the "Party"--quote-unquote--wants in China? Isn't it important for us to understand that distinction, and when we talk about private versus SOEs always include some understanding about the state-controlled enterprises?

I'd ask Mr. Johnson or Mr. Hanemann.

MR. JOHNSON: I would say one of the first things I would look at is to take a look at the industry as the whole. We tend to like to look at a specific transaction, but it helps us when we look at what's happening in the industry. So in the industry as a whole, they may, they may use one state-owned enterprise to make one acquisition, state-controlled enterprise to make another, and then something in between, maybe even a U.S. company that's controlled, where they've infiltrated it and then control it through Chinese Americans.

But it's a holistic approach, and they're just using different mechanisms to buy more ownership of those industries. I'll give you an example with Motorola. You know, we saw, once saw Motorola at the top of the industry in the early 2000s, and you just track the mobile company alone, just the mobile business line. Motorola was heavily infiltrated at one point by Chinese coming to America and IP theft. An economic espionage case won in U.S. court, sentencing the lead individual to prison, but then shortly after that, the line of business gets under duress, it gets acquired by Google for about 12 billion, and about a year-and-a-half, year later, it gets acquired by China for two billion. Right. It keeps going down, down, down.

Once it's acquired, it didn't matter that it was a so-called private company such as Lenovo because that is a company that falls into a state-controlled versus state-owned category. They now have ownership of Motorola and now you look at what has happened to the jobs associated with that; right? So it's been more of the brain drain. They've, the things that they have done to manage that Motorola business line, since the acquisition, have destroyed it. They've allowed it to build great phones and released some significant technology, but they don't let them market it. Right. So how are you going to increase sales in a competitive market if you don't?

So there are certain ways they are using these different Chinese owned or controlled companies to degrade Motorola, but the real benefactor in this case is going to be Huawei. Huawei is going to be sitting on the other side, and they're the ones that are growing, along with Xiaomi and some of the others. So if you look at it from the industry perspective, how they insert different companies makes a lot more sense than looking at each unique event or breach.

COMMISSIONER DORGAN: That's helpful, and isn't it the case that when I met with the Amcham in Beijing, they indicated that they are not able to purchase in almost every case a majority interest in a Chinese company. If an American firm has this interest to purchase controlling interest in a Chinese company, they can't get to first base? Isn't that--

MR. JOHNSON: The only time that we--when there are cases that they let you come in and get a majority stake, is when it's really a shell company they don't care about. So like in the case of a Caterpillar and a Joy Global, they were allowed to buy some Chinese assets because they were not tangible assets, and they failed after being acquired. Caterpillar had to take about a $500 or $600 million write down and nobody knows what happened with the Joy Global 1.4 billion.

But that's the only time they really let you take that kind of position, when it's not a real entity.

COMMISSIONER DORGAN: So we have two different systems.

MR. JOHNSON: Yeah.

COMMISSIONER DORGAN: Largely to the disadvantage of the United States?

MR. JOHNSON: Right.

COMMISSIONER DORGAN: Thank you.

MR. JOHNSON: And that's why you often need to apply FCPA types of checks. Did it make sense for Caterpillar to invest "x," and did it make sense for Joy Global to invest 1.5 billion when their overall revenue was five billion? Sometimes it just doesn't add up because you just look at the numbers, and it's like that entity should have been worth maybe 200 million, why did you pay 1.4 for it? Because you're being set up.

HEARING CO-CHAIR WESSEL: Chairwoman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thanks very much. And thank you to all of our witnesses. I have limited time and questions for each of you, but I'll do this and hope we have a second round.

First, Mr. Johnson, I just wanted to note when you talk about media and entertainment segment campaigns, I didn't see there actually movie theaters. Have you included somewhere in the context of what you list here? You list nine. I'm thinking about distribution through movie--

MR. JOHNSON: Yes. Production is what I meant for the--

CHAIRMAN BARTHOLOMEW: Production. Okay.

MR. JOHNSON: Yeah.

CHAIRMAN BARTHOLOMEW: So just an observation, which is that as Wanda has purchased the AMC movie theater company, AMC is now purchasing or trying to acquire Nordic Cinemas in Sweden, and the bigger overlying concern, of course, is that through censorship, they will be able to--

MR. JOHNSON: Right.

CHAIRMAN BARTHOLOMEW: --you know if there's a movie made about Tibet, will that be ultimately controlled so that it can't be shown just about anywhere? So just an observation.

But my question for you is you mentioned specifically in your testimony that Chinese corporation investors have a unique advantage, which is apparent immunity to the Foreign Corrupt Practices Act. Now do you mean there that they don't have a similar FCPA that they have to work under or do you mean that they are immune from the--now I'm sounding like a lawyer--that they are immune here on FCPA issues? And in a time of heightened concern about conflicts of interest, can you talk us through a little bit what that means?

MR. JOHNSON: Yeah. What that's really getting to is that there are a few ways to look at that. Yeah, they'll still be held to our FCPA if it has to do with our country, and they do have an equivalent within their own laws, but they apply their laws like a weapon, right. They apply it very, very specifically to their advantage just like the penalties that they have applied to a company like Qualcomm--right--the NDRC.

So they will selectively choose when and where to apply a penalty over there to benefit their own industry and even to veer the penalty payments off to their industry. Whereas they can send somebody into the U.S. and because they have state support, they could provide a bribe that doesn't look like a bribe.

I mean if Apple were to go into China and just pay them, it comes off as a bribe, but if they come out here and invest two billion in a pulp plant, a supposed pulp plant in Virginia and Arkansas, that looks like a great investment, but the fact that the pulp industry in the U.S. is in negative growth and that Virginia and Arkansas really don't have a strong pulp industry or the materials for it, those are the things so that you can bring money into the country and you can influence politics or other companies because they have so many means to bring the money in that our companies don't.

So our FCPA, we look normally in accounting, forensic accounting, or specific checks, but they have many ways to get around that.

CHAIRMAN BARTHOLOMEW: So part of what I think you're saying here also is that, is that they make, they can make acquisitions or build plants or do whatever without commercial consideration. They don't have to turn a profit on these investments.

MR. JOHNSON: They don't have to turn a profit, right.

CHAIRMAN BARTHOLOMEW: Which is a result of the deep pockets of the Chinese government.

MR. JOHNSON: That's right.

CHAIRMAN BARTHOLOMEW: Correct.

MR. JOHNSON: Yes.

CHAIRMAN BARTHOLOMEW: Okay.

Mr. Hanemann, thank you, as always, for the data, then facts that you provide us. It's really important to have a fact-based world, I think.

I wanted to talk a little bit. You mentioned CFIUS, and you mentioned that CFIUS, make sure it has adequate resources. But do you believe that CFIUS itself, the statute, needs to have a serious look at whether the statute is adequate for the kinds of acquisitions that are taking place?

There is, for example, an ongoing situation where there is a company that is subject to U.S. duties that it looks like they're circumventing and they are in the process of acquiring an American company, does CFIUS protect against something like that?

MR. HANEMANN: Yes, it is my belief that CFIUS has worked well in the past to safeguard U.S. national security interests. That's the mandate that it is tasked with. There might be certain adjustments that make sense. I don't have access to classified information so I can't really speak to some of the more narrow concerns.

One of them, for example, is early stage financing for technology companies. There might be some adjustments that do make sense. However, when you talk about things like circumventing antidumping and tariffs, I think those are economic considerations, and I do strongly believe that CFIUS should remain a national security screening body only and that we should look for other bodies and solutions to address some of these economic concerns.

And I think Mr. Johnson already mentioned competition policy. I do believe that there are ways that the U.S. could change its antitrust laws and competition policy to discipline some of the concerns that we have on state-owned companies, and there are other mechanisms that would make sense to explore, but we should stay away from expanding CFIUS to a net benefit test.

CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Stivers.

COMMISSIONER STIVERS: Thank you. Thank you all for being here this morning.

Mr. Hanemann, as Commissioner Bartholomew just mentioned, we know CFIUS is set up to defend national security interests and analyze those transactions, and you mentioned that you don't think CFIUS' mandate should be altered at this time.

But if not, with the boom of Chinese investment in the United States, how do we handle situations where state-owned enterprises or OPSIEs --

CHAIRMAN BARTHOLOMEW: You heard it here first.

COMMISSIONER STIVERS: --or private firms with heavy subsidies or government support take actions that can either harm our economy or are anticompetitive? What other--you mentioned other bodies and solutions. Could you expand on that a little bit?

MR. HANEMANN: Yeah, sure. So I think the two main concerns on the economic side that the U.S. and many other OECD economies have are (a) the question of asymmetries in market access, which Commissioner Talent has mentioned earlier, and the second concern is potential spillovers of market distortions and unfair competition from Chinese companies when it comes to acquiring U.S. companies or distorting functioning market mechanisms.

And I think there's a very good debate within the OECD world about things like competitive neutrality regimes, state aid, like we have in Europe, for example, that companies that are state-owned or state-controlled, state-influenced, do have a higher threshold when it comes to disclosures, transparency, and again I think it makes sense to explore an expansion or different approach to competition policy for some of these entities.

We haven't had a situation like this before that there's a large economy, a large and still emerging economy that has a state involvement similar to the Chinese economy. So it's really a unique situation right now, and I think it is a debate that we should be having, but we should not water down CFIUS for that, for that approach.

COMMISSIONER STIVERS: Great. Thank you. Thank you.

In my first three days on the Commission I spent a lot of time reading your report, which is I think outstanding. In it, you mentioned that the experience of other countries that have used this net benefit test, I think UK, Australia, could you talk a little bit about that. What are the challenges in using that net benefits test and maybe some of the things that have gone right or wrong for those countries?

MR. HANEMANN: Sure. So I think that the two main examples you just mentioned are Canada and Australia. They do have a net benefit test. And I think the biggest concern is that there are no objective criteria for defining what a net benefit is, and there's different views within governments, and governments change, and I think opening up that process, there's already a lot of politicization of inbound investments happening from special interests, and I think opening up that discussion to a net benefit test would really reduce the, or increase the, uncertainty that foreign investors have closing transactions.

And if you look at Canada, for example, Canada just a couple weeks ago had a debate whether retirement homes are a critical national infrastructure. So the Chinese company was interested in buying a retirement home chain, and they were debating whether that's a national security interest.

So I think a lot of different interests get injected in the process. And, you know, posit that a Trump administration has to review a foreign investment in the U.S. hospitality sector, would you be confident that can be entirely taken out from conflicts of interest? I don't know. But I think what you want to do is reduce that leeway for the executive branch in making judgments about economic benefits, and I think CFIUS has done that well on the national security side, and we should find solutions that allow that kind of narrow band, as little as possible leeway when it comes to making those judgment calls.

COMMISSIONER STIVERS: Leaving aside possible conflicts of interest, I mean isn't it possible that you could narrowly tailor a test, an economic test? Maybe countries currently haven't done that, but wouldn't it be possible to put together something that's more objective?

MR. HANEMANN: I mean there's only certain criteria you could look at. You could look at the jobs impact, for example. You could look at competition policy, and you could take a broader sense of it. Yeah, certainly. I haven't seen a really good proposal so far. It might be possible, but it would require a lot of work.

COMMISSIONER STIVERS: Right.

MR. HANEMANN: I'll just give you one, maybe one example, on what a very problematic case is. The cost of capital; right. There's a lot of debate about whether Chinese companies have access to preferential financing from--Bank of China was mentioned before and other state-owned banks. That is certainly a concern, but there is no globally accepted correct cost of capital.

What is the right market-based cost of capital? There's no such thing. And so it is really difficult for us to define that and especially define it at a certain point in time and in having it adjusted going forward. So a lot of these metrics are very fluid and legislation always takes some time to catch up with reality. So I just haven't seen any proposals that would really allow that to design it in an objective and narrow way.

COMMISSIONER STIVERS: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: Thank you.

We had a hearing a couple years ago where the SEC appeared and talked about filings for companies that were listing on our exchanges, and they presented a number of challenges in terms of the content of those filings. So I'm interested in your perspectives on--and Mr. Hanemann, let me back up. You talk a lot about reporting requirements, mandatory reporting requirements, but you speak in terms of thresholds for those reports to be triggered.

I'm less interested in the threshold and more interested in when companies file with the SEC or are required to fill these surveys out. How adequate is the information? What's disclosed? Can you talk a little? And all of you may speak to this. What is it that we are requiring companies to disclose, and is it adequate?

MR. HANEMANN: So I think we have to make a bit of a distinction here between FDI and Chinese companies listing at U.S. stock exchanges. From an economist point of view those are two very different things: Chinese companies acquiring hard assets in the U.S. for the long term interest; and the other, we economists would see the other thing more as an outflow of U.S. capital to China.

So those are two very different things, and I can't--I'm not a securities lawyer and a securities expert so I can't really comment on the adequacy of SEC filing requirements. I think certainly taken from the perspective of somebody who is trying to find information, SEC filings are very useful for us when we look at a Chinese company's activity here in the U.S., and I would like to see more Chinese companies being required to do so.

But I do believe, for example, in the case of state-owned companies acquiring assets in the U.S., if you had a requirement, a mandatory requirement to file information on the source of funding, the conditions that those companies got from state-owned Chinese banks, I think that would already go a long way in clarifying some of these questions that we still have.

HEARING CO-CHAIR CLEVELAND: Anybody else?

MR. JOHNSON: Yeah, I would say we monitor the financials very closely, and I'll say that most of what you need to be able to determine whether or not a Chinese company is involved in what we call the cyber economic campaigns is in the financials they present. They're just not being paid attention to by us. We forgive a lot.

So my overall opinion on it, though, is that when they are submitting--let's say Alibaba is coming to the market, and they submit their financials, and there are so many things about Alibaba and so many things about Alibaba's financials, and they're coming from a high-risk nation--it should be categorized as a high-risk nation because you have so much state-owned influence--that they'd be required to rationalize some of the most obvious issues like you brought in two billion in overall investment, you have a billion in cash, but somehow you spent ten billion in acquisitions over the last three years. Can you explain where those funds came from? Right? And then see the documentation.

And that, it is that obvious in most cases. So you go company after company that gets listed, and the red flags are there. And we just tend to forgive and then can't understand why it collapses long term. But that's what we see all the time.

The financials themselves--it's very difficult to manipulate every line item of a financial statement. So they can show whatever they want on revenue, but if their revenue is growing at 50 percent a year in a market that's growing four, there's an issue; right?

HEARING CO-CHAIR CLEVELAND: Uh-huh.

MR. JOHNSON: If their cost of goods is still higher than the western counterparts, and the cash on hand and the liquidity is broken, it's an issue. All right. So it does show up. But requiring that they provide that level of transparency would be very, very helpful to prevent some of this.

HEARING CO-CHAIR CLEVELAND: In these surveys that you talk about, Mr. Hanemann, is the governance structure, the source of capital, are those fundamentals included or not?

MR. HANEMANN: You're referring to the BEA surveys that we have?

HEARING CO-CHAIR CLEVELAND: Well, you mentioned that, and then there were several other where there are quarterly filings?

MR. HANEMANN: Yes. So the BEA surveys are not designed to get information on financials or funding sources, and moreover, it is my impression that there isn't really a whole lot of enforcement of these filing requirements. So if companies decide not to file, I believe Commerce Department is probably following up, but there is really no--

HEARING CO-CHAIR CLEVELAND: Consequence.

MR. HANEMANN: No consequence if you don't file. So that could be another thing that Congress could look at in terms of increasing compliance with those rules would also help.

HEARING CO-CHAIR CLEVELAND: Yeah. Thank you.

HEARING CO-CHAIR WESSEL: Senator Goodwin.

COMMISSIONER GOODWIN: Thank you, Mr. Chairman.

Mr. Stengel, a quick point of clarification. In both the Chinese drywall case and other cases that you've had experience in, when the sovereign immunity has been raised, that hasn't foreclosed pursuing relief from other defendants including subsidiaries of those companies that claimed the immunity; correct?

MR. STENGEL: That is correct.

COMMISSIONER GOODWIN: Okay. So in the Chinese drywall case, the manufacturers, the distributors, others actually in the chain of distribution, remained in the case and subject to the jurisdiction of our courts?

MR. STENGEL: CNBM Group, which was the sovereign directly-owned entity, was I think the fifth level parent of the manufacturing defendant, and there are, I think, 15 or 16 active defendants still in litigation. So only the top level defendant was taken out. And to my knowledge, I can't think of another assertion of immunity involving an SOE where you didn't have remaining subsidiaries or codefendants.

COMMISSIONER GOODWIN: Okay. Let's talk about that commercial activity exception. In my estimation, the thrust of the exception, the intent is to treat market actors the same. Once you enter into commerce in the market, you will be treated the same regardless of your ownership structure, regardless of whether you are owned by a sovereign or privately held?

MR. STENGEL: That's correct.

COMMISSIONER GOODWIN: But that's not what happened with regard to CNBM in that Chinese drywall case. If CNBM was privately held, a privately held holding company, a parent company or shareholder, they would still be in that case; correct?

MR. STENGEL: Actually not. We didn't get to the point of litigating the alter-ego issues, but--

COMMISSIONER GOODWIN: Well, subject to other jurisdictional challenges and legal arguments, they would still, they obviously could not get out of the case on immunity grounds.

MR. STENGEL: I'm sorry. I may have missed your question. If they were not state-owned--

COMMISSIONER GOODWIN: The thrust of the exception is to treat commercial actors the same.

MR. STENGEL: Right.

COMMISSIONER GOODWIN: Is that occurring with application of this exception in our federal courts? If CNBM is getting out where a privately-held company, five levels up also, would not be able to enjoy that immunity from suit?

MR. STENGEL: Right. By definition, a non-sovereign entity would not be able to enjoy the benefits of sovereign immunity.

COMMISSIONER GOODWIN: So are they being treated the same?

MR. STENGEL: No, because they're sovereigns.

COMMISSIONER GOODWIN: Right. And is that defeating the intent of this commercial activity exception? That is, it is being applied in a way that is undermining the intent of the commercial activity exception? They're clearly engaging in some level of commercial activity.

MR. STENGEL: Well, keep in mind the exception requires commercial activity related to the claim, and it has to touch or concern the United States.

COMMISSIONER GOODWIN: Right.

MR. STENGEL: In this case, as a Chinese, essentially a Chinese holding company operating in China with no contact with respect to these transactions, didn't manufacture, ship, sell any product, that was all at the nth level subsidiary Taishan.

COMMISSIONER GOODWIN: Right.

MR. STENGEL: They engaged in no commercial activity. So there isn't a question of parity with other commercial actors because there is no commercial activity on the part of CNBM Group.

COMMISSIONER GOODWIN: If that same group was entirely privately held, they could not claim sovereign immunity obviously. I mean it's self-evident. It's by definition, they're not a sovereign. So the point is they're not being--it's disparate treatment.

MR. STENGEL: You are correct obviously that if it's not a sovereign, it can't claim sovereign immunity.

COMMISSIONER GOODWIN: For the same commercial activity?

MR. STENGEL: Well, but there was no commercial activity. That was the basis of the court's finding.

COMMISSIONER GOODWIN: One can be held to the jurisdiction of United States courts, state and federal courts, and one could not.

MR. STENGEL: Well, if it was a privately held entity. Say Ford Motor Company owned Taishan at some level of remove--

COMMISSIONER GOODWIN: Right.

MR. STENGEL: Ford Motor Company by definition couldn't claim immunity. I would say, as I would have expected CNBM Group to have ultimately prevailed on, they had nothing to do with the facts at issue in litigation, and because piercing the veil or ignoring the corporate structure is a commonplace in American litigation involving American companies, they would have been out of the litigation as well but not on the same grounds. Sovereign immunity is obviously restricted to sovereigns.

COMMISSIONER GOODWIN: Sure. Right. Appreciate it.

Well, in my remaining time, I want to follow Commissioner Stivers' lead and try to work in reference to OPSIEs so we can get Commissioner Shea's newly coined acronym into common usage.

[Laughter.]

COMMISSIONER GOODWIN: State officials, governors, economic development people face immense pressures and expectations from their constituents to attract investment, create and maintain jobs, and diversify their economies.

Those pressures run up against challenges when you're dealing with investment and foreign direct investment flowing from state-owned enterprises.

The question I have for you is investment, foreign direct investment from China is simply different. Mr. Hanemann, in your written testimony, you suggested that because of the pervasive level of control even of ostensibly privately-held entities, or OPSIEs, we need to reassess our traditional approach to this investment.

So how would you do that? What advice would you give to governors, economic development officials in states and municipalities and jurisdictions across the country as to how to assess the risks, costs and benefits of foreign direct investment even in private companies when it's coming from China?

MR. HANEMANN: So I think, first of all, there is, and I'm glad you're bringing this up because from a federal level down, there is a very different perception of what the risks and benefits from Chinese investments are.

We talk a lot to local officials, governors, mayors, and local investment promotion agencies, and for those folks, Chinese FDI, the increase that we're seeing last year, for them, that's not something that they're scared of. That's something that they really are excited about and so there's a lot of people in this country trying to get more of that investment in.

In terms of how to treat it differently, I think, first of all, there's a lot of homework to be done. So a lot of local investment promotion agencies, what they're traditionally focused on is other OECD economies, European companies, Japanese companies, as their customers or their targets, and I think a lot of local officials are still learning about some of the specifics for Chinese companies, Chinese capital. So there's a lot of educational effort at the moment happening.

Two, in terms of the risk assessment, I believe that there are a lot of things that are different for Chinese companies, and I think probably the most important thing is understanding some of the political risk on the Chinese side that's very different from an open market economy in Europe or Asia, the rest of Asia, and that partially goes back to a question of to what extent the Chinese government controls outbound flows, and while we had a blockbuster 2016, the Chinese government has over the last couple of months retightened some of its outbound investment policy.

So we're not the only ones who are nervous about that increase of Chinese outbound FDI. Beijing is very much anxious that some of these flows have gotten too large, and they're actively cracking down on some of the more financial nature flows that we're seeing coming through in the outbound FDI channel.

And so the ability of actually sticking to investment commitments--so if a Chinese company announces a transaction, and we have a bunch of cases currently. One big battery factory in Nevada, for example, by a company called Faraday Future, where local officials have worked a lot with the Chinese investor, they've, they were ready to provide grants and tax benefits, but the Chinese investor had financial troubles, had troubles getting the money out of the country.

So a lot of these difficulties related to the political economy in China I think local officials should take into account and be prepared to mitigate, to not lose any state money, government money, and to make sure that some of the benefits that they have, they are counting on, are actually coming in.

And then maybe the second dimension would be the jobs benefit. I think there are, you know, whenever a local government gives out money and grants, there are certain targets or commitments that the investor has to adhere to, and I think that is certainly particularly important on the Chinese side, and making sure that there's enough handholding and supervision that they comply with some of these promises and that they stick to their commitments from a local side.

I think those are the two main issues: making sure you understand the risks and monitor and make sure that there's specific milestones and targets in terms of the local jobs impact.

COMMISSIONER GOODWIN: Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

We're going to begin a second round. Please compress your questions. Commissioner Shea.

VICE CHAIRMAN SHEA: Sure. I'll try. A question for Mr. Johnson. You mentioned that the Chinese state is engaged in a sustained cyber and economic campaign against various industries, including telecom/wireless, IT security, financial industry, microchips, and then you mention the media and entertainment campaign.

Could you just very quickly, in four minutes, I guess, how are these campaigns decided? How are they operationalized? I mean how is this obtained and then fed back into China and then utilized by the actors there that are presumably benefiting from this, and why Hollywood? Why are they targeting, in your view, media and entertainment segment?

MR. JOHNSON: On the first question, I'll go back in time. They've laid out their strategy since the mid-'80s, and it's really been very logical from a business perspective; right. You have to get the infrastructure pieces put in first. You have to start building your own educational capacity. So the industries that they began with when they laid them out in those plans were really to start recovering from the 30 years before that, you know, Chinese Cultural Revolution, Great Leap Forward, really the decimation of their education system, but the easier industries, the infrastructure.

Then when it got to the '90s, and they learned how to use cyber, then it just allowed them to accelerate so they were continuing with the infrastructure, and that's why you got heavy equipment. That's why you got railway. Those types of industries came first. And then after that, they laid out a very specific plan for gaining equality or an advantage in technology. That really started around 2006 with the big push, but they had to start there the same way.

When you look at their plans, they start with easier things. So the telecom switches are easier than let's say a microchip. Right. So they are progressing along the lines that a normal business person would, you know, if you didn't have capacity, I'd build it this way. So that's where the planning is documented and that's where it's all been laid out, and it always connects to the campaigns.

Now, again, the massive amount of structure behind it, you get to how do they operationalize it; how do they bring it back? Well, again, we tend to look at a company alone, let's say a Lenovo or a Huawei or a ZTE, and again you have to open it up. You have to see what's behind Huawei, ZTE and everybody else. If they have the equivalent of CIA and NSA supporting, forget for a moment that's espionage, it's also an illegal subsidy. Right. You have support and a support infrastructure your competitors don't have.

Then you have your universities, and those universities are tied to U.S. research institutions. They're all getting funding. Okay. So they're operationalizing it a lot through just relationships, open source, but they also merge the espionage-related information, and then the scariest part that came up in our campaigns research over the last four years is the impact of the infiltration rates, and you'll read about that in the written testimony.

The infiltration efforts include putting Chinese resources into the different companies in America and into the investment organizations and then the programs they had behind that. The Ministry of Planning, the Ministry of Education, the overseas Chinese returnee programs, the research parks, and the pioneer parks. It is a massive infrastructure to help bring the intellectual property from the Chinese that are here back, right, back to China through incentives, payments, et cetera.

So that's all happening in each industry. Now when it comes to the top four for us, I said IT--top three--IT, media and entertainment are completely linked because, one, the media is the content that goes on the IT devices that attracts the users. Right. So you get them to use your phone and you get them to use your applications because you have the gaming industry, you have the media, the movies, TV shows, and now you control the minds.

So the media and entertainment campaign not only has an IT leadership component but a Ministry of Propaganda component. So we have to follow both tracks. We have to watch the policies and the budgets associated with both campaigns.

So, then you look at things like the resorts, like a Disney resort in Shanghai, and you saw that they lured them in. That's always the enticement stage. Stage two of their plans. They let them go in, but now you have to look at Wanda. Okay. So Wanda starts using the same IP, and now they're starting to put their parks in strategic areas to stop the flow of the attendees to the Disney Park. So this is how elaborate these campaigns get.

And in terms of the insiders I mentioned, as well, what we've also found recently is the evidence of large, what we call "controller organizations" here in the U.S. And what they do is they set themselves up as career counseling services so like one in the financial services organization, they claimed to be connected to about 125,000 Chinese here in America.

And what they do is they help place them into strategic companies, whether it's a JP Morgan, Citi, Bank America, you name it, but they literally give them the questions they're going to be interviewed with and things like that. So it's a massive infrastructure that flows down from the Ministry of Education, etc., down to the United Front, different organizations, and they help manage these resources. And the information ultimately flows back to that other infrastructure that I mentioned that's on the Chinese side.

So you have to be watching all the conversion points. You have to be looking for where the white papers are going back, where the patents are going back, and where the people are going back. And then you even look at the transition between companies like one going from this microchip company, and this individual then takes five and goes to this one, another microchip company, you have to sometimes follow them, and then follow the IP.

It's a long convoluted process to describe in three minutes or four minutes, but it's a very well-run process, much more so than people think. The numbers and the volume of organizations and individuals involved, they're able to manage because they had such a massive infrastructure built up for reverse engineering.

They were doing reverse engineering from the time they broke off. So they already had a lot of the pieces in place in the '80s, and then they just put the cyber piece on top of it. I hope that answers the question, but that's what's behind it.

VICE CHAIRMAN SHEA: Thank you very much. Appreciate that.

HEARING CO-CHAIR WESSEL: Mr. Johnson, we first met I believe about a year ago at the introduction of one of our U.S. attorneys, who will go unnamed, and I've been very interested in your work since.

I read your testimony, and it felt somewhat like a gut punch, if you will, for some of your observations and conclusions, and you've identified, and I'd appreciate if you'd elaborate, that a lot of the companies that the Chinese have acquired in the U.S., they have engaged in pre-acquisition activities to dramatically reduce their market capitalization.

So, you know, a $4 billion company last year, they want to acquire it, they engage in activities to reduce its market cap down to two billion and then come in, and it's not attractive to others because they don't know what's been going on. So, one, can you comment on that?

Two, have you had any contact with the SEC, which should be protecting investors against these kind of things, or House/Senate banking committees, et cetera, or others? What response by our government are you getting? What do you think is being done to make sure that we protect the investors and U.S. national security interests?

MR. JOHNSON: Okay. Let me answer that last part and then I'll talk about that first part.

I've been involved in presentations of the cases to members at the SEC as well as Treasury and FBI, a couple of the others. The first reaction is typically kind of a shock because you're putting evidence in front of them, asking their opinion, and they're seeing the same things, and then they're not quite sure why they hadn't seen it before. So there's always that, that moment, that stunned period.

But then it normally gets back to, okay, but how do we address this because it's so much bigger than we thought? So at that point, then we normally step back and it goes into some number of meetings. I am seeing a lot of progress lately though. Over the last four to five months, the government organizations that we've been keeping up to date seem to really be getting a new momentum. They're all relieved that they seem to have all figured it out.

So there's even some progress with the DOD and a joint task force they're working on so we're very involved in some of those initial efforts as well as supply chain risks. So there are efforts going on, but not at the SEC. Okay. SEC, I haven't been into in about 18 months so that would be a great starting point as well again.

Now in terms of how they use it, yeah, it is routine. It's a playbook they follow. So when they get involved and they want to acquire a company, you just have to know which indicators to look for.

So that first case we talked about last year, it was the very first time we actually applied our methods, and it was a chemical company, and they had--they had breached that company about nine to 12 months before we went in. And in that nine to 12 months, they were able to go in and selectively manipulate sales, the supply chain, take the R&D, start building the green product that was going to be their differentiator and a requirement for a successful IPO.

That company was getting ready to go IPO. Instead, the Chinese had created so much duress on each line item, it's only three to four percent, but it's a cumulative value, so three percent, four percent on sales, three to four percent on revenue, you're missing your numbers. They can't go IPO now. Right. So, again, four years getting ready to go IPO and now they can't go because their line is suffering.

And then when they see our data, and they see that there's another company out there that has their IP and that product, now all that money they put into investing, into building that green product, is gone. That's why so many of our companies say they've stolen our future. They did. They invested in it. It was their IP. It was their green product. And now there's a company that used to be partnered with you, and they have it. They're also the company that when we were done with our investigation and we asked them, have you received any offers for acquisition, yes, they had, and it had been from this partner that now had their IP.

So that was just the beginning of it. Now we see them all the time. We saw the same duress with Motorola. We saw how brilliantly that was played out where they're bought by Google; Google plans to introduce it into China. China then puts in legislation to stop the Google services, which means you're not going to be able to take that phone in. Okay. So now Motorola's phone dives in value, and Lenovo picks it up for two billion.

You see it again recently with Didi/Uber. All right. So Uber goes over. They put the infrastructure in place, and then all of a sudden Didi is riding behind them, drafting, and they're getting the money from the princelings, and you see it coming. You can see it coming because China is putting in rules that impact Uber, right, that decrease Uber's ability to operate, and Uber then has to sell. So all that investment and they sell for pennies on the dollar, and now Didi is the one to watch out for.

So those, they happen all the time, and it's a matter of understanding what those indicators are because they're so far off the chart, it's not normal. You can't just say, well, no, that's normal business. No, it's not. There is a significant difference between normal and what is happening to the western companies.

HEARING CO-CHAIR WESSEL: Commissioner Cleveland.

COMMISSIONER STIVERS: I just have a quick question for you, Mr. Stengel. You note in your testimony that Chinese state-owned enterprises are entitled to immunity, but the instances in which Chinese SOEs have availed themselves of that protection are few in number and make up only a small proportion of the overall number of cases.

Can you tell me how many a “few” is and what the overall number of cases are?

MR. STENGEL: Well, it's not a scientific survey, but looking at reported federal cases, which is, of course, a distorted population, there are probably ten to 15 reported cases involving Chinese SOEs, and there are hundreds of cases generally. So that's the basis. I don't know that there's any way you could actually do a complete census of those cases, but I think it gives you a fair representation.

HEARING CO-CHAIR CLEVELAND: So about ten percent is--

MR. STENGEL: Probably less than that.

HEARING CO-CHAIR CLEVELAND: Okay. Thank you.

HEARING CO-CHAIR WESSEL: Senator Talent and somewhat abbreviated, please.

COMMISSIONER TALENT: Yeah. All right. One question for Mr. Hanemann.

Mr. Johnson has described in his testimony, if I'm getting it correctly, and tell me if I'm wrong, I mean a systematic effort by the Chinese government using not just the SOEs but a large part of the Chinese corporate world, as well as the direct agencies of the Chinese government, to engage in, to conduct a campaign overtly and covertly, predatory investment, illegal subsidization, planting agents, subverting and bribing existing corporate personnel, along with the cyber espionage and the rest of it that we knew about for purposes like destroying competitors in strategic industries, gaining control of key nodes of the financial system, gaining technology and strategic systems, influencing the policy and politics of key core American corporations.

Now do you just think--is your disagreement with him that you think this isn't happening on this or isn't anything like happening on anything like this scale or do you think that it just doesn't matter? And I don't mean--because your two--the testimony, yours and Mr. Johnson's testimony just sort of sail right by each other, and I'm trying to reconcile it.

MR. HANEMANN: So let me start with saying I do fundamentally disagree with Mr. Johnson's view that the Chinese government is or the Chinese state should be considered as a monolithic entity, that it has a holistic approach or a master plan to send its companies overseas and acquire, systematically acquire specific assets.

There are instances in which there is concrete evidence that I can see for a nexus between Chinese industrial policy and outbound investment, and I think we mentioned--we did a case study on semiconductors activity where I think there is a clear, there is clear evidence that we can pin down to make those connections.

I have not been aware of some of the cases that Mr. Johnson makes, and I don't, I don't really see a whole lot of evidence and testimony that would make me believe that these assertions are true. It might just be that I don't have access to classified or corporate confidential materials.

If that's true, if those cases are true--I'm aware of one case that Mr. Johnson hasn't mentioned where that theme has come up. The acquisition of Aixtron most recently. I think there we had some evidence, public evidence, that big Chinese buyer was canceling contracts right before the acquisition, and, yes, if we're seeing that kind of predatory behavior, that's absolutely scandalous and should be addressed and sanctioned.

HEARING CO-CHAIR WESSEL: Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you. And thank you again for witnesses. This is our first hearing, and it's a great way to kick off our work.

One comment, and then, Mr. Stengel, I have a question, but I think given the time, I might ask it and then ask you to respond for the record if you don't mind.

MR. STENGEL: That's fine. Thank you.

CHAIRMAN BARTHOLOMEW: Great. Mr. Hanemann, I just want to emphasize--well, two things. One, the Chinese government does have a plan. I mean it's got a Five Year Plan. We're in the 13th Five Year Plan, and so I sort off fall in between Mr. Johnson and you in the context of I believe at least they know what they do. They know where the investment is going, and that's where a lot of these acquisitions are taking place.

But what I really want to emphasize is that you mentioned the ability of Beijing to control investment, to control outbound investment. They can turn the spigot on, and they can turn the spigot off. They can pull companies back from acquisitions for commercial reasons, for financial reasons, and for political reasons. And I think that's a really good example of how the Chinese economy is not a free market economy.

Our government does not have that. It would be anathema to what we have always stood for for our government to be engaging like that. So I think that's an important point.

Mr. Stengel, I just wish if you could--ask if you could elaborate a little bit. You talk in your testimony about the Ninth Circuit's view, and they basically have a six-part test in terms of whether an organ is engaging in a public activity on behalf of the foreign government, and I'm just wondering if you could elaborate a little bit, perhaps in a written response, about how has that been applied, and sort of what does that mean in the bigger context of these acquisitions?

MR. STENGEL: Be happy to do that.

CHAIRMAN BARTHOLOMEW: Great. And I'll mention again the OPSIEs. That's some of what we're really looking at. Thank you.

HEARING CO-CHAIR WESSEL: And we'll close this segment on OPSIEs and take a 15 minute break. We'll resume at 11 a.m. Thank you.

[Whereupon, a short recess was taken.]

PANEL II INTRODUCTION BY COMMISSIONER MICHAEL R. WESSEL

HEARING CO-CHAIR WESSEL: We will resume. Our second panel will examine Chinese investments in U.S. information and communications technology, agriculture and biotech, and manufacturing.

To start, we welcome or re-welcome or welcome you back Dr. Robert Atkinson, the Founder and President of the Information Technology and Innovation Foundation, ITIF. Dr. Atkinson's research focuses on technology-related topics ranging from tax policy to advanced manufacturing, productivity, and global competitiveness.

He serves as a member of the U.S. Department of State's Advisory Committee on International Communications and Information Policy and has served in several other technology policy capacities in the White House. He holds a Ph.D. from the University of North Carolina, Chapel Hill, and earned his master's degree from the University of Oregon.

He has testified before the Commission several times. Appreciate your being back.

Next we have Mr. Patrick Woodall. Mr. Woodall is Research Director and Senior Policy Advocate at Food & Water Watch, a non-profit organization focused on food policy and water infrastructure issues.

Mr. Woodall is an expert on topics related to the globalization of food and agriculture, international trade, and agriculture policy, and has done extensive work on Chinese investments in U.S. agriculture.

He received his bachelor's degree from Johns Hopkins University. Mr. Woodall previously testified to the Commission in 2008, on food safety, as I recall.

Finally, we welcome Mr. Patrick Jenevein, the Chairman of WattStock LLC and CEO of Tang Energy Group, an active clean energy investor and developer in China for over 20 years.

Mr. Jenevein formed Tang in 1996 to build, own, and operate energy delivery systems in China and has since become a leading U.S. entrepreneur abroad. In 2010, Tang Energy was selected as one of 12 global finalists for the U.S. Department of State's Award for Corporate Excellence, which recognizes the important roles American businesses play as corporate ambassadors abroad.

Mr. Jenevein is a member of the Council on Foreign Relations and earned his B.A. from Davidson College in Davidson, North Carolina.

Thank you for being here today. Each witness will have seven minutes to deliver his oral statement. Your written statement will be entered into the record, and, Dr. Atkinson, we'll begin with you.

OPENING STATEMENT OF DR. ROBERT ATKINSON PRESIDENT, INFORMATION TECHNOLOGY AND INNOVATION FOUNDATION

DR. ATKINSON: Well, thank you, Chairman Wessel. It's a pleasure to be here and it's a pleasure to be here again to testify before you on this important question.

I don't think there's any doubt that Chinese FDI into our country is increasing and a not insignificant share of that FDI is directed towards U.S. technology companies.

The Rhodium Group reports that over the last 16 years, there was roughly $18 billion of Chinese FDI into ICT and electronic industries, but most of that was just in the last few years. And the majority, in fact the vast majority, of that is in acquisitions, not greenfield investments.

For example, in electronics, 99.9 percent was acquisitions. In ICT, 95 percent was acquisition.

These numbers would have been significantly higher had CFIUS not informally or indirectly sent a message to some of these Chinese acquirers that their acquisitions wouldn't have been approved. For example, the Chinese tried to buy ten percent of Western Digital, a major hard drive maker. Tsinghua Unigroup, an SOE that's backed by the Chinese government, tried to buy Micron. And most recently a California, quote "California IC fund," California fund backed by the Chinese government, tried to buy Lattice Semiconductor Corporation.

So in some cases though deals go through. A case in point was when Chinese firm Apex Microelectronics bought Lexmark, the well-known printer company. Lexmark had brought a patent case against Apex, as has HP and a number of other companies, for selling counterfeit printer cartridges. Apex had a tenth of the revenue of Lexmark but was able to receive about $2.6 billion from the Chinese government in order to go out and buy Lexmark at a 17 percent price premium, and there was some discussion by Apex that they were told by the Chinese government that this was a core part of the Chinese government strategy, and that Apex's job was to, quote, "dominate the global printing industry."

So to be sure, not all Chinese FDI is strategic and directed at weakening our technology base. Some is a net positive when a Chinese company comes and builds a factory, but certainly a growing share is much more around taking our technology. In fact, as China doubles down on its indigenous innovation strategy, acquiring foreign technology companies and taking their know-how and technology is a core tactic.

I think it's very important to differentiate that between other country's firms who would come in and buy our firms or vice versa. Most of those acquisitions are based upon building synergies and finding market opportunities.

Chinese strategy in some of these cases, in a growing number, is not about that. It's about taking technology. So I think we should be under no illusion that this is a long-term strategy for them to catch up and surpass us, and ultimately to take our companies, either destroy their market share or just put them out of business.

So what do we need to do about that? I think, number one, we need to have a nuanced approach here. I think a blanket denial of all Chinese investment into the U.S. would be a mistake. We need to differentiate the kinds that are in our interest and the kinds that are not. However, I would argue we need a much more aggressive investment review process that targets the kinds of investments that I've just been talking about:

acquisition investments designed to get and take our technology.

CFIUS has been pretty good on that, but I think it needs to be improved. We would recommend a number of improvements to CFIUS:

One being expanding staff. Extending the time to review, particularly on deals from countries like China where there is a significant state backing. Mandatory notification of deals from countries like China where a significant amount are state-owned or state-influenced.

Also expanding the scope of CFIUS to go beyond a simple sort of acquisition to think about non-traditional forms of control such as joint ventures or novel licensing transactions.

And finally, we would argue CFIUS shouldn't be in Treasury. It should be perhaps in Commerce, an agency that looks more carefully at defending U.S. commercial and economic interests.

I would go beyond that, though, and we would recommend actually a comprehensive foreign investment review process at one level akin to what Canada and Australia do, but in a different way. I think Canada and Australia frankly are too broad. They sometimes use those mechanisms for protectionist reasons. I think we should have a broader foreign review process but targeted at countries where there's clear evidence that they're not playing by global investment rules. Clearly, China would be in that category, and we shouldn't just say if the technology doesn't affect our military, that it's carte blanche go ahead and do it.

I think we need to have an economic security lens through which we would evaluate those kinds of deals from those kinds of countries.

And then, secondly, we need to do a lot better job in the U.S. government of just understanding these deals. What are they? What's behind them? Simple things like enough money to translate Chinese documents for the U.S. government. Better and more institutionalized capacity in the National Security Council, in USTR, within CFIUS, to really get a better analytical handle on what's actually going on and how these strategies are intended to work.

The IC plan for China is a good example. What's the effect of putting $160 billion into a slush fund, essentially funneled through a, quote, "market-oriented" entity to make it so that you can't apply WTO rules, subsidy rules, to it? What's the effect of that going to be on U.S. semiconductor capabilities? How is that going to play out? What should we do about it? We need a lot more time and effort spent on those kinds of questions within the government.

And lastly, I would just say the Trump administration has real opportunities in this space, but I would urge them and I would urge you to urge them that we really need to do this in concert with our allies. If we tighten up our investment review process, the Chinese will simply go and buy European companies and compete with us using their technology.

The Europeans need to have similar tight investment review processes. We need to work with them to ensure that. The Japanese, the Koreans, and the Taiwanese actually have pretty good investment review processes. They protect their crown jewels more than we or Europe do. But I think it's important for any approach going forward, including for the Trump administration, to work much more closely with our allies.

Thank you very much.

PREPARED STATEMENT OF DR. ROBERT ATKINSON PRESIDENT, INFORMATION TECHNOLOGY AND INNOVATION FOUNDATION

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

Robert Atkinson

President

Information Technology and Innovation Foundation

Thank you for inviting me to testify before the Commission. I appreciate the opportunity to appear before you today to discuss the impact of Chinese company investment in the United States. I am President of the Information Technology and Innovation Foundation. ITIF is a nonpartisan research and educational institute whose mission is to formulate and promote public policies to advance technological innovation and productivity. Recognizing the vital role of technology in ensuring American prosperity, ITIF focuses on competitiveness, innovation, and productivity issues, including in the context of trade and globalization.

INTRODUCTION

For many years, China has recycled the earnings from its large and sustained trade deficit with the United States into U.S. Treasury bills. But the last few years have seen a marked increase in the amount of inward foreign direct investment (FDI) from China to the United States, across a range of industries. While the underlying motivation for some of this investment is commercial, at least one-third is from Chinese state-owned enterprises, and it is likely that considerably more is guided and supported by the Chinese government, specifically targeting sectors that are strategically important for U.S. national security or economic leadership. Indeed, as China ramps up its so-called "indigenous innovation" strategy designed to slow down foreign companies in China and enable Chinese-owned firms to take global market share in advanced industries, there is a growing trend for China to have its firms acquire foreign technology companies, including in the U.S., in order to acquire badly needed know-how, compress innovation cycles, and develop indigenous supply chains for particular sectors. As such, policymakers should be under no illusion that many of these acquisitions are in the service of an overarching strategy to accomplish one, and only one thing: take U.S. technology capabilities so that Chinese firms can gain global market share at the expense of their foreign competitors, including U.S. firms. Without access to U.S. technology and know-how, the process by which China gains and ultimately surpasses the United States in technology capabilities will be delayed substantially.

To be sure, not all Chinese FDI is strategic or related to China's indigenous innovation strategy. Indeed, much of it, particularly greenfield investment, is, at least on a deal-by-deal basis, a net positive for the U.S. economy. But the choice is not a binary one. As The Asia Society suggests, we have more options that just rolling "out the red carpet, or put[ting] up floodgates to hold it back."[1] This should not be a debate about whether America's historic openness to foreign direct investment has been beneficial, or whether it should or should not be changed writ large. What is needed is a nuanced discussion and approach that recognizes that some Chinese FDI is neutral or positive, but a significant share is harmful, because it is not based on market forces or commercial interests, but rather guided by a Chinese state that is intimately involved in directing and shaping economic outcomes well beyond what any other major economy does.

This goes to the heart of the difficulty of applying traditional, free-market, pro-globalization prescriptions to China (e.g., liberal FDI review). Indeed, any discussion of Chinese FDI needs to be grounded in two fundamental realities: First, the best way for China to help the U.S. economy is not through increased FDI, as many defenders of China argue, but rather to use these foreign exchange earnings to buy and import more American-made goods and services. Second, any analysis of Chinese FDI needs to be understood in the broader context of China's indigenous innovation strategy, which is powered in large part by innovation mercantilist policies (trade-distorting and unfair policies such as forced technology transfer, standards manipulation, subsidies, intellectual property theft, etc.) to replace U.S. technology leaders with Chinese-owned ones.[2] In this sense, some Chinese FDI, especially acquisition of U.S. technology firms, large and small, undermines the principle of market-based trade and investment, and represents a direct challenge to U.S. technology leadership and jobs and national security interests. Thus, any policy response to this kind of Chinese FDI needs to be grounded in the broader understanding and task of rolling back Chinese "innovation mercantilism."

But this response will be difficult to enact as long as most U.S. economists, trade experts, pundits and policymakers view Chinese "industrial policy" as a problem only because it "distorts markets." This market-distortion frame makes it seem as if China is creating some ripples in an otherwise smooth market pond—i.e., ripples that hurt both them and us, but ultimately resolve themselves as the two economies find a new equilibrium. This macro-economic framing misses what is a stake. These Chinese government policies are not so much market distorting as they are firm destroying; representing a coherent array of measures designed to attack U.S. companies with the goal of defeating them. Americans should be able to recognize the point of the competition. As former Procter & Gamble CEO Alan Lafley wrote in his business strategy book *Playing to Win: How Strategy Really Works*, "Winning is what matters—and it is the ultimate criterion of a

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[1]. Daniel H. Rosen and Thilo Hanemannm, "An American Open Door?: Maximizing the Benefits of Chinese Foreign Direct Investment" (special report, Center on U.S.-China Relations Asia Society and Kissinger Institute on China and the United States Woodrow Wilson International Center for Scholars, May 2011), p. 35, http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

[2]. Robert D. Atkinson, "Enough is Enough: Confronting Chinese Innovation Mercantilism" (Information Technology and Innovation Foundation, February 2012), https://itif.org/publications/2012/02/28/enough-enough-confronting-chinese-innovation-mercantilism.

successful strategy." Indeed, in business strategy the goal is not to distort markets, but to gain competitive advantage, ideally by defeating one's competitors. But in the United States most policymakers and experts worry about distorted markets, as if a level playing field is the end goal, while Chinese officials worry about attacking and defeating their business opponents so their companies can win and even dominate. In a *Harvard Business Review* article titled "Hardball: Five Killer Strategies for Trouncing the Competition," the authors use terms like "relentless," "uncompromising," "ruthless," and "playing rough," to describe how firms need to act to be profitable.[3] In describing companies that don't play by these rules they write:

> Softball players, by contrast, may look good—they may report decent earnings and even get favorable ink in the business press—but they aren't *intensely* serious about winning. They don't accept that you sometimes must hurt your rivals, and risk being hurt yourself, to get what you want. Instead of running smart and hard, they seem almost to be standing around and watching. They play to play. And though they may not end up out-and-out losers, they certainly don't win.[4]

In contrast, hardball players play to win. The authors write, "In sports, after all, playing hardball means brushing back an aggressive batter with a 100-mile-an-hour pitch. It means bare-knuckle boxing, John L. Sullivan-style. It means giving someone a head fake in a pickup basketball game on a city court littered with broken glass—and leaving him sitting on his rear."[5] When it comes to the economic competition between China and the United States, the United States is playing recreational softball to China's major league hardball. China is playing to win; America is playing to play. When China's FDI technology firm acquisition strategy is seen in this light, it should be much more worrisome than some irritating market distortion.

My testimony today first lays out policy recommendations in five areas: 1) reforming the investment review process, including CFIUS; 2) insisting on mutual access and treatment; 3) developing stronger analytic competence within the administration; 4) rethinking antitrust to consider foreign innovation mercantilism; and 5) working with U.S. allies to coordinate measures to constrain mercantilist-inspired Chinese FDI. I then turn to the question of why inward FDI can benefit the U.S. economy as long as it is market-driven and based on commercial, rather than foreign government interests. Then I examine the conventional defenses offered in favor of Chinese FDI and why these arguments are flawed. Finally, I examine Chinese acquisitions of U.S. technology firms that have recently been competed or attempted, with a particular focus on semiconductor firms.

Policy Recommendations

A policy that seeks a blanket denial of all Chinese investment in the United States would be a mistake because despite discomfort we have to accept that globalization is not going

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3. George Stalk, Jr. and Rob Lachenauer, "Hardball: Five Killer Strategies for Trouncing the Competition," *The Harvard Business Review,* April 2004, https://hbr.org/2004/04/hardball-five-killer-strategies-for-trouncing-the-competition.

4. Ibid.

5. Ibid.

away. However, that does not mean, as many organizations that hew to the Washington trade consensus would have us believe, that we should simply turn a blind eye and accept all Chinese FDI except perhaps the most explicitly military focused.
However, given China's capabilities, intentions, and innovation mercantilist policies it is imperative that policy makers move beyond the Washington consensus, laissez faire position. And this means first and foremost rejecting the Washington trade consensus that holds that only companies compete, not countries, and that nations can be indifferent to their economy's sectoral mix.[6] There should be no doubt that the United States as a nation is in fierce competition for global share in advanced industries and that losing this competition will mean tangible harm for the nation.

This means that U.S. policy needs to affirmatively work to limit unfair and inappropriate Chinese actions to gain technology advantage, including, but not limited to, investment reviews. More active screening, and where appropriate, rejection of Chinese investment in U.S. technology companies is not protectionist, despite what the defenders of Chinese FDI might claim. Rather, if done right, it is about building the capabilities and taking the actions to support liberal market principles, including an insistence on market-based FDI. To achieve this, there are a number of steps the U.S. government should take.

Reform CFIUS and Investment Review
According to the Foreign Investment and National Security Act (FINSA) of 2007 (P.L. 110-149), the Committee on Foreign Investment in the United States (CFIUS) may conduct an investigation on the effect of an investment transaction on national security if the covered transaction is a foreign government-controlled transaction (in addition to if the transaction threatens to impair national security, or results in the control of a critical piece of U.S. infrastructure by a foreign person).

CFIUS has worked fairly effectively in some technology areas, especially semiconductors as attempted acquisitions of Fairchild, Micron, GCS, Lumileds, Western Digital, and Aixtron have been stopped either formally or informally.[7] However, it has not prevented all acquisitions. For example, a Chinese investor group bought Silicon Valley semiconductor firm ISSI in 2015.[8] Moreover, Chinese firms are getting more sophisticated about attempted acquisitions, including hiring the best U.S. legal, financial, and public relations talent to advocate for their U.S. technology acquisitions, and obscuring their involvement in U.S. shell companies, as they did with the attempted acquisition of Lattice Semiconductor.[9]

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6. Stephen Ezell, "Krugman Flat Wrong that Competitiveness is a Myth," *The Innovation Files*, January 26, 2011, http://www.innovationfiles.org/krugman-flat-wrong-that-competitiveness-is-a-myth/.

7. Michael Gershberg and Justin Schenck, "CFIUS Takeaways From Blocked Aixtron Deal," *Law 360*, December 16, 2016, https://www.law360.com/articles/873348/cfius-takeaways-from-blocked-aixtron-deal.

8. Junko Yoshida, "Lurking Behind Every M&A is China," *EE Times*, December 13, 2016, http://www.eetimes.com/document.asp?doc_id=1330969.

9. Liana B. Baker, "Lattice Semiconductor to be bought by China-backed Canyon Bridge," *Reuters*, November 4, 2016, http://www.reuters.com/article/us-lattice-us-m-a-canyon-bridge-idUSKBN12Y1K5; Junko Yoshida, "Lurking

As such, there is a need for CFIUS reform. Congress should, at a minimum, update the charter of CFIUS to address the realities of modern-age state capitalism.[10] Other nations, and as noted particularly China, have put in place coordinated strategies to systemically target key defense and industrial technologies resident in U.S. enterprises and attempt to acquire them by having state-owned or-financed enterprises purchase the U.S. entity, using the veneer that these are “market-based” transactions. Because the threat to both the U.S. defense industrial base and the U.S. industrial base overall is systemic, the charter of CFIUS needs to be updated to allow reviewers to move beyond solely case-by-case examinations to allow them to assess and gauge systemic threats and examine covered transactions in a broader context. They have arguably done this in semiconductors, but they should expand that scope. CFIUS also needs greater capacity to review attempted acquisitions by Chinese firms of small and young U.S. technology firms that might reflect promising future technology capabilities for the nation.

Moreover, CFIUS reviewers often do not have adequate time to complete a serious analysis, having only 30 calendar days to approve transactions or move them to a second-stage investigation (although there is an ability to extend an investigation for 45 days on top of the original 30). Therefore, Congress should increase the time period permitted for the initial CFIUS review and also better equip CFIUS with additional personnel and financial resources to support more thorough reviews. Congress should also require mandatory notification for deals involving state-owned or state-financed entities by countries of concern such as China and Russia. It’s also important that as CFIUS committees consider whether the entity in question will come under “foreign control” that they consider “non-traditional” forms of control, such as joint ventures or novel licensing transactions that seek to achieve the same effect as the outright acquisition of a U.S. company. For instance, Chinese acquirers may be exploiting a loophole in CFIUS by designing licensing transactions that, when combined with the associated follow-on agreements that utilize U.S.–based assets to operationalize the licensed intellectual property, are substantively the same outcome as if the Chinese company had simply purchased the U.S. business that holds the intellectual property (IP). CFIUS reform should make clear that these types of deals are “covered transactions” that could be investigated.

Finally, the CFIUS chair should be transferred from the Treasury Department to another department, perhaps the Department of Commerce. Treasury has an important role in tracking investment and other financial flows, but Treasury largely hews closely to the lines of the Washington trade consensus, seeing all or most inward FDI as an unalloyed good. Commerce is better suited to focus on the implications of a given foreign investment on the industrial economy and America’s innovation system.

Behind Every M&A is China, http://www.eetimes.com/document.asp?doc_id=1330969.

[10]. Stephen Ezell and Robert D. Atkinson, “Fifty Ways to Leave Your Competitiveness Woes Behind: A National Traded Sector Competitiveness Strategy” (Information Technology and Innovation Foundation, September 2012), http://www2.itif.org/2012-fifty-ways-competitiveness-woes-behind.pdf.

But while CFIUS reform is a minimum, Congress should move beyond the relatively narrow CFIUS process to create a more comprehensive foreign investment review process, as many other nations, including Australia, Canada, and the United Kingdom, have instituted. Indeed, a number of other nations take much more proactive measures to prevent the hollowing out of their key industries. For example, both Taiwan and South Korea have essentially banned Chinese acquisition of their domestic semiconductor firms. Under current law, CFIUS can only restrict investments that could adversely affect the United States' national security. As the civilian industrial base has become an ever-more central part of the defense industrial base, however, the current limitations on CFIUS need to be reexamined and a broader national interest standard established. To be clear, the goal of any foreign investment review scheme should not be to give in to domestic protectionist interests, but to effectively differentiate between foreign direct investment that operates according to market-driven principles and that which operates according to state-directed, mercantilist principles. In other words, when a Chinese company, backed and directed by the Chinese government, attempts to buy an American technology company with the main goal of expropriating its intellectual property and moving it (or the company's operations) to China, that is clearly not in the interest of the United States. It would be important for any such expanded regime to not apply to investments from allies who are designated by the U.S. government as operating largely according to market principles (e.g., nations like Canada, Germany, Mexico, etc.). Those would continue to operate under the current criteria of effect on national security. Rather, the more stringent review regime would be for nations that are not allies and most importantly that operate according to mercantilist principles.

To govern such a differentiated regime, we would call on the Office of the U.S. Trade Representative to prepare an annual global mercantilist index along the lines of ITIFs template report which identified a number of variables (e.g., tariffs, IP protection, foreign equity restrictions, etc.) and ranked nations accordingly.[11] Not surprisingly China was one of two nations, out of 55, that has ranked in the "high" category. In these cases, all inward FDI would at least be reviewed and potentially rejected if it is deemed to harm U.S. innovation and competitiveness. If such a regime had been in place, for example, there would have been no justification for approving the Apex acquisition of the U.S. printer company Lexmark, given that Apex was accused of IP theft by U.S. printer companies and was backed by Chinese government money.

Some will argue that instituting such a regime would just be emulating the Chinese and thereby closing our economy. On the contrary, it is exactly the opposite. It is about working to ensure that China roll back its mercantilist policies. Indeed, if implemented properly it would be a measure to improve the integrity of the global trade and investment climate. Others will object that this will lead to overreach, perhaps blocking acquisitions of assets like hotels because of false concerns about knowledge transfer. But clearly the current CFIUS review process has proven itself highly sophisticated and

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[11]. Robert D. Atkinson, Stephen J. Ezell and Michelle Wein, "The Global Mercantilist Index: A New Approach to Ranking Nations' Trade Policies" (Information Technology and Innovation Foundation, October 2014), https://itif.org/publications/2014/10/08/global-mercantilist-index-new-approach-ranking-nations%E2%80%99-trade-policies.

mostly capable of effectively analyzing knowledge transfer risks. There is no reason to assume that a more encompassing review process would not also be of equal sophistication. But even if it were not, it would be better to make a few Type I errors (rejecting a hotel deal) than to make a large number of type II errors (not rejecting acquisition deals that take U.S. technology to China).

FDI is not the only way China has of obtaining U.S. technology. Theft is another way. Encouraging Chinese scientists currently employed at U.S. firms to return home is another. But perhaps the most effective is forced tech transfer from U.S. firms seeking market access in China. While a violation of the WTO rules, China pursues this policy largely with unwritten "administrative guidance" which makes current WTO disciplines largely toothless. Often China is able to succeed at this by focusing on second-tier players in any particular industry segment which, as McKinsey notes, "have less to lose than global giants—and everything to gain."[12] In this case the losers are the leading U.S. firms and the overall U.S. economy. In theory CFIUS could be expanded to cover these forced transfers. However, unless our major allies, particularly Europe, Japan and South Korea also agreed to adopt such a provision concurrently such a step could backfire, with the Chinese government singling out U.S. firms for retaliation, including limiting market access, while getting needed technology from firms from other nations without such a regime.

Insist on Mutual Access and Treatment

It is clear that U.S. FDI in China faces significantly different conditions than Chinese FDI in the United States. In most cases, U.S. technology firms seeking market access in China must engage in a joint venture with a Chinese firm. As one industry article advising U.S. companies wrote, "To participate in China's industry ecosystem, it is essential to establish connections with the stakeholders in China, such as government, customers, suppliers, and even competitors, and to seek opportunities in cooperation and development through mutual understanding and engagement."[13] With regard to the life sciences market in China, one industry analyst writes that, "To enter the Chinese market, you may come in by licensing an asset, which we have done, or you can create a joint venture, which we have also done. But you cannot go in by yourself."[14] And as the U.S. Congressional Research Service reports, "The OECD's 2014 FDI Regulatory Restrictiveness Index, which measures statutory restrictions on foreign direct investment in 57 countries (including all OECD and G20 countries, and covering 22 sectors), ranked China's FDI regime as the most restrictive, based on foreign equity limitations, screening or approval mechanisms, restrictions on the employment of foreigners as key personnel, and operational restrictions (such as restrictions on branching, capital repatriation, and

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[12]. Gordon Orr and Christopher Thomas, "Semiconductors in China: Brave new world or same old story?," (article, McKinsey & Company, High Tech, August 2014), (http://www.mckinsey.com/industries/high-tech/our-insights/semiconductors-in-china-brave-new-world-or-same-old-story.

[13]. Dr. Adam He, "Will new policy in China trigger big changes?" *Solid State Technology*, http://electroiq.com/blog/2015/01/will-new-policy-in-china-trigger-big-changes/.

[14]. Richard Daverman, "China Puts Priority on Biotech," *China Bio Today*, April 14, 2016, http://www.chinabiotoday.com/articles/20160414.

land ownership)."[15] Chinese investment in the United States faces vastly fewer restrictions.

Because of this steep divergence, Congress and the Trump administration should insist on a level playing field and mutual access should be one baseline. As a report on China acquisitions of German firms noted, the "EU should emphasize …the need for mutuality: if Chinese firms are given free access to more and more 'crown jewels' of German industry, China… would have to further open up their FDI regime and the possibilities for M&A in their territories."[16] In other words, as long as China restricts U.S. investment in China, largely in ways to take technology, the federal government should feel few constraints to use stricter investment review as a tool to achieve better behavior from the Chinese government.

Defenders of the Washington trade consensus object to such measures, believing that that the vast majority of Chinese FDI is good for America and we only hurt ourselves by limiting it. As The Asia Society writes, "were the United States to single out China for restrictive FDI treatment, it should expect the same treatment for U.S. firms in China."[17] But this overlooks that U.S. firms already receive that treatment in China and that actions to insist on free trade and market-oriented investment are in the interest of the United States and the global trading system as a whole.

A related issue of mutual access and treatment relates to the technology licensing rules China imposes.[18] Under Chinese contract law and import-export regulations, a foreign licensor into China is obligated to offer an indemnity against infringement to the Chinese licensee (e.g., the foreign licensor is required to indemnify (i.e., protect) a licensee against third-party infringement). But this legal obligation only attaches to the foreigner licensing the technology; the Chinese licensor has no such obligation. This creates a disequilibrium in cross-licensing. The foreign licensor has to offer something that the Chinese licensee does not, making it almost legally impossible for starts-ups to license their technologies in China, because no start-up would want to offer such insurance. A second provision in Chinese law holds that Chinese recipients of technology licenses are entitled to own the improvements they make on licensed technologies and to sell them in any market. Thus, U.S. firms cannot negotiate to say they will own any improvements, or that such improvements can or cannot be shared, or to stipulate that a license is only for

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15. Wayne M. Morrison, *China-U.S. Trade Issues* (Washington, D.C.: Congressional Research Service, January 2017, pg. 25), https://fas.org/sgp/crs/row/RL33536.pdf.

16. Gert Bruche and Bernhard Wallner, "Dragons and Tigers Hunting in Germany: Chinese and Indian acquisitions of German firms 2002 – 2012," (working paper, BGM Associates, 2013, pg. 15), http://www.bgmassociates.net/uploads/6/8/9/2/68925041/bgm_associates__-_dragons_and_tigers_hunting_in_germany.pdf.

17. Rosen and Hanemannm, "An American Open Door," pg. 41, http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

18. Robert D. Atkinson and Stephen Ezell, "False Promises: The Yawning Gap Between China's WTO Commitments and Practices" (Information Technology and Innovation Foundation, September 2015), 28-29, https://itif.org/publications/2015/09/17/false-promises-yawning-gap-between-china%E2%80%99s-wto-commitments-and-practices.

the Chinese market and the licensor cannot export any product that makes improvements to the originally licensed technology. Put simply, U.S. companies are obligated to let Chinese firms own the improvements and to let them export to other markets.

To address this imbalance, the United States should enact a regime whereby if Chinese entities seek licenses in the United States, then the Chinese enterprise must license on the same terms by which foreigners are required to license into China. In other words, the U.S. Congress could enact legislation which would specifically require the Chinese licensee to offer an indemnity against infringement by the U.S. licensee and stipulate that the U.S. recipient of any technology licenses from Chinese entities are entitled to own the improvements they make and to sell them in any market. Another possible approach: Congress could pass a law requiring that the company whose original technology was improved by the Chinese receives an automatic exclusive license to use that improved Chinese technology in the United States, such that the Chinese entity does not have the right to sell that technology in the United States.

Finally, many experts argue that a key solution to this problem is for China and the United States to conclude a bilateral investment treaty (BIT). The idea is that if China commits to a regime where they must treat foreign, including U.S., firms fairly that this will solve many problems. But while a BIT may have some upsides, any clear-eyed view of it must recognize that is a two-edge sword. A strong investment treaty could make things better, but it would be very hard to get a strong treaty, it might not be enforced well, and it risks legitimizing China's practices that are not included in the BIT and setting a ceiling (a seal of approval). And perhaps most importantly, just as China's accession into the WTO severely limited the ability to impose unilateral sanctions against Chinese mercantilist practices (and the WTO regime provided itself incapable of stepping up the task), a China BIT would likewise tie the hands of the United States to use investment review as a tool to respond to Chinese innovation mercantilism, while not constraining China which has shown that they do not believe they have to follow the spirit, if not the letter of their treaty commitments.[19]

Develop Stronger Analytic Competence Within the Administration

The United States largely continues to consider the challenge of foreign acquisition of U.S. technology on an ad hoc, case-by-case basis. There is no entity in government charged with thinking about this challenge from a holistic and strategic perspective that can think across agencies to analyze, understand, anticipate, and respond to these challenges. There is no entity analyzing China's capacity to absorb knowledge, to understand their determination to do something with it, to understand the source of their technology, and how determined their foreign technology partners are to help them. A glaring example of this is that it took the U.S. government four years to recognize that China had articulated, and then to get translated into English, its *National Medium- and Long-Term Program for Science and Technology Development (2006-2020)*, or "MLP" and even begin to understand what its implications might be for U.S. industry.

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[19]. Stephen Ezell and Robert D. Atkinson, "False Promises: The Yawning Gap Between China's WTO Commitments and Practices" (Information Technology and Innovation Foundation, September 2015), https://itif.org/publications/2015/09/17/false-promises-yawning-gap-between-china%E2%80%99s-wto-commitments-and-practices.

Part of this lack betrays a lack of imagination that other countries might possibly use these types of aggressive innovation mercantilist policies because the Washington consensus thinking is so prevalent in the United States that we would find the use of such policies unlikely or at least self-injuring. And part of this lack reflects a naïveté that holds that other nations, particularly China, simply cannot catch up to us. But the notion that China can't innovate is fundamentally wrong. The Chinese are strong innovators at cost innovation, supply chain innovation, and incremental innovation and are rapidly increasing their ability to absorb technical know-how. Indeed, the gap between the United States and China is closing and the learning curve for them has shortened because they have accumulated considerable knowledge and capabilities. As a result, thinking about these issues with a China of ten, five or even three years ago in mind is dangerous.

To remedy this deficiency Congress should require that the President establish a new National Industrial Intelligence Council stood up within the White House and charged with developing a better process and structure to understand the long-term implications on U.S. industries and companies of other nations' economic development strategies, so that the United States can respond more effectively. This group would develop a better process and structure to understand the long-term implications of China's economic development strategy on U.S. competitiveness. It would also develop approaches to better leverage intelligence assets to boost the competitiveness of U.S. companies. (This would not represent industrial espionage, but rather sharing public knowledge about the competitiveness plans of Chinese enterprises and industries.)

Rethink Antitrust to Take Into Account Foreign Innovation Mercantilism

Given that the Chinese have and are created large national champions in most export-based industries, competing with the Chinese in advanced industries will require even greater scale on the part of U.S. companies. This means that U.S. anti-trust authorities will need to assess mergers through the lens of whether they enable the combined companies to effectively compete with large Chinese champions.

Moreover, anti-trust authorities will need to be careful to ensure that their actions do not inadvertently provide opportunities for Chinese firms to acquire divisions of U.S. companies. We saw this with the U.S. Federal Trade Commission's recent requirement that semiconductor maker NXP divest of its RF power business as a condition for its $11.8 billion acquisition of U.S.-based Freescale Semiconductor Ltd. This opened up the business for acquisition by the Chinese Jianguang Asset Management Co. Ltd. and just like that, U.S. technology capabilities went to China, courtesy directly of an action undertaken by the U.S. government. This was anything but pro-competition but reflected a lack of understanding of the new nature of global competition in the technology industry.[20] Likewise it is ironic and troubling that U.S. chipmaker AMD created a joint venture with China's Nantong Fujitsu Microelectronics when AMD owes its very

[20]. Federal Trade Commission, "FTC Requires NXP Semiconductors N.V. to Divest RF Power Amplifier Assets as a Condition of Acquiring Freescale Semiconductor Ltd.," news release, November 25, 2015, https://www.ftc.gov/news-events/press-releases/2015/11/ftc-requires-nxp-semiconductors-nv-divest-rf-power-amplifier.

existence to the requirement by U.S. antitrust officials for Intel to license its core x86 technology to a U.S. competitor.[21]

These blinders on competition policy harken back to the 1950s and 60s when U.S. antitrust authorities forced U.S. technology firms to compulsorily license between 40,000 to 50,000 patents.[22] Many of these patents ended up going to Japanese firms that were at the time significantly lagging behind their U.S. competitors, but with this technology gift from the U.S. government they rapidly caught up to and then exceeded U.S. firms, costing the U.S. economy hundreds of thousands of middle- and high-wage jobs. We saw this with AT&T where transistor technology was licensed to Sony. The forced listening of RCA's color TV patents was the single most important factor in the Japanese taking the color TV market away from its inventor, the United States.[23] Similarly Xerox was forced to license its technologies, again handing Japanese copier firms the crown jewels. This aggressive competition policy enforcement blithely ignored the threat of global competition to the U.S. economy. With global competition, even more intense today, and U.S. leadership much weaker, we cannot afford to repeat the mistakes of the 1950s and 60s today.

Work With Our Allies to Coordinate Measures to Constrain Mercantilist-Inspired Chinese FDI

All of this gets to the critical need for the Trump administration to work with America's major allies to coordinate policies and actions against Chinese innovation mercantilism. For example, the Trump administration should work closely with our allies, particularly in Europe, to encourage them to also expand the scope of their national security screenings so that Chinese firms don't simply switch their focus to trying to acquire European tech firms and then come after U.S. firms in the marketplace.

The Benefits of FDI

Defenders of the Washington consensus on trade and investment like to portray any criticism of particular Chinese FDI investments as a wholesale rejection of FDI underpinned by economic ignorance. To be sure, in general foreign direct investment is a net plus to economies, including the U.S. economy. Foreign direct investment builds international linkages and knowledge networks that augment innovation both domestically and globally, particularly by fostering the international diffusion of technology, know-how, and best practices. Indeed, research shows that FDI can contribute significantly to regional innovation capacity and economic growth, in part through the transfer of technology and managerial know-how.[24] For example, Eaton and

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21. Junko Yoshida, "Lurking Behind Every M&A is China," http://www.eetimes.com/document.asp?doc_id=1330969.

22. Barry C. Lynn, "Estates of Mind," *Washington Monthly*, July/August 2013, http://washingtonmonthly.com/magazine/julyaugust-2013/estates-of-mind/.

23. Robert Sobel, *RCA* (Stein and Day, 1986), pg. 212.

24. Michael P. Ryan, "Intellectual Property and Economic Growth" (working paper, George Washington University,

Kortum estimate that one-half of the productivity growth in OECD economies is derived from trade, licensing, and FDI.[25] Foreign R&D investment also has been shown to spur local companies in the receiving country to increase their own share of R&D, leading to regional clusters of innovation-based economic activity. This is particularly true for greenfield investment in new plants and other operations.
Another channel through which a country's domestic firms benefit from inward foreign direct investment is competition.[26] The right level of competition from foreign firms (based on market forces alone, and not government action) pressures indigenous rivals to update their technology and production processes and to use their existing resources more effectively.[27] In other words, greater levels of inbound FDI force domestic companies to ratchet up their competitiveness, potentially spurring them to greater levels of innovation output that can benefit both domestic and global constituencies.

But as discussed below, the debate should not be about whether FDI is good or bad. It is almost always good if it is based on free-market forces and commercial interests. But it can often be harmful it's based on mercantilist forces and state interests. But rather the debate should be whether Chinese FDI is based on free-market forces and commercial interests. As I discuss below, this is not always the case.

Arguments Made Supporting Chinese FDI
When it comes to assessing the impacts of Chinese FDI on the U.S. economy, the Washington trade establishment generally repeats the broad economic consensus on FDI and assumes that Chinese FDI is no different, and therefore labels any criticism as misguided or self-interested. Indeed, while most reports defending Chinese FDI will acknowledge that there may be isolated problems, particularly as it relates to FDI in defense-related enterprises, the general view is that Chinese FDI is an unalloyed good and more would be better. As one report on Chinese FDI states, "Whether a new facility or the acquisition of an existing one, these local operations pay local, state, and federal taxes, provide jobs, push innovation, build trade linkages, and, in the process, touch and improve the lives of countless Americans."[28] Another states, "trade with China is getting plenty of attention on the campaign trail this year but is becoming less important.

Washington, DC, 2008).

25. Jonathan Eaton and Samuel Kortum, "Trade in Ideas: Patenting and Productivity in the OECD" (working paper, NBER Working Paper No. 5049, 1995), http://www.nber.org/papers/w5049.

26. Jitao Tang and Rosanne Altshuler, "The Spillover Effects of Outward Foreign Direct Investment on Home Countries: Evidence from the United States" (working paper, SSRN, January 4, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2545129.

27. But as an MIT study shows, too much government-supported competition can harm innovation as it drives down margins needed to support risky investments in innovation: David Autor, David Dorn, Gordon H. Hanson, Gary Pisano, and Pian Shu, "Foreign Competition and Domestic Innovation: Evidence from U.S. Patents"(NBER Working Papers 22879, National Bureau of Economic Research, Inc., 2016), http://economics.mit.edu/files/11708.

28. Rhodium Group, "New Neighbors: Chinese Investment in the United States by Congressional District" (report, National Committee on US-China Relations May 2015 and Rhodium Group), pg. 5, https://www.ncuscr.org/sites/default/files/Chinese-FDI-in-US_Full-Report-2015-NCUSCR_0.pdf.

Meanwhile, investment from China is becoming more important but is largely ignored."[29] Moreover, at the highest levels of the U.S. government, the government encourages Chinese FDI. The Joint U.S.-China press statement following the July 2014 Strategic and Economic Dialogue states, "The U.S. side welcomes Chinese enterprises' investment in the United States and commits to maintain [an] open investment environment for various kinds of Chinese investors."[30] Former Vice President Biden stated, "President Obama and I, we welcome, encourage and see nothing but positive benefit from direct investment in the United States from Chinese businesses and Chinese entities. It means jobs."[31] But as we will see, it's not that simple. Some Chinese FDI does mean jobs. Some is neutral at best. And some ultimately will cost U.S. jobs (and technology leadership). Supporters make at least eight misguided arguments as to why increased Chinese FDI is good for the economy.

Claim 1: China Needs to Expand FDI to Rebalance Its Economy: China has pursued an export-led strategy for at least thirty years that has not only hurt the U.S. economy but destabilized the global economy.[32] So in this context, many defenders portray the growth in Chinese FDI as positive for the United States and the world as it is supposedly different than China's focuses on export-led growth. In a Center for Strategic and International Studies (CSIS) report on the topic, Charles Freemen and Wen Jin Yuan write, "From the government's perspective, there are a number of reasons China is increasing its OFDI in the service sector, particularly in technological M&A. With an increasingly imbalanced economy, mounting inflationary pressure and growing criticism from the US and other countries over an undervalued renminbi (RMB), the Chinese government has initiated a comprehensive campaign to rebalance its economy."[33] Brookings senior fellow David Dollar concurs, writing, "A few years ago China was largely using [its assets] to invest domestically and drive its growth. But when you invest at that level, what I think inevitably happens is you get very serious problems of excess capacity. And that's what's happening in China's domestic economy now…There are lots of empty apartments, enormous excess capacity in steel and other manufacturing sectors. They've overbuilt infrastructure. ... So just think of there being a lot fewer good investment opportunities in China."[34] Likewise, The Asia Society writes, "The

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29. Derek Scissors, "America Needs a China Pivot—From Trade to Investment," *AEI*, August 22, 2016, https://www.aei.org/publication/america-needs-a-china-pivot-from-trade-to-investment/.

30. "Joint U.S.-China Press Statements at the Conclusion of the Strategic & Economic Dialogue," U.S. Department of State, accessed January 10, 2017, https://www.state.gov/secretary/remarks/2014/07/228999.htm.

31. "Remarks by Vice President Biden and Chinese Vice President Xi at a U.S.-China Business Roundtable," The White House, Office of the Vice President, accessed January 10, 2017, https://www.whitehouse.gov/the-press-office/2011/08/19/remarks-vice-president-biden-and-chinese-vice-president-xi-us-china-busi.

32. Robert D. Atkinson, The Hidden Decline of Manufacturing Output," *RealClear Policy*, May 27, 2015, http://www.realclearpolicy.com/blog/2015/05/27/the_hidden_decline_of_manufacturing_output_1308.html.

33. Charles W. Freeman III and Wen Jin Yuan, "China's Investment in the United States --- National Initiatives, Corporate Goals, and Public Opinion" (briefing, Center for Strategic & International Studies, Freeman Chair in Science Studies, pg. 5), https://csis-prod.s3.amazonaws.com/s3fs-public/legacy_files/files/publication/111107_Freeman_Briefing_China_Investment_in_US.pdf.

34. Andrew Soergel, "China Is Buying Its Way Into the U.S. Economy," *U.S. News*, May 17, 2016,

competitive pressures arising from this rebalancing process will provide further incentives to managers to seek greater internationalization…"[35]

But this view is wrong. First, China doesn't need to rebalance between investment and consumption; it needs to rebalance between exports and imports. Nor does it need to rebalance in the sense of "moving up the value chain" away from low skill manufacturing to more productive sectors as Chinese officials claim. As ITIF and others have shown the surest way to grow an economy is not to spur the development of a few high-tech sectors, but to ensure that all sectors from agriculture to services are highly productive, in part through the use of technology.[36] Even if growing high tech sectors were part of this, this does not justify mercantilist policies that hurt the United States and the world. But this gets to the problem: to the extent China is "rebalancing" its economy it is rebalancing from an export-led strategy of low-value added products to one of high-value added ones. If China was truly focused on rebalancing it would pursue an across the board productivity policy while rolling back the suite of policies that result in limited U.S. imports. In short, to truly rebalance its economy it needs to buy more U.S. goods and services and turn its trade surplus into a trade deficit. China could easily redeploy its "excess" savings for consumption and imports, rather than investment in U.S. Treasury bills and U.S. companies. Indeed, to characterize increases in FDI as rebalancing is to miss the point. This is in part just another vehicle to recycle earnings from the Chinese trade surplus back into the United States, in lieu of buying more actual U.S. goods and services.

Others argue that China is switching from recycling its dollars back to the United States from low interest rate Treasury bills to higher return FDI, just like any individual rational investor would do. But this ignores the fact that the returns to the Chinese economy from either approach are not real until they are translated into purchased foreign goods and services. Economies don't consume money, they consumer goods and services. In other words, unless the Chinese government decides it wants to spend more of the current account surplus on foreign goods and services, the higher returns they are getting are only paper. Moreover, to the extent Chinese companies are paying significant price premiums over market valuations that either means that commercial non-Chinese companies don't know how to value US companies or that the actual Chinese returns are lower than they would otherwise be.

Claim 2: The United States Needs Chinese Capital: There has been a long-held argument by many defenders of the U.S.-China status quo that the imbalance in trade

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http://www.usnews.com/news/articles/2016-05-17/china-is-buying-its-way-into-the-us-economy

35. Daniel H. Rosen and Thilo Hanemannm, "An American Open Door?: Maximizing the Benefits of Chinese Foreign Direct Investment" (special report, Center on U.S.-China Relations Asia Society and Kissinger Institute on China and the United States Woodrow Wilson International Center for Scholars, May 2011), http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

36. Robert D. Atkinson and Stephen J. Ezell, "The Indian Economy at a Crossroads" (Information Technology and Innovation Foundation, April 2014), https://itif.org/publications/2014/04/21/indian-economy-crossroads.

between China and the United States is a win-win because they get jobs and we get capital. This has been focused on with the purported benefits of the Chinese buying U.S. government debt to finance our budget deficit, but now with the rise of Chinese FDI. In both cases the argument is that America needs this capital to finance its economy. As Law professor Tim Bakken writes, in regard to the need for Chinese FDI: "As the Obama Administration illustrated, the U.S. will be increasingly reliant on foreign investment because as the U.S. continues to borrow and increase its debt, now about $18 trillion, it will lack the resources to finance domestic investment."[37] Peking University professor Mark Feldman argues that "The need for some $8 trillion in investment over the next 15 years to modernize U.S. infrastructure should provide many opportunities for the U.S. Government to further demonstrate that Chinese investment is indeed welcome in the United States."[38] Orville Schell of The Asia Society states that "the largest new pool of capital is built up in China and the United States is in debt, and to keep our economy vibrant we very much need foreign investment."[39]

But the United States does not need China to finance its debt. If China did not buy U.S. debt, interest rates could rise, giving Americans an incentive to save more. Or Congress could cut spending or increase taxes to reduce the debt. Moreover, eliminating the trade deficit with China would grow the U.S. economy, thereby reducing the federal budget deficit. Likewise, the United States doesn't need China to finance its economy or infrastructure. Indeed, there is no shortage of capital in the United States, as good deals have access to deep capital markets. For example, with regard to infrastructure, the issue is not capital—indeed major infrastructure investment funds exist and are looking for deals. Rather, the problem is a lack of deals with an ongoing cash flow to pay back bond holders. Finally, the only reason China has so much capital is because the Chinese government has committed to an export-led strategy to sell more than it buys and then to use that money to both keep its currency low, and, increasingly, to buy foreign, including U.S. companies.

Claim 3: Chinese FDI Creates Jobs: Perhaps the most prevalent argument made by supporters of Chinese FDI is that it is needed to create jobs. Certainly many city and state officials believe this. As the *Wall Street Journal* noted, "The trend could bring much-needed jobs and investments to states hit by the recession, and they are pulling out all the stops to attract Chinese investment. That includes opening offices in China, offering preferential tax policies and hosting Chinese delegations."[40]

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37. Tim Bakken, "Legal Takeovers Of Nations: The Value And Risks Of Foreign Direct Investment In A Global Marketplace," *University of Dayton Law Review, Volume 40:3 (2015),* https://udayton.edu/law/_resources/documents/law_review/vol40_no3/40-3_legal_takeovers_of_nations.pdf.

38. Mark Feldman, "China's Outbound Foreign Direct Investment: The U.S. Experience" (Peking University School of Transnational Law Research Paper No. 15-1, March 4, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2481442.

39. "An American Open Door?" Asia Society, Video, Minute 3:47, accessed January 10, 2017, http://asiasociety.org/center-us-china-relations/american-open-door.

40. Kathy Chen, "U.S. Cities to Woo Chinese Investment," *Wall Street Journal*, April 6, 2010, http://www.wsj.com/news/articles/SB10001424052702303410404575151593460208482.

But leaving aside the fact that when the economy is not in recession the number of jobs is determined by the size of the labor force and by federal reserve monetary policy, it is important to distinguish between types of FDI. Most supporters of Chinese FDI lump all FDI together, not distinguishing between “greenfield” investment (e.g., establishing new production) or acquisitions (buying some or all of the assets of a U.S. company). In general, greenfield FDI advances U.S. economic interests as companies build new capacity and create jobs. But this depends in part on the market for that output. When Japanese auto companies began investing in the United States in the 1980s and 1990s they were building plants that largely substituted for Japanese imports, which on balance helped reduce the U.S. trade deficit. There is no evidence that any Chinese acquisitions substitute for Chinese production; why would it since production costs in China are around 20 percent of U.S. costs. Greenfield FDI that competes for market share with domestic producers has less net economic benefit as it replaces domestic-owned output with foreign.

Likewise, acquisitions may or may not advance U.S. economic interests, depending on the strategy and actions of the acquiring company. Indeed, one study of FDI into the United States found that “The acquisition of domestic firms by foreign interests appears to have little aggregate positive impact upon employment, while new plants, constructed by foreign concerns, have positive employment impacts on the foreign manufacturing sector in the United States.”[41] This is logical because when a foreign company buys an American enterprise, it is at one level simply switching ownership. Net benefits depend on the capabilities the acquiring enterprise brings to the acquired firm.

So, what has been the pattern of Chinese FDI? According to the Rhodium Group, from 2002 to 2016, Chinese companies invested around $100 billion in companies in the United States, with almost half of this ($45.6 billion) taking place in 2016. However, just 8 percent of this financing went to greenfield investments, with the rest to acquisitions.[42]

Finally, it’s important to understand that Chinese FDI is a form of recycling U.S. dollars that the Chinese economy accumulates through its systemic trade surpluses. China has really only two choices with what to do with these accumulated foreign reserves. It can open up its markets and purchase more foreign goods and services so that its trade is in balance or it can recycle the trade surplus reserves back into the United States. The latter, even if it is in the form of FDI, comes at the expense of greater imports from the United States, which would be an unalloyed good given the large U.S. trade deficit. Spending its reserves to buy U.S. companies simply postpones the day of reckoning when China must run a trade deficit with the world. For recycling that money into the United States, in the form of stock market purchases, government bond purchases, or direct acquisition of U.S.

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41. Bruce Pigozzi and Sharmistha Bagchisen, “Impacts of Acquisitions and New Plants on the Employment in US,” *Journal of Economic and Social Geography* (September 1995), http://onlinelibrary.wiley.com/doi/10.1111/j.1467-9663.1995.tb01362.x/abstract.

42. Rhodium Group, “Chinese Investment Monitor,” accessed January 4, 2017, http://rhg.com/interactive/china-investment-monitor.

firms is no different in the sense that it allows the value of the RMB to remain lower that it would be otherwise, which in turn allows China to continue running trade surpluses. These investments, regardless of their type, are in essence promissory notes. China's economy does not get anything of value from them in the short run, other than cash on its balance sheet. But that cash is worthless unless it is spent on buying U.S. goods and services. It would be akin to someone having a large bank account but being unwilling to spend that money. Their actual wealth would be no different than someone who has fewer assets but the same buying habits.

Claim 4: Chinese FDI Brings Technology and Other Benefits: Many defenders of Chinese FDI argue that Chinese firms bring other benefits than just jobs to the U.S. economy. As a report by the National Committee on U.S.-China relations writes, "foreign firms often bring technology and knowledge with them, leading to innovation and productivity spillovers to local economies. A famous historical example are production and management techniques that Japanese automakers brought with them in the 1980s, such as the "just in time" production model."[43] This is true. When Japanese companies invested in largely greenfield facilities in America they brought "lean production" systems to the United States and that helped U.S. automakers companies as they now had an easier time learning these systems. But it's important to realize that when the Japanese firms were investing in the United States in autos and related sectors their productivity was generally higher than American firms, so there was a lot for U.S. firms to learn. For China, the opposite is true, as virtually all Chinese firms are less productive than their U.S. counterparts. Chinese firms come here to learn from American firms, not teach them. Moreover, as Wang and Wang note, "The Chinese government has spared no effort in attracting FDI into China because foreign firms bring with them not only capital, but also technology, employment and other positive spill-over effects. Conversely, if Chinese firms going abroad intend only to bring back technology and resources, no wonder the host country is resistant to such investments."[44]

Even if they are not bringing new capabilities, what's wrong with Chinese acquisitions of U.S. technology firms? Defenders will claim, rightly in most cases, that there is no evidence of Chinese buying U.S. firms and shutting them down and transferring the assets to China. An Asia Society report writes, "we do not find evidence of Chinese firms systematically acquiring technology assets and then moving capacities to China or other countries."[45] But that's not the point. As discussed below, the point is that they are often transferring the intangible assets to China: the technical knowhow, so that the Chinese-

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[43]. Rhodium Group, "New Neighbors: Chinese Investment in the United States by Congressional District" (report, National Committee on US-China Relations May 2015 and Rhodium Group), pg. 59, https://www.ncuscr.org/sites/default/files/Chinese-FDI-in-US_Full-Report-2015-NCUSCR_0.pdf.

[44]. Bijiun Wang and Huiyao Wang, "Chinese Manufacturing Firms' Overseas Direct Investment (ODI): Patterns, Motivations and Challenges," in Rising China: Global Challenges and Opportunities, p. 99, Jane Golley and Ligang Song, eds., August 9, 2011, p. 114, http://ssrn.com/abstract=1907170.

[45]. Thilo Hanemann and Daniel H. Rosen, "High Tech: The Next Wave of Chinese Investment in America," (special report, Asia Society, April 2014, pg. 55), http://rhg.com/wp-content/uploads/2014/03/RHG_HighTechOFDI.pdf.

based establishments become more robust global competitors.

Claim 5: More Chinese FDI Will Spur Needed Reforms in China: Supporters of Chinese FDI claim that it is in U.S. interests because it will encourage liberalization in China, including more respect for intellectual property. As a report by The Rhodium Group states, “Embracing the FDI trend will also accelerate compliance with law-based innovation protections. The greater the value of IPR and other intangible assets on the balance sheets of Chinese firms, the more these firms will pressure Beijing for better protection of these assets in China and globally.”[46] Yet when China entered the World Trade Organization (WTO) to great fanfare in 2001, pundits and policymakers alike predicted already then that in doing so China would embrace market-based economic principles and commit to the core tenets guiding liberalized trade and globalization. And to be sure, China did reform thousands of domestic laws and has complied with many of its WTO commitments—such as joining the Information Technology Agreement (ITA) and reducing average tariffs on industrial products. But all too often, one step forward has been met with two steps backward, as China has erected new, often behind-the-border non-tariff barriers (NTBs) to more than compensate for concessions elsewhere. These have more than offset China’s apparent concessions.[47] As such, there is no reason to believe that somehow “this time is different,” and that expanded FDI will empower reform and reformers, especially with such a large share of Chinese FDI government-backed.

Claim 6: Chinese Acquisitions Are Beneficial Since U.S. Owners Voluntarily Choose to Sell: Some defenders of Chinese FDI argue that because the U.S. owners benefit by selling to a Chinese company that the deals must by definition be good for America. As the co-head of Global Mergers and Acquisitions at investment bank J.P Morgan Chase writes in the *Wall Street Journal*, “[U.S.] firms should seriously consider whether a Chinese buyer’s motives are any less suited to their best interests than a conventional competitor’s. Given that Chinese companies generally have a longer investment time horizon, and are able to pay a premium as a result, their offers may be the best choice on the table.”[48]

But this logic fails to differentiate between societal and private gain. Clearly the owners of any U.S. company selling out to a Chinese firm benefit. They get an exit opportunity and often more money than they would if they sold to a firm that was making its calculus solely on commercial considerations. But if the result is the transfer of needed technology and know-how to China, the societal result could very well be negative as the United States loses high-value-added production. But that is not usually in the U.S. owner’s

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46. Ibid.

47. Robert D. Atkinson and Stephen J. Ezell, “False Promises: The Yawning Gap between China’s WTO Commitments and Practices” (Information Technology and Innovation Foundation, September 2015), http://www2.itif.org/2015-false-promises-china.pdf.

48. Hernan Cristerna, “Mergers and Suspicions: China in the U.S.” *Wall Street Journal*, June 26, 2016, http://www.wsj.com/articles/mergers-and-suspicions-china-in-the-u-s-1466975802.

calculation.

And to claim that such transactions are in U.S. interests because they are often the "best choice on the table" ignores that this is often the case because the Chinese government is kicking in the sweetener. For example, China-backed Canyon Bridge proposed a price premium of 30 percent in its proposal to acquire Lattice Semiconductor.[49] In these cases the price premium would reflect mercantilist rather than market economics, thus leading to allocation inefficiency. It would be no different than the Chinese subsidizing exports through government grants or tax incentives where U.S. consumers may benefit in the short run, but the U.S. economy is hurt in the medium- and longer-term. [50]

Claim 7: Chinese FDI Should Be Treated the Same as FDI From Any Other Nation: Given that foreign direct investment is generally good for the U.S. economy, the most important question in evaluating the likely impact of Chinese FDI is whether it operates along the same lines as other nations' U.S. FDI. If it does, then all this concern is much ado about nothing. In other words, if Chinese firms are making these investments solely on commercial merits then America should welcome it. But if these are strategic investments to achieve government goals with government support and subsidies, that is something very different. Indeed, China differs in at least three key ways from many of the leading nations that invest in U.S. FDI (e.g., the United Kingdom, Japan, the Netherlands, Canada, Germany, Switzerland and France).[51]

First, in contrast to investment from these nations who are our military and diplomatic allies, China is not. China vies with the United States for global influence and their FDI can help them achieve that goal.

Second, much of Chinese FDI is from state-owned enterprises (SOEs) that often have different motives than simply maximizing profits. Rather, their investments are often to serve state goals. Chinese state-owned enterprises account for the majority of China's offshore foreign direct investment (OFDI) activity. In 2010, the SOE-share of China's outward FDI equaled 66.6 percent. In Europe, acquisitions from state-owned enterprises "account for a stunning 72% of the total deal value of all Chinese acquisitions … in the period of 2002 to 2012."[52] As one study notes, China's OFDI is "state-driven and

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[49]. Liana B. Baker, "Lattice Semiconductor to be bought by China-backed Canyon Bridge," http://www.reuters.com/article/us-lattice-us-m-a-canyon-bridge-idUSKBN12Y1K5.

[50]. Usha C.V. Haley and George T. Haley, *Subsidies to Chinese Industry State Capitalism, Business Strategy, and Trade Policy* (Oxford University Press, 2013).

[51]. Organization for International Investment, "Foreign Direct Investment in the United States,"(2016 report), http://ofii.org/sites/default/files/Foreign%20Direct%20Investment%20in%20the%20United%20States%202016%20Report.pdf.

[52]. Gert Bruche and Bernhard Wallner, "Dragons and Tigers Hunting in Germany: Chinese and Indian acquisitions of German firms 2002 – 2012," (working paper, BGM Associates, 2013, pg. 3), http://www.bgmassociates.net/uploads/6/8/9/2/68925041/bgm_associates__-_dragons_and_tigers_hunting_in_germany.pdf.

centralized" and it's "probably historically unprecedented for the SOEs to invest on such a massive scale."[53] Within the United States, the share from SOEs is lower, but still significant. According to the Rhodium Group, from 2002 to 2016, of the 582 acquisition deals, about 20 percent (116) were made by government-owned corporations, accounting for about 30 percent of the total monetary value.[54] Information and communications technology (ICT) and electronics industries deals totaled roughly $18 billion, with government-backed deals accounting for roughly $5 billion of this amount. Moreover, the lines between public and private in Chinese firms is opaque, with many "private" firms have deep financial and other ties to the Chinese government.

The role of Chinese government money in U.S. deals is underreported in part because of the opaque nature of this support. As Wang and Wang note, many Chinese firms lack transparency, making it difficult for host countries to know enough about the investing firm.[55] This was evident for example in the attempted purchase of German semiconductor equipment firm Aixtron by a Chinese investor where there were "a web of relations among the customer, the buyer, and the Chinese state."[56] Moreover, the Chinese government channels funds to supposedly private investment bodies, making it look as if these deals are commercial." Even the CSIS report admits that "in order to successfully lobby the Ministry (MIIT) and receive adequate financial resources, the private enterprises have to link corporate goals with national government initiatives, otherwise the Ministry will be reluctant to endorse the companies' OFDI initiatives."[57] This influence is clearly apparent in the semiconductor sector, where government-directed funds channeled from SOEs to private equity firms have played an important role in China's pursuit of a number of foreign enterprises in the semiconductor sector, such as Spreadtrum Communications, RDA Microelectronics, and Micron.[58]

The third major difference is that while many nations dabble in mercantilism, China specializes in it. As ITIF showed in its report "Contributors and Detractors: Ranking

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53. Yasheng Huang, "Business and Government Relations in China," (presentation, MIT Sloan School of Management, August 2015).

54. Rhodium Group, "Chinese Investment Monitor," accessed January 4, 2017, http://rhg.com/interactive/china-investment-monitor.

55. Bijiun Wang and Huiyao Wang, "Chinese Manufacturing Firms' Overseas Direct Investment (ODI): Patterns, Motivations and Challenges," in Rising China: Global Challenges and Opportunities, p. 99, Jane Golley and Ligang Song, eds., August 9, 2011, p. 104, http://ssrn.com/abstract=1907170.

56. Paul Mozur and Jack Ewing, "Rush of Chinese Investment in Europe's High-Tech Firms Is Raising Eyebrows," *The New York Times*, September 16, 2016, http://www.nytimes.com/2016/09/17/business/dealbook/china-germany-takeover-merger-technology.html?_r=0.

57. Charles W. Freeman III and Wen Jin Yuan, "China's Investment in the United States --- National Initiatives, Corporate Goals, and Public Opinion" (briefing, Center for Strategic & International Studies, Freeman Chair in Science Studies, pg. 11), https://csis-prod.s3.amazonaws.com/s3fs-public/legacy_files/files/publication/111107_Freeman_Briefing_China_Investment_in_US.pdf.

58. Paul Mozur, "Using Cash and Pressure, China Builds Its Chip Industry," *The New York Times*, October 26, 2014, http://www.nytimes.com/2014/10/27/technology/using-cash-and-pressure-china-builds-its-chip-industry.html?_r=1.

Countries' Impact on Global Innovation," of 56 nations, only Thailand did more on a per-capita basis to harm global innovation through innovation mercantilist policies than China.[59] In the last decade China has embraced a strategy of "indigenous innovation" that favors Chinese enterprises not only in the procurement activities of state-owned or state-influenced enterprises, but by any means possible, including forced technology transfer, intellectual property theft, joint ventures requirements, and other means. From semiconductors to e-commerce, Chinese President Xi Jinping has unabashedly trumpeted the goal of making China the "master of its own technologies," and, to do so, the Chinese government is pursuing an aggressive by-hook-or-by-crook strategy that involves serially manipulating the marketplace and wantonly stealing and coercing transfer of American knowhow. It is in this context that at least some of China's U.S. FDI needs to be evaluated, for the FDI strategy of acquiring U.S. technology firms is just one tactic in an overarching, long-term strategy designed to gain global self-sufficiency at least, and global dominance at most, across a wide array of technologies. As such, this differs fundamentally from the firm-led FDI from most U.S. trading partners.

A case in point is the recent efforts by Chinese solar companies to buy the bankrupt assets of U.S. solar companies. In this case, GCL-Poly Energy Holdings Ltd., one of China's largest makers of solar equipment, bought the solar materials assets of bankrupt U.S. renewable energy company SunEdison Inc. for $150 million.[60] GCL and other U.S. companies were put out of business because Chinese firms were selling solar panels below cost, in part because of Chinese government subsidies. In some cases, prices were depressed by 75 percent making it impossible for any company except government-backed ones to survive.[61] This is a classic case of predation, something anti-trust authorities prohibit when firms do it: weaken your opponent by charging below price and then when they lose market share and money, come in and buy the assets at fire sale prices. As such, this kind of systemic behavior and policy differs fundamentally from the firm-led FDI from most of the U.S. trading partners.

Claim 8: Any Opposition to Chinese FDI Reflects Protectionism: Supporters of the Washington trade and investment consensus have long labeled any efforts to fight back against unfair and protectionist trade practices as protectionist. Now many likewise assert that any efforts to limit mercantilist-inspired inward foreign investment deals from China is also protectionist. The Asia Society writes that the increase in Chinese FID is "certain to test American resolve to stand by its long-held notions about the virtues of unfettered flows of investment."[62] The co-head of Global Mergers and Acquisitions at investment

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59. Robert D. Atkinson et. al., "Contributors and Detractors," https://itif.org/publications/2016/01/20/contributors-and-detractors-ranking-countries-impact-global-innovation.

60. Chester Yung, "SunEdison to Sell Some Assets to GCL-Poly Energy," *The Wall Street Journal*, August 29, 2016, http://www.wsj.com/articles/sunedison-to-sell-some-assets-to-gcl-poly-energy-1472463269.

61. Usha C.V. Haley and George T. Haley, *Subsidies to Chinese Industry State Capitalism, Business Strategy, and Trade Policy* (Oxford University Press, 2013).

62. Daniel H. Rosen and Thilo Hanemannm, "An American Open Door?: Maximizing the Benefits of Chinese Foreign Direct Investment" (special report, Center on U.S.-China Relations Asia Society and Kissinger Institute on China and the United States Woodrow Wilson International Center for Scholars, May 2011), p. 14,

bank J.P Morgan Chase writes in the *Wall Street Journal* that any concern about Chinese FDI represents “paranoia.”[63] But the implication is that Chinese FDI is the no different than FDI from other nations, and therefore the only rational response is to welcome it. As described, this is not always the case.

Likewise, but not unexpectedly, the voices from China are that any policy regime other than virtual complete openness to Chinese FDI represents a dark plot by the Western hegemon to suppress the poor, struggling developing Chinese nation. An article in China’s *Global Times* states, “It is clear that the U.S. wants to repress China’s development of strategic industries.”[64] But while this may whip up patriotic fervor, it is clearly not true. What the United States wants to repress, or at least should want to repress, is the development of China’s strategic industry achieved through *unfair, mercantilist means*. If China seeks to gain global leadership through legitimate policies—such as investing in scientific research, supporting STEM education, having a strong patent system, etc., the likely American response would at worst be indifference and at best support.[65]

Technology-Based Chinese FDI

A not insignificant share of Chinese FDI is in technology industries. According to Select USA, the top four industrial categories in terms of numbers for Chinese FDI projects from 2003 to 2015 were electronics, industrial machinery, software and IT services, and communications.[66] The Rhodium Group reports that over the last 16 years there was roughly $18 billion of Chinese FDI into ICT and electronics industries deals, with most of that in just the last few years. Of the $4.9 billion invested in electronics, $4.2 billion was invested in 2016, with 99.99 percent of that going to buy U.S. firms.[67] Of the $14.2 billion invested in ICT, 74 percent was made from 2014 to 2016, with more than 95 percent going to acquisitions.[68] These numbers would have been considerably larger if the federal government had not informally or formally blocked some deals through CFIUS.

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http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.

63. Hernan Cristerna, “Mergers and Suspicions: China in the U.S.” http://www.wsj.com/articles/mergers-and-suspicions-china-in-the-u-s-1466975802.

64. Song Shengxia, “Possible US protectionist moves could help grow China’s semiconductor industry,” *Global Times*, January 5, 2017, http://www.globaltimes.cn/content/1027207.shtml.

65. Robert D. Atkinson, Stephen J. Ezell and Adams B. Nager, “Contributors and Detractors: Ranking Countries’ Impact on Global Innovation” (Information Technology and Innovation Foundation, January 2016), https://itif.org/publications/2016/01/20/contributors-and-detractors-ranking-countries-impact-global-innovation.

66. Select USA, “Foreign Direct Investment (FDI) China,” accessed January 10, 2017, http://selectusa.commerce.gov/country-fact-sheets/China_Fact_Sheet.pdf.

67. Rhodium Group, “Chinese Investment Monitor,” accessed January 4, 2017, http://rhg.com/interactive/china-investment-monitor.

68. Ibid.

Chinese firms are also actively buying up U.S. life science companies in part because biotech is one of the 10 industries targeted in Chinas' "Made in China 2015" plan. As one Bloomberg study reports, Chinese firms announced more than $3.9 billion in overseas acquisitions in the pharmaceutical, biotechnology and health care sectors in 2016, a ten-fold increase from 2012.[69] For example, Fosun Pharma acquired Ambrx Inc., a protein therapeutics R&D company in the United States. China National Chemical Corp., an SOE, is seeking to buy Swiss pesticide and seed maker Syngenta for about $43 billion.

One area where the Chinese have been very active of late is in the semiconductor industry. Based on the 2014 National Guidelines for Development and Promotion of the IC Industry, China has developed a national integrated circuit (IC) plan that seeks to eliminate its trade deficit in integrated circuits (ICs) by 2030 and make China the world's leader in IC manufacturing by 2030. This includes IC manufacturing, design, packaging and test, materials and equipment.[70] As part of this plan, China wants 70 percent of the semiconductor chips used by companies operating in China to be domestically produced by the year 2025.[71] Between national and provincial government funds, the industry is expected to be supported with as much as $160 billion of government-backed funds.[72] The direction is clear, as in statements such as "Make up our mind, push forward persistently; Focus on the bottleneck, innovation is the route; Stress the focal point, coordinate in development; Companies are the players, market is the direction; and Concentrate resources to make world-class companies" and "Set up state leading group for development of integrated circuit industry, push forward the coordination of works with an emphasis on top planning."[73]

China justifies this innovation mercantilist plan on the basis that it needs to reduce imports since IC imports are China's biggest import. But this rationale is wrong on several levels. First, it fails to account for the fact that around half of these semiconductor imports are re-exported—with value-added during assembly and manufacturing—from China as part of global production networks for cell phones, tablets, and other electronic products. More importantly, the fact that China has a trade deficit in semiconductors is simply irrelevant and not an acceptable rationale to justify an industrial development strategy that would seek to intentionally limit imports of foreign technology products. From 2002 through to the end of November 2016, China accumulated a $3.5 trillion trade

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69. Hui Li and Jonathan Browning, "China Inc. Goes on a Buying Spree for Global Health Assets," *Bloomberg*, July 5, 2016, https://www.bloomberg.com/news/articles/2016-07-05/china-inc-goes-on-a-buying-spree-for-global-health-care-assets.

70. Dr. Adam He, "Will new policy in China trigger big changes?" *Solid State Technology*, http://electroiq.com/blog/2015/01/will-new-policy-in-china-trigger-big-changes/.

71. Ian Talley, "U.S. Gears Up to Restrict Chinese in Chip Industry," *The Wall Street Journal*, January 2, 2017, http://www.wsj.com/articles/chinese-access-to-u-s-semiconductor-industry-may-be-curbed-1483397701.

72. Ibid.

73. "State Guideline to the Development of Integrated Circuit Industry" State Council, China, June 2014.

surplus in goods with the United States.[74]

Chinese government leaders, including at MIIT, are well aware that they cannot meet the IC plan's objectives without buying up the expertise and knowledge they need through foreign acquisitions. Indeed, as a report from Bain Consulting counseling Chinese IC companies stated, "Since reaching scale through organic growth would be an almost insurmountable challenge, domestic Chinese players should look for partnerships (often with followers with strong IP that could benefit from funding and access to China's market) and takeover opportunities of companies looking to leave the industry or divest, both inside and outside of China."[75] Indeed this plan is self-reinforcing as one reason some foreign IC companies may seek to leave the market is that they understand how difficult it will be to access the Chinese IC market and more broadly to compete with these well-funded, government backed competitors. Better to sell out now while they can still command a nice price premium. Likewise, McKinsey writes, "We should expect China to continue to actively seek opportunities to acquire global intellectual property and expertise, usually with the intent of transferring them back home. What's still to be determined, however, is how global governments will react to proposed deals in light of the emerging policy and market changes."[76]

That is why China has been on a global buying spree to buy companies all along the IC value chain. As the Mercator Center for Chinese Studies notes, "Since 2014, new policies by the Chinese government to promote the development of China's semiconductor industry have fueled a boom in acquisitions in this segment. The first major deals were completed in 2015, including the purchase of Integrated Silicon Solutions for about $736 million. Total investment in semiconductors has reached more than $1 billion, but semiconductor deals have received considerable scrutiny from the Committee on Foreign Investment in the United States (CFIUS), dampening the prospects for several announced acquisitions."[77] For example, China tried to buy its way into a leading U.S. semiconductor company, Western Digital. The Western Digital deal was the latest in a string of numerous acquisitions that Chinese firms have attempted along the semiconductor value chain.[78] Notably, China's Tsinghua Unigroup—a state-owned enterprise once headed by the son of former Chinese President Hu Jintao—bid $23 billion last year for the Idaho-based Micron Technologies. That deal fell apart after Senators Orrin Hatch (R-UT) and Chuck Schumer (D-NY) raised national security

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74. United States Census Bureau, "Foreign Trade: Trade in Goods with China," (accessed January 7, 2017), https://www.census.gov/foreign-trade/balance/c5700.html#2000.

75. Kevin Meehan, Florian Hoppe, Jihyo Lee and Steven Lu, "China Chases Chip Leadership," *Bain and Company*, August 24, 2016, http://www.bain.com/publications/articles/china-chases-chip-leadership.aspx.

76. Gordon Orr and Christopher Thomas, "Semiconductors in China: Brave new world or same old story?," (article, McKinsey & Company, High Tech, August 2014), (http://www.mckinsey.com/industries/high-tech/our-insights/semiconductors-in-china-brave-new-world-or-same-old-story.

77. Lisa Beilfuss, "Uphill Tops Cypress Semi's Latest Bid for Integrated Silicon," *The Wall Street Journal*, June 23, 2015, http://www.wsj.com/articles/uphill-tops-cypress-semis-latest-bid-for-integrated-silicon-1435062435.

78. Thilo Hanemann, Daniel H. Rosen, and Cassie Gao, "Two-Way Street: 25 Years of US-China Direct Investment" (report, US-China FDI Project, Rhodium Group and the National Committee on U.S.-China Relations, in partnership with the American Chamber of Commerce in Shanghai and the China General Chamber of Commerce, 2016), pg. 77, http://rhg.com/wp-content/uploads/2016/11/TwoWayStreet_FullReport_En.pdf.

concerns. So Unigroup pivoted, working through its Unisplendour subsidiary to try to acquire a 15 percent stake in Western Digital (which CFIUS rightly blocked). Interestingly, China's Ministry of Commerce then suddenly approved Western Digital's 2012 acquisition of Hitatchi, Ltd.'s hard drive business—a deal that competition authorities in the United States, Europe, Australia and Japan all had studied and approved, but China had slow walked, thereby preventing Western Digital from achieving $400 million in savings. Western Digital is now the third global information technology company to accept investments from Chinese state-owned corporations in order to win such antitrust regulatory blessing.

To defend against charges of inappropriate government subsidies the Chinese government claims that its China Integrated Circuit Industry Investment Fund Co. Ltd., the entity it established to fund Chinese IC firms, is actually a private sector entity operating according to market principles. In reality it is a fund established by MIIT, staffed in large part by former MIIT officials, and funded in significant part by Chinese SOEs including China Mobile, China Tobacco, and the China Development Bank, presumably because the latter were "asked" to do so by MIIT and the State Council.[79] MIIT presumably established the fund this way, as opposed to simply funneling subsidies through MIIT, in order to avoid any potential WTO challenge against unfair government subsidies. But this laundered money does not make it any less of a subsidy. Chinese central government officials also supported the creation of a number of local semiconductor subsidy funds which also are used to subsidize foreign acquisitions. Thus, when Chinese officials assert that this is a new kind of IC strategy based not on government subsidies but on market principles, they are obscuring the fact that the new strategy is still based on government subsidies, but in this case usually in the form of equity investments that may or not get ever paid back. Indeed, many of these Chinese firms would be unable to acquire foreign IC firms without such subsidies as their balance sheets would be inadequate.

For example, Jiangsu Changjiang Electronics Technology Co. used $300 million from the national IC fund to help pay for the $780 million acquisition of Singapore's STATs Chip Pac Ltd., a leading provider of semiconductor packaging design assembly and test solutions.[80] The IC fund backed the buyout firm seeking to buy U.S.-based Lattice Semiconductor Corp.[81] And they were purportedly behind the purchase of Germany Aixtron.[82] In some cases, these deals are truly perverse, as in the case of Chinese firm

[79]. Ling Dongmei, "China Integrated Circuit Industry Investment Fund Leads $47M Round In Centec Networks," *China Money Network*, September 22, 2016, https://www.chinamoneynetwork.com/2016/09/22/china-integrated-circuit-industry-investment-fund-leads-47m-round-in-centec-networks.

[80]. Jonathan Davis, "Industry Luminaries Outline China's Semiconductor Growth Prospects," *Semiconductor*, May 14, 2015, http://m.blog.naver.com/mkpark1122/220359057588.

[81]. Liana B. Baker, "Lattice Semiconductor to be bought by China-backed Canyon Bridge," http://www.reuters.com/article/us-lattice-us-m-a-canyon-bridge-idUSKBN12Y1K5.

[82]. Georg Fahrion, "Aiztron-Chinas Staatsstreich," *Capital*, October, 24, 2015, http://www.capital.de/dasmagazin/aixtron-chinas-staatsstreich.html.

Apex Microelectronics buying the U.S. printer company Lexmark. Prior to the acquisition, Apex had been accused of producing counterfeit printer cartridges and infringing the patents of U.S. printer companies, including Lexmark.[83] And despite having revenues about one-tenth those of Lexmark, Apex was able to purchase Lexmark at a 17 percent premium over listed stock price, in part because it received funding from the Chinese national IC fund.[84] Indeed, the company is now 5 percent owned by the IC fund.[85]

This fund is also used subsidize Chinese semiconductor firms. For example, the fund bought several billion in new shares in **the Semiconductor Manufacturing International Corporation,** China's largest and most advanced sem**i**conductor foundry.[86] It invested $47 million in Chinese Centex networks, an Ethernet switching company.[87]

China technology firms have one other advantage over U.S. firms; their ability to suffer losses in foreign markets, both for their investments and sales. As Wang and Wang write, "China itself is a huge market, which means that firms losing profits in overseas markets can be compensated by selling their goods in the domestic market. For instance, Chinese consumer electronics producer TCL has been losing profits in overseas markets, but it survives with the profits from selling in the domestic market."[88] This then explains the fundamental difference between state-backed and purely commercial FDI acquisitions. When a corporation from Canada, Germany or any other market-based economy looks to acquire a U.S. technology firm they have to balance the purchase price with the benefit to them, and in many cases acquisitions do not make financial sense. But when the principal goal is not profit, but national economic advancement and attaining military capabilities, many more deals make sense, especially when the Chinese government is footing at least part of the bill.

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83. Recharge Asia, "HP Sues Apex, Ninestar," news release, October 8, 2014, http://www.rechargeasia.com/index.php/Industry-News/hp-sues-apex-ninestar.html?Itemid=; Tom Randall, "Tesla Flips the Switch on Gigafactory," *Bloomberg Technology*, January 4, 2017, https://www.bloomberg.com/news/articles/2017-01-04/tesla-flips-the-switch-on-the-gigafactory.

84. Tom Randall, "Tesla Flips the Switch on Gigafactory," https://www.bloomberg.com/news/articles/2017-01-04/tesla-flips-the-switch-on-the-gigafactory.

85. http://www.hupogu.com/S/SZ002180/info-shareholder, accessed January 10, 2017.

86. Semiconductor Manufacturing International Corporation, "Smic Receives Investment From China Integrated Circuit Industry Investment Fund," News Release, February 12, 2015, http://www.smics.com/eng/press/press_releases_details.php?id=264990.

87. Ling Dongmei, "China Integrated Circuit Industry Investment Fund Leads $47M Round In Centec Networks," *China Money Network*, September 22, 2016, https://www.chinamoneynetwork.com/2016/09/22/china-integrated-circuit-industry-investment-fund-leads-47m-round-in-centec-networks.

88. Bijiun Wang and Huiyao Wang, "Chinese Manufacturing Firms' Overseas Direct Investment (ODI): Patterns, Motivations and Challenges," in Rising China: Global Challenges and Opportunities, p. 99, Jane Golley and Ligang Song, eds., August 9, 2011, p. 107, http://ssrn.com/abstract=1907170.

Thus, the main purpose of most Chinese technology companies buying U.S. technology companies is not to make a profit, but to take U.S. technology in order to upgrade their own technology capabilities. The Rhodium Group notes that in the aviation sector, “The dominant player is aviation conglomerate AVIC, which is looking to the US market to upgrade its technology and other capabilities.”[89] Likewise, in the electronics and electrical equipment sector, “Chinese investors are drawn to the US electronics and electrical equipment sector for building their brands, expanding their sales and distribution channels, and upgrading their innovative capacity and technology portfolios.”[90] Investments in pharmaceuticals and biotechnology are “often driven by upgrading technology (such as Wuxi’s acquisition of AppTec, a laboratory services firm).”[91] As one study of Chinese FDI estimated, 30 percent of the private firm deals and 46 percent of the SOE deals are motivated by technology acquisition.[92] The authors go on to state that Chinese acquisition of overseas firms “has become the most widely used methods [of investing overseas] for Chinese firms, largely because it provides rapid access to proprietary technology…”[93]

As noted above, this tech-based FDI is a component of the Chinese government’s overarching indigenous innovation strategy. As the German Mercator Center for Chinese Studies notes:

> Chinese high-tech investments need to be interpreted as building blocks of an overarching political programme. It aims to systematically acquire cutting-edge technology and generate large-scale technology transfer. In the long term, China wants to obtain control over the most profitable segments of global supply chains and production networks. If successful, Made in China 2025 could accelerate the erosion of industrial countries’ current technological leadership across industrial sectors.[94]

The report goes on to note that, “There are strong indications that the absorption of

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89. Thilo Hanemann, Daniel H. Rosen, and Cassie Gao, “Two-Way Street: 25 Years of US-China Direct Investment” (report, US-China FDI Project, Rhodium Group and the National Committee on U.S.-China Relations, in partnership with the American Chamber of Commerce in Shanghai and the China General Chamber of Commerce, 2016), http://rhg.com/wp-content/uploads/2016/11/TwoWayStreet_FullReport_En.pdf.

90. Bijiun Wang and Huiyao Wang, “Chinese Manufacturing Firms’ Overseas Direct Investment (ODI): Patterns, Motivations and Challenges,” in Rising China: Global Challenges and Opportunities, p. 99, Jane Golley and Ligang Song, eds., August 9, 2011, p. 99, http://ssrn.com/abstract=1907170.

91. Ibid, 103.

92. Ibid, 110.

93. Ibid, 111.

94. Jost Wübbeke, Mirjam Meissner, Max J. Zenglein, Jaqueline Ives and Björn Conrad, “Made in China 2025: The making of a high-tech superpower and consequences for industrial countries” (Merics Paper on China, No. 2, December 2016, pg. 8), https://www.merics.org/fileadmin/user_upload/downloads/MPOC/MPOC_Made_in_China_2025/MPOC_No.2_MadeinChina_2025.pdf.

advanced technology is an increasingly prevalent motive for the state's push for outbound FDI. From this perspective, Made in China 2025 can be read as a grand strategy for technology-seeking investment."[95] As the report continues:

> the Chinese state promotes investment in leading foreign technology enterprises with the aim of systematically acquiring cutting-edge technology and generating large-scale technology transfer. Since state-led FDI in high-tech sectors is a new phenomenon, its full extent and precise effects are not yet entirely clear. But it is a realistic scenario that the widespread technology absorption by China will contribute to the erosion of industrial countries' technological leadership in specific industries.[96]

Likewise, as a report from a major IC conference in Shanghai noted, "clearly there will be a focus on [foreign] M&A [mergers and acquisitions] to achieve the rapid technological scale up necessary to realize the vision of the new national policy."[97]

In other words, Chinese tech-based FDI acquisitions is just one tactic in a comprehensive strategy of global knowledge acquisition in order to catch and ultimately surpass current technology leaders, including the United States. As one study of Chinese acquisitions of German firms noted, "'Cherry picking strategic assets of hidden champions, knowledge absorption, and gaining access to high-end markets are major strategic intentions behind the M&As."[98] The report goes on to note that "[what] most acquirers were targeting was the inherent knowledge of the target firms held by the employees in the form of engineering capabilities or process know-how, the knowledge embodied in its technological assets like products, machines and plants, the brand in terms of reputation and customer relationships as well as the worldwide distribution and service assets."[99] The report concludes that this is different than most FDI from other nations where the acquirer seeks integration, synergy, and efficiencies.

To be sure, some Chinese technology companies seek to be in the U.S. market for the same reason some U.S. companies seek to be in the Chinese market: to be able to better understand the domestic market and adjust their product offerings in response. But some do not.

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[95]. Ibid.

[9696]. Ibid, pg. 51.

[97]. Jonathan Davis, "Industry Luminaries Outline China's Semiconductor Growth Prospects," *Semiconductor*, May 14, 2015, http://m.blog.naver.com/mkpark1122/220359057588.

[98]. Gert Bruche and Bernhard Wallner, "Dragons and Tigers Hunting in Germany: Chinese and Indian acquisitions of German firms 2002 – 2012," (working paper, BGM Associates, 2013, pg. 3), http://www.bgmassociates.net/uploads/6/8/9/2/68925041/bgm_associates__-_dragons_and_tigers_hunting_in_germany.pdf.

[99]. Ibid, 10.

FDI acquisition is not the only path to U.S. technology capabilities. For example, China is investing in U.S. research universities to gain access to their research, often with U.S. state government-backing. For example, Maryland is committing nearly $600,000 over three years to build up the Maryland International Incubator, in a bid to attract high-tech companies from China and elsewhere to collaborate with University of Maryland researchers. Of the 18 companies in the incubator, nine are from China, with most of these being biotech companies.[100] In addition, Chinese firms have become investors in early stage U.S. technology companies. These include the venture capital arms of Chinese Internet companies such as Alibaba or Tencent. The idea here is to invest in start-ups and use that as a way to bring technology and knowledge back to China. Indeed, at least a few Silicon Valley experts report that they are seeing a significant uptick in Chinese venture investment in Silicon Valley. This trend could very well increase in coming years as China sees that its traditional acquisition route becomes more difficult. We see this pattern in other nations as well. 40 percent of venture capital in Israel in 2015 reportedly came from China.[101]

In summary, both the issue of Chinese foreign direct investment and trade overall needs to be approached from a “third way” perspective: neither blithely embracing a free market economics ethos that turns a blind eye to foreign mercantilist competition nor trying develop a “fortress America.” However, with regard to Chinese FDI in U.S. technology industries fueled by Chinese government money and Chinese government strategy, more needs to be done to protect U.S. technology leadership and jobs.

[100]. “Maryland International Incubator,” accessed January 10, 2017, http://www.mi2.umd.edu/#companies.

[101]. Hui Li and Jonathan Browning, “China Inc. Goes on a Buying Spree for Global Health Assets,” *Bloomberg*, July 5, 2016, https://www.bloomberg.com/news/articles/2016-07-05/china-inc-goes-on-a-buying-spree-for-global-health-care-assets.

OPENING STATEMENT OF MR. PATRICK WOODALL RESEARCH DIRECTOR AND SENIOR POLICY ADVOCATE, FOOD AND WATER WATCH

MR. WOODALL: Good morning, Co-chairs Cleveland and Wessel and members of the Commission. Thank you for holding this important hearing on the implications of Chinese investment into the United States, including farms and food processing and agribusiness. The government of China, its state-owned enterprises, and its quasi-independent Chinese companies, the OPSIES, have aggressively pursued agricultural assets worldwide including here in the United States.

This acquisition strategy is an extension of China's food security policy, which is designed to guarantee food self-sufficiency, but it can have significant and substantial effects on the U.S. food system.

Converting U.S. farms and food enterprises into export platforms for the Chinese market can raise domestic prices, disadvantage U.S. farmers, accelerate global agribusiness consolidation, all to the detriment of American farmers, rural--

HEARING CO-CHAIR WESSEL: Can you speak a little more into the microphone so everyone can hear you better? Thank you.

MR. WOODALL: I think it's on. I'm sorry.

HEARING CO-CHAIR WESSEL: Now it is.

MR. WOODALL: Sorry. All to the disadvantage of American farmers, rural communities, and consumers.

China's pursuit of global food and farm mergers can undermine food security and ultimately have destabilizing effects on national security implications.

The CFIUS review process is primarily designed to address specific national security concerns. It's not designed and it's not adequate to evaluate the impact of foreign takeovers of U.S. food and farm assets.

I want to talk just about a few things. First, that China has a uniquely comprehensive strategy to secure cross-border food and farm investments that includes policy directives, state-backed funding, and state-owned enterprises.

Its 2011 Five Year Plan specifically targeted cross-border investments in food companies and cross-border investments in chemical companies. Agricultural technology, including biotechnology, seeds, and agrichemicals, is considered a real prize to the Chinese government. The Chinese government directly and indirectly supports these purchases. Some are state-owned enterprises. ChemChina's $43 billion purchase of Syngenta last year was one of these cases.

Others are heavily financed by the Chinese government. So the majority of the $7 billion in the Smithfield takeover was backed by the Bank of China, as we heard earlier today, and the buyer was a former state-owned meat packer and it retains very cozy relationships with the Chinese government today even after it was privatized.

The indirect benefits include things like subsidized credit and access to low interest loans, subsidized agricultural production within China, and the benefits of Chinese currency manipulation. All of these investments are designed to create export platforms that can ship food and farm products to feed China's growing demand for food.

The second is that Chinese investments in food and farm assets here and worldwide have substantial and I think widespread downsides. Since 2000, China investments have totaled $7 billion in the food and agricultural space in the U.S.

according to the Rhodium Group that testified earlier today.

And as of 2012, Chinese investors owned 42,000 acres of farmland in the United States. Two of China's cross-border mergers were superlatives in the agriculture space. So the purchase of Smithfield was the biggest purchase of any U.S. company, and the Syngenta purchase is the biggest purchase of any company outside of China. It's four times bigger than the next big--it's bigger than the next four acquisitions.

So these are huge deals, and they're part of a global investment strategy, not just here, but includes farmland in the developing world. There are a million Chinese farmers cultivating crops in Africa destined for the Chinese market, and there are many stronger Chinese transnational firms, including the Cofco Corp, which is a huge commodity broker, and Bright Foods, which owns the noted British firm Weetabix.

In the U.S., these purchases can have substantial effects on the food chain. Shifting agricultural production to an export food platform can really raise food prices, especially when drought or disease affects supplies here in the U.S. This happened after Smithfield changed hands at the same time that we had an outbreak of a hog virus, and U.S. pork prices rose 13 percent.

It can also disadvantage U.S. farm exports. Now, 97 percent of the U.S. pork exports to China are from Smithfield, and that disadvantages all the other people exporting, and with the ChemChina-Syngenta merger, China is in a position to approve the imports of biotechnology crops, but they also have an incentive with the state-owned enterprise to favor the crops grown with Syngenta seed. So that has a real impact.

Food security I think most people think is a really key component of national security. This is really important, and in the 2008 food crisis, more than 30 countries faced real civil instability--food riots and problems related to food security.

Right now China owns nine million more acres of land in the developing world than when the 2008 food crisis hit. So the next time that there's a supply interruption that is likely to be exacerbated by China's current investment in these agricultural assets.

I want to just say lastly that the current review process is really inadequate to address the potential national security risks. I think lots of people believe that an army marches on its stomach. There is widespread understanding that this is a national security issue, but the CFIUS review of whether or not food is a critical infrastructure component really is at odds with what Homeland Security says.

This is not a situation where we're talking about something like retirement homes, as an earlier witness mentioned. Food is something that is integral to the military and it's integral to the civilians as well, obviously. They're allowed to review--they have a broad discretion to review food as a critical infrastructure, but to date they have not done it.

Both the Syngenta and the Smithfield mergers were unconditionally approved, and so we think that there needs to be a much better scrutiny of these kind of deals in the food system that have such widespread issue.

Senator Grassley has introduced legislation that would address this by specifically making food issues and agriculture issues part of a critical infrastructure. We support this. We think there are other areas where CFIUS could be strengthened on technology where there is clear direction that CFIUS should consider biotechnology as critical technology but has not done so in the Syngenta case.

So we think these could substantially improve the review process and is necessary for farmers and consumers here in the U.S. and for national security.

Thanks for the opportunity to testify, and I'd be happy to answer any questions.

PREPARED STATEMENT OF MR. PATRICK WOODALL RESEARCH DIRECTOR AND SENIOR POLICY ADVOCATE, FOOD AND WATER WATCH

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

Patrick Woodall

Research Director and Senior Policy Advocate

Food and Water Watch

Good morning Co-Chairs Cleveland and Wessel and members of the Commission. My name is Patrick Woodall and I am the Research Director and Senior Policy Advocate at Food & Water Watch, a national non-profit advocacy and consumer organization dedicated to ensuring the food, water and fish we consume is safe, accessible and sustainably produced. Our food program promotes a secure and resilient food system that can provide healthy food for consumers and an economically viable living for family farmers and rural communities.

Thank you for holding this hearing and inviting Food & Water Watch to testify on the implications of Chinese investment in U.S. farms, food processing and agribusiness. The government of China, its state-owned enterprises and independent Chinese companies have aggressively pursued agricultural and food assets worldwide, including here in the United States. This agricultural acquisition strategy is an extension of China's food security policy designed to ensure that it can guarantee food self-sufficiency.

The purchase of U.S. food, farm and agricultural assets can have substantial effects on the food system. Converting U.S. farms and food enterprises into export platforms for the Chinese market can raise domestic food prices, disadvantage U.S. farmers and accelerate global consolidation in the agriculture sector to the detriment of American farmers, rural communities, and consumers. China's pursuit of global food and farm mergers — in the United States and worldwide — undermines food security and ultimately can have destabilizing national security implications.

The Committee on Foreign Investment in the United States (CFIUS) reviews foreign direct investments in the United States, but its review process is primarily designed to address specific national security concerns and is inadequate to evaluate the impact of foreign takeovers of U.S. food and farm assets. Even though the CFIUS statute and regulation theoretically would consider various national security elements of cross-border food and farm mergers, the opaque nature of the CFIUS review process makes it impossible to know whether these legitimate issues have been seriously considered.

China's growing investment in U.S. farm, food and agricultural assets

Chinese firms and state-owned enterprises purchase assets and firms in the United States for the same reasons that make U.S. firms attractive takeover targets. America's open investment market attracts the largest pool of foreign direct investment.[1] Federal and state programs affirmatively encourage and solicit foreign investment.[2] The U.S. economy represents the largest consumer market and the biggest pool of venture capital and private equity.[3] The United States also boasts highly productive workers, an innovative economic environment and transparent and effective legal and regulatory systems.[4]

But China is also targeting investments in farm, food and agricultural assets in the United States to further its domestic food security and global food ownership ambitions. In 2011, the Chinese government included global food company acquisitions in its five-year plan to secure food resources to feed the country's growing demand for food.[5]

Chinese businesses also seek takeover targets in part to secure technology and intellectual property. Chinese state-owned enterprises are encouraged to pursue cross-border mergers in order to "acquire much-needed technologies," according to professors from Peking University and Stanford University.[6] China considers agricultural technology to be a strategic prize for these cross-border takeovers.[7] China's twelfth Five Year Plan focused on developing self-sufficiency in chemicals and developing national champions that can aggressively pursue access to foreign chemical technologies and processes.[8]

Since the United States granted China permanent normal trade relations (PNTR) and China entered the World Trade Organization in 2000, China's investment in the U.S. economy has grown rapidly. Total Chinese foreign investment into the United States soared more than 670-fold from $68 million in 2000 to $45.6 billion in 2016, according to the Rhodium Group.[9]

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[1] Organization for International Investment. "Foreign Direct Investment in the United States 2016 Report." 2016 at 1.
[2] Jackson, James K. Congressional Research Service. "Foreign Direct Investment in the United States: An Economic Analysis." CRS-7-5700. December 11, 2013 at i; Beal, Dave. "From Cirrus to Schwing America, firms in Minnesota are part of China's growing U.S. investment." *MinnPost*. July 2015; Sturgeon, Jeff. "Chinese deals fraught with peril." *Roanoke (VA) Times*. March 6, 2016.
[3] Organization for International Investment (2016) at 2.
[4] U.S. Department of Commerce. Office of the Chief Economist. "Foreign Direct Investment in the United States: Update to 2013 Report." June 20, 2016 at 1.
[5] "Who's behind the Chinese takeover of world's biggest pork producer?" *Frontline PBS*. September 12, 2014.
[6] Fan, Gang and Nicholas C. Hope. China-United States Exchange Foundation. *US-China 2022: Economic Relations in the Next 10 Years.* Chapter 16: The Role of State-Owned Enterprises in the Chinese Economy. 2013 at 14.
[7] Scissors, Derek. "After Syngenta, what's next for China Inc.?" *Barrons*. February 23, 2016.
[8] Hartmann, Bernhard and Ulrich Deutschmann. AT Kearney. "China's Chemical Industry: Flying Blind." 2012 at 1 and 13.
[9] Rhodium Group. China Investment Monitor. Available at http://rhg.com/interactive/china-investment-monitor. Accessed January 2017.

Food, farm and agricultural firms have been a common target of Chinese investors. Chinese firms have made 34 food and agricultural acquisitions in the United States totaling $7.4 billion since 2000.[10] And Chinese firms and investors owned over 42,000 acres of U.S. farmland worth $900 million in 2012, according to the latest U.S. Department of Agriculture figures.[11] But the two largest and highest profile takeovers were the 2013 purchase of U.S. pork powerhouse Smithfield Foods and the 2016 purchase of Syngenta, a Swiss-based seed and chemical company with substantial assets in the United States. Both of these purchases benefited from Chinese government support and both will continue to have a substantial impact on the U.S. food supply.
The WH Group (then known as Shuanghui) takeover of Smithfield was the largest purchase of a U.S. firm by a Chinese company at the time.[12] Shaunghui paid more than $7 billion for Smithfield including the firm's debt.[13] Smithfield was and remains the largest pork processor and hog producer in the United States with a significant impact on the food supply. In 2012, Smithfield had 25 U.S. plants with 46,000 workers that slaughtered 27.7 million hogs annually, controlling a quarter (26 percent) of the U.S. pork market.[14] Smithfield also dominated hog production, with 862,000 sows producing litters for hog production in the United States annually (28 percent of the domestic sows).[15] The United States approved the Shuanghui-Smithfield deal in September 2013.[16] In 2017, Smithfield completed its purchase of Hormel's Clougherty Packing, including three more hog producing sow operations, bringing Smithfield's market share to 28 percent.[17]

ChemChina's $43 billion purchase of Syngenta, announced in 2016, would create the world's largest manufacturer and distributor of agrichemicals and pesticides.[18] The deal would be the largest Chinese purchase of any foreign firm in history and is larger than the next four largest deals combined.[19] The takeover of the Swiss-based agrichemical and seed company includes manufacturing facilities in the United States, perhaps explaining the 22 percent premium ChemChina offered.[20] Syngenta is the largest seller of

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[10] *Ibid*.
[11] U.S. Department of Agriculture. Farm Service Agency. "Foreign Holdings of U.S. Agricultural Land." 2013 at 200.
[12] Erman, Michael and Greg Roumeliotis. "China Inc.'s Smithfield bid expected to pass Washington test." *Reuters*. May 31, 2013.
[13] Ho, Prudence, Cynthia Koons and Nopparat Chaichaleammongkol. "Morgan Stanley to provide $3bn in Smithfield bid." *Wall Street Journal*. May 31, 2013; Felerbaum, Michael. "China's Shuanghui in $4.7B deal for Smithfield." *Associated Press*. May 29, 2013.
[14] Gelles, David and Gregory Meyer. "Deal saves pig farmer from a break-up." *Financial Times*. May 30, 2013; Smithfield Foods. U.S. Securities and Exchange Commission (SEC) filing 10-K. July 31, 2012 at 13, 24 to 25.
[15] "Top 25 U.S. Pork Powerhouses 2012." *Successful Farming*. December 2012.
[16] Singh, Shruti Date and Bradley Olson. "Smithfield receives U.S. approval for biggest Chinese takeover." *Bloomberg*. September 6, 2013.
[17] Smithfield Foods. [Press release]. "Smithfield Foods completes acquisition of Clougherty Packing LLC." January 2, 2017; Food & Water Watch analysis of Pork Board data. "Estimated Daily U.S. Slaughter Capacity by Plant (head per day)." August 2016. Available at http://www.pork.org/wp-content/uploads/2016/08/estimated-daily-us-slaughter-capacity-by-plant.pdf. Accessed January 2017.
[18] Browning, Jonathan. "ChemChina said to add time for U.S. Syngenta deal review." *Bloomberg*. June 14, 2016.
[19] Held, Robert. "To buy a Swiss company, ChemChina must pass through Washington." *The Hill*. February 19, 2016; Scissors (2016).
[20] Wyant, Sara. "Syngenta says 'yes' to ChemChina bid, as farm, food groups raise concerns." *Agri-Pulse*. February 3, 2016.

agrichemicals in the United States.[21] It also is a major seller of U.S. field crop seeds, selling 10 percent of soybean and 6 percent of corn seeds.[22] More than one-fourth (25.9 percent) of Syngenta's $13.4 billion in global 2015 sales were generated in the United States.[23] In August 2016, U.S. regulators approved the ChemChina-Syngenta deal and Australia declined to block the merger in December 2016, but the antitrust review is still pending in the European Union.[24]

Chinese government support for Smithfield, Syngenta takeovers

These two agribusiness mega-mergers benefited from considerable support from the Chinese government. The Chinese government provides a host of benefits to its domestic enterprises, even privately held firms, that make them more competitive than international firms that operate without state subsidies. These firms receive below-market interest rate loans from state-owned banks and often the debt from these loans is forgiven or significantly written down. China's policy to ensure food self-sufficiency provides a subsidy for domestic food processing, meatpacking and agricultural production. And China's protection and manipulation of its currency provides a benefit to Chinese firms. These state-sponsored benefits helped both Shuanghui and ChemChina become big enough to pursue global takeover targets.

Shuanghui grew into the country's largest meatpacker largely through generous subsidies, government policies and investment.[25] It was founded as a state-run meatpacking enterprise.[26] The state-owned Bank of China provided $4 billion to purchase Smithfield and the loan will be collateralized by both Smithfield and Shuanghui's physical assets, namely the processing plants in United States and China.[27] The Bank of China approved the Smithfield takeover loan in one day and it fulfills the bank's mission to finance the global takeover efforts of Chinese businesses.[28]

Some of Shuanghui's management and many of the investors had cozy relationships with the Chinese government. The Chairman of Shuanghui, Wan Long, has strong ties to political leadership in Beijing and has been a member of the National People's Congress for decades.[29] A key financial backer of the deal, New Horizon, was co-founded by the

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[21] Roumeliotis, Greg. "Exclusive: USDA to join U.S. panel reviewing ChemChina's Syngenta deal —sources." *Reuters*. May 16, 2016.
[22] Bunge, Jacob and Brent Kendall. "Merger of Dow, DuPont likely to get close antitrust scrutiny." *Wall Street Journal*. December 9, 2015.
[23] Wooten, Casey. "Treasury asked to include crop regulators in Syngenta review." *Bureau of National Affairs*. March 24, 2016.
[24] Shields, Michael and Greg Roumeliotis. "U.S. clearance of ChemChina's Syngenta deal removes key hurdle." *Reuters*. August 22, 2016; Westbrook, Tom. "Australia regulator will not block ChemChina's Syngenta bid." *Reuters*. December 7, 2016; Aizhu, Chen and Michelle Price. "ChemChina, Syngenta submit minor concessions to EU watchdog: Sources." *Reuters*. January 10, 2017.
[25] Haley, George and Usha Haley. "Purchase poses strategic risks." *USA Today*. June 6, 2013.
[26] De la Merced, Michael and David Barboza. "China, in need of pork, to buy U.S. supplier." *New York Times*. May 29, 2013.
[27] Jing, Mao. "Shuanghui gets $7.9b loan for Smithfield acquisition." *China Daily*. June 20, 2013.
[28] *Frontline PBS* (September 12, 2014).
[29] Mattioli, Dana and David Kesmodel. "China makes biggest U.S. play." *Wall Street Journal*. May 31, 2013.

son of the former Chinese prime minister, and although he left the investment house to become chairman of the government-owned China Satellite Communications Corporation, New Horizon retained close financial ties with China's leading families.[30]

ChemChina is one of more than 100 companies directly controlled by China's State Council (akin to the Cabinet of the United States).[31] The Chinese central government maintains firm control over state-owned chemical companies.[32] ChemChina's president is a senior member of the Chinese Communist Party and there is a party office inside ChemChina's headquarters.[33]

ChemChina is especially leveraged — its debt is nearly ten times revenues — but as a state-owned enterprise it still has managed to secure financing for the Syngenta takeover.[34] ChemChina is financing the Syngenta deal with $50 billion in loans from foreign and Chinese lenders.[35] Much of the funding is expected to come from government-backed sovereign wealth funds or state-owned banks.[36] ChemChina already received a $5 billion investment for the deal from another state-owned industrial conglomerate, Citic Ltd.[37] The level of government financing — through sovereign wealth funds, direct capital infusions and loans from government-owned banks — suggests a concerted effort by the apparatus of the central government to secure these international takeovers and perhaps exercise control over these assets if the deals are approved.

The U.S. implications and potential risks of China's food, farm and agricultural takeovers

China's investments in the U.S. agricultural and food sector can provide needed capital for continued success or expansion, but it can also come with substantial risks. Foreign investment can create jobs — but new jobs are predominantly created by "greenfield" investments in new facilities and 90 percent of foreign investment dollars go towards takeovers like Smithfield and Syngenta, not new investments.[38] Not all Chinese investments generate promised jobs. For example, several Chinese investments in Virginia failed to generate promised jobs — the investors defaulted or deals fell apart as loans came due.[39] And although wages were generally higher than the U.S. average at jobs at companies owned by foreign investors, the wages at China owned employers were

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[30] Barboza, David. "Billions amassed in the shadows by the family of China's Premiere." *New York Times*. October 26, 2012; Barboza, David. "Chinese bid for U.S. pork had links to Wall Street." *New York Times*. June 2, 2013.
[31] "Tycoon behind Syngenta bid China's most aggressive dealmaker." *Associated Press*. March 26, 2016.
[32] Hartmann and Deutschmann (2012) at 9.
[33] Mitchell, Tom. "Monday interview: Ren Jianxin, ChemChina." *Financial Times*. April 19, 2015.
[34] Kynge, James. "State-owned Chinese groups' acquisitions in Europe raise concern." *Financial Times*. February 29, 2016.
[35] *Associated Press* (March 26, 2016).
[36] Scissors (2016).
[37] Bunge, Jacob. "ChemChina details changes to structure of planned Syngenta purchase." *Wall Street Journal*. June 17, 2016.
[38] Jackson (2013) at 7.
[39] Sturgeon (March 6, 2016).

a third lower than at average foreign owned firms ($51,000 and $81,000, respectively in 2014).[40]

Chinese food and farm investments are designed to export food to China, capture valuable international brands and create a more resilient global network of productive food and agricultural assets. The purchased assets could be converted to export platforms, diverting U.S. productive resources to feed China and leaving any externalities like agricultural pollution and economic inequality here in America. The purchases can share productive technologies — hog genetics, seed technologies or others — with China's domestic agricultural sector. The combined capture of valuable U.S. brands and innovation can allow China's agricultural sector to disadvantage U.S. agricultural exports.

Potentially damaging impact on U.S. food supply: Food prices, equity and food safety

Chinese investment can have widespread impact throughout the U.S. food supply. Senator Chuck Grassley (Iowa) noted that "We're seeing more and more foreign investment in our agriculture assets, and it's something that we need to very aware of. The transactions that are occurring today will shape the food industry for decades to come. We need to be thinking strategically about who will control our food supply tomorrow."[41] Senator Debbie Stabenow (Michigan) noted during the Smithfield takeover that the American people will not be comfortable if "half of our food processors are owned by China. And I think there are some very, very tough questions that need to be answered."[42]

Increased exports can increase U.S. consumer food prices: China's agricultural investments are specifically designed to increase food exports to China.[43] For example, the Smithfield takeover provides a steady supply of pork exports and the Chinese-owned firm faces fewer administrative import barriers than other U.S. exports to China.[44] Diverting more of Smithfield's supply to exports could tighten up U.S. pork supplies and increase U.S. retail pork prices.[45] American consumers are very price sensitive to food price increases during economic downturns.[46] Creating tight market conditions for pork in the U.S. market because of increasing exports can exacerbate price increases caused by other factors. For example, after the Smithfield takeover, the pork industry faced a widespread virus outbreak that drove up pork prices by 13 percent in 2014.[47]

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[40] U.S. Department of Commerce. Bureau of Economic Analysis. Selected Data of Majority-Owned U.S. Affiliates by Country of Ultimate Beneficial Owner, 2014; U.S. Department of Commerce (2016) at 2.
[41] Senator Chuck Grassley. [Press release]. "Grassley: Food security is national security." July 12, 2016.
[42] *Frontline PBS* (September 12, 2014).
[43] Mattioli and Kesmodel. May 31, 2013.
[44] Gelles and Meyer (May 30, 2013); Schneider, Howard and Brady Dennis. "Smithfield Foods to be brought by Chinese firm Shuanghui International." *Associated Press*. May 30, 2013.
[45] Fielding, Michael. "Little risk for Smithfield, little impact on U.S. hog industry, analysts say." *Meatingplace*. May 30, 2013.
[46] Felerbaum (May 29, 2013).
[47] Swanson, Abbie Fentress. "As pig virus spreads, the price of pork continues to rise." *NPR Morning Edition*. June 27, 2014.

While it is difficult to precisely estimate the impact that increased exports can have on consumer prices, diverting significant supplies of agricultural production to exports can significantly increase retail food prices in the United States. According to a University of Missouri 2013 economics paper, a one percent increase in the net export of pork would increase U.S. hog prices by about 3 percent.[48] In 2012, Smithfield exported 18 percent of its pork production; by 2015, Smithfield exported 25 percent of its pork.[49] The combination of export diversion — for pork or any farm or food product — and agricultural instability from disease, pests, drought or market volatility can rapidly drive up U.S. consumer food prices. Today, half of U.S. pork production is controlled by two foreign firms (Smithfield and JBS), making U.S. consumers more vulnerable to retail price spikes.

Cross-border mergers can undermine economic viability of U.S. farms: The agriculture and food sector is unusually concentrated, with just a few companies dominating the market in each link of the food chain. Fewer, larger buyers of farm products (like Smithfield) and sellers of farm inputs (like Syngenta) can compromise the economic viability of family farms that have to pay more for supplies and receive less for their crops or livestock. The impact of these mergers is more pronounced during downturns in the farm economy. Many agricultural prices are forecast to remain persistently low for the next decade, creating a substantially more precarious economic situation for family farmers.[50]

The two Chinese mega-mergers may represent only the beginning of a wave of Chinese investment in an already hyper-consolidated sector.[51] The proposed ChemChina-Syngenta deal would increase consolidation and market power in the seed and agrichemical industries. In the United States, the seed market is already intensely consolidated; the top four firms produced 83 percent of corn seed and 77 percent of soybean seed in 2014.[52] Moreover, the majority of seeds have “stacked” biotechnology traits from more than one company.[53] The proposed deal would enable ChemChina to exert anticompetitive pressure on the seed and agrichemical market and drive up prices that farmers pay for seeds and other inputs.

With ChemChina in control, Syngenta would likely act to further the business interests of not only its corporate parent but also China itself. Syngenta would have an incentive to focus its development on seed varieties engineered to work with patented ChemChina agrichemicals, vertically integrating the two firms’ products into a more expensive product for U.S. farmers. The proposed deal could hinder innovation because Syngenta

[48] Plain, Ron. University of Missouri-Columbia. “Economic Impact of U.S. Pork trade, 1986-2012.” Department of Agricultural & Applied Economics Working Paper No. AEWP 2013-2.
[49] Smithfield Foods. SEC 10-K. July 31, 2012 at 5; Smithfield Foods. SEC 10-K. January 3, 2016 at 4.
[50] Food and Agricultural Policy and Research Institute. University of Missouri. “U.S. Baseline Briefing Book.” Report #02-16. March 2016 at 2 and 45; Johansson, Robert. Chief Economist USDA. “Focus on the Farm Economy: Growing Farm Financial Pressure.” Statement before the Subcommittee on General Farm Commodities and Risk Management. Committee on Agriculture. U.S. House of Representatives. April 14, 2016 at 3.
[51] Erman and Roumeliotis (May 31, 2013).
[52] Gjerde, Sonya. “Seed competition heats up.” *Farm Journal*. July 2015.
[53] Letter from American Antitrust Institute, Food & Water Watch and National Farmers Union to U.S. Department of Justice. Re: The Proposed Dow-DuPont Merger. May 31, 2016 at 11.

would be more likely to foreclose new developments from the U.S. market. For example, it could refuse to cross-license Syngenta seed patents for stacked seed traits offered by other seed companies. This would enable ChemChina to leverage its market power over the entire U.S. crop sector, limit the choices of U.S. farmers, raise prices and reduce innovation.

The Smithfield takeover contributed to the growing consolidation in the pork packing industry that has been exacerbated by the recent approval of Smithfield's takeover of Clougherty. The rising concentration in the pork packing industry increases buyer power significantly and gives firms more leverage over farmer suppliers. This power dynamic allows processors to exercise considerable control over farmers, lower the prices they pay for hogs and more easily collude with other packers.[54]

Agribusiness consolidation contributes to the decline in independent, medium-sized and smaller livestock producers that can sap the economic vitality of rural communities.[55] The earnings from locally-owned and locally-controlled farms generate an economic "multiplier effect" when farmers buy their supplies locally and the money stays within the community.[56] The economic multiplier effect is much lower with large corporate-affiliated livestock operations than with smaller independent farms.[57] Foreign ownership exacerbates many of these problems. The earnings and profits from meatpacker-owned hog production facilities are shipped to corporate headquarters instead of invested locally, and with foreign firms these earnings are not shipped to Virginia but to China.

Chinese technology and brand investments can distort global trade and disadvantage U.S. exports: The use of U.S. farmland and processing plants as an export platform, as well as the capture of valuable U.S. brands and technology can distort trade and disadvantage U.S. agricultural exports. Chinese businesses seek to partner or purchase Western firms in part to secure their technology and intellectual property. Both Smithfield and Syngenta were ripe technology targets for Chinese investors.

The Smithfield takeover not only included packing plants and farms but also the technology and hog genetics that have helped build the company. Smithfield has developed high-value hog genetic strains that it contends are "the leanest hogs commercially available."[58] Providing foreign competitors access to these intellectual property and technology assets could disadvantage the domestic hog industry on the global market.[59]

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[54] Paarlberg, Philip et al. Department of Agricultural Economics, Purdue University. "Structural Change and Market Performance in Agriculture: Critical Issues and Concerns About Concentration in the Pork Industry." Staff Paper 99-14. October 1999 at 6 to 8.
[55] Democratic Staff Report, U.S. Senate Committee on Agriculture, Nutrition and Forestry. "Economic concentration and structural change in the food and agriculture sector: Trends, consequences and policy options." October 29, 2004 at 2.
[56] Pew Commission on Industrial Farm Animal Production. "Putting meat on the table: industrial farm animal production in America." April 2008 at 41.
[57] *Ibid*. at 41.
[58] Smithfield Foods. SEC 10-K. July 31, 2012 at 6.
[59] "This little piggy in the US market." *China Economic Review*. June 5, 2013.

The WH Group was expected to rapidly adopt Smithfield's hog genetic lines that could weaken the U.S. pork export opportunities.[60] The WH Group has an extensive supply chain and distribution system in China and throughout Asia with operations in Japan, Singapore, the Philippines and South Korea and ships considerable amounts of pork to Japan and South Korea.[61] The merger would improve the position of the WH Group's Mainland China processing plants by sharing U.S. technology and expertise and potentially allow it to undercut U.S. pork exports to other Pacific Rim countries.[62] The merger has already disadvantaged other U.S. pork exporters to China. In 2015, Smithfield's exports to China rose 50 percent and controlled nearly *all* U.S. pork exports to China (97 percent).[63]

ChemChina's proposed Syngenta takeover would include its portfolio of high-tech agrichemicals, including pesticides, crop protection products, seeds and advanced fertilizers.[64] It also would create a unique conflict between a state-owned enterprise and government regulator with the Chinese government effectively both approving and manufacturing seeds and agrichemicals.[65] This would give ChemChina-Syngenta a significant commercial edge over its rivals in accessing the Chinese market. China's seed market is the second largest in the world but the largest international seed companies only capture 20 percent of the Chinese market.[66]

While China is in the process of modifying laws and regulations governing biotechnology, many biotech food crops have not yet been approved for cultivation. At times, China's regulatory approval process has hindered U.S. grain and oilseed exports.[67] Crops approved for cultivation in the United States but not allowed for import into China wreak havoc on export markets. ChemChina-Syngenta could manipulate the Chinese government import approvals to disadvantage crops grown with rivals' seeds. ChemChina is a state-owned enterprise of China and, as such, does not act in economically rational ways. Should Syngenta get preferential treatment after its acquisition by ChemChina, this could dramatically impact the competitiveness of the agriculture biotechnology sector.

Syngenta suggested that the company did not anticipate favored regulatory treatment from the Chinese government and even projected that the deal would pave the way for the approval of other U.S. crops and biotechnologies.[68] But it admitted that the deal would give Syngenta "a lot of opportunities to totally transform the landscape for

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[60] Herzstein, Robert. "The dangers behind the Smithfield deal." *Washington Post*. June 1, 2013.
[61] Fielding, Michael. "With merger, Smithfield gains massive Chinese distribution network." *Meatingplace*. May 29, 2013; "Shuanghui apologizes over additive scandal." *Xinhua*. March 16, 2011.
[62] "Stabenow worried by Smithfield acquisition, but CFIUS clearance likely." *Inside US-China Trade*. June 12, 2013.
[63] Clayton, Chris. "China's next steps 1: China's global ag conquest." *DTN Progressive Farmer*. April 12, 2016.
[64] *Associated Press* (March 26, 2016).
[65] Wooten (March 24, 2016).
[66] Bunge, Jacob. "ChemChina deal offers new formula for seed sector." *Wall Street Journal*. February 4, 2016.
[67] Bunge, Jacob. "Syngenta says ChemChina deal poses no food safety or major security issues." *Dow Jones*. March 24, 2016.
[68] *Ibid*.

agriculture in China."[69] The proposed deal could give exports grown from Syngenta seeds preferential access to the China market and reinforce a barrier to crop exports grown from other companies' seeds.

Potential food safety risk of exports from China of U.S. brands: China's food supply has suffered from the persistent trend of "economically motivated adulteration" and a culture of adulteration in China's food and agricultural sector.[70] In the first nine months of 2016, China discovered half a million food safety violations that reflected "deep seated" problems in the food system, according to the head of the China Food and Drug Administration.[71] Cross-border takeovers from this lax and dangerous food safety environment could weaken commitments to food safety in domestic facilities — but it also could mean that Chinese-owned multinational firms could export well-known brands to the United States from considerably more suspect processing plants in China.[72]

The Smithfield takeover presents a case study in how these deals could expose U.S. consumers to risky imported foods. American food processing companies operate in an environment the *Wall Street Journal* has characterized as having "strong brands creating the right incentives all along supply chains, transparent regulations that are well enforced, and rule of law compensating victims of lapses."[73] In contrast, the WH Group (then Shuanghui) evolved in China's Wild West business environment that allowed many food manufacturers and processors to cut corners, sell tainted food products and rely on adulteration to maximize their competitive advantage. Chinese officials have readily acknowledged the country's food system as "grim."[74]

Shaunghui became the dominant meatpacker in this landscape of tainted food. In 2012, one of its subsidiaries sourced hogs treated with the illegal veterinary drug clenbuterol, which is used to produce leaner meat but is hazardous for humans to eat.[75] More than 38,000 hogs raised with the illegal drug were purchased and slaughtered without testing.[76] The company fired four executives at the processing plant and ordered the factory to recall its pork products.[77] Five Shuanghui employees received prison sentences for their role in the tainted pork scandal.[78] This catastrophic lapse in governance is hardly something that should be exported to the U.S. business culture, but nor should Smithfield-branded pork be exported to the United States from China.

Ultimately, the WH Group could export Smithfield pork back to the United States.[79] A significant portion of U.S. pork exports are half-hog carcasses which are processed into

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[69] Bunge (February 4, 2016).
[70] Barboza, David and Alexei Barrionuevo. "Filler in animal feed is open secret in China." *New York Times*. April 30, 2007.
[71] Stanway, David. "China uncovers 500,000 food safety violations in nine months." *Reuters*. December 24, 2016.
[72] Erman and Roumeliotis (May 31, 2013).
[73] Sternberg, Joseph. "Rethinking that Chinese pork takeover." *Wall Street Journal*. June 20, 2013.
[74] "Food safety situation still grim in China." *Associated Press*. March 3, 2009.
[75] Pinghui, Zhuang. "TV report on clenbuterol in pigs sees 22 people held." *South China Morning Post*. July 19, 2012.
[76] Pinghui, Zuang. "5 jailed in tainted pork scandal." *South China Morning Post*. August 14, 2012.
[77] Pinghui (July 19, 2012).
[78] "China cracks down on clenbuterol; arrests 2,000 for other offenses." *Food Chemical News*. August 4, 2011.
[79] De la Merced and Barboza (May 29, 2013).

value-added pork cuts, including by firms like the WH Group.[80] The adoption of Smithfield hog genetics and processing technologies could allow the company to reverse the global flow of pork products and begin the export of Chinese pork to the United States.[81] Currently, China is not eligible to export pork products to the United States, but in 2013, after years of pressure, USDA approved China to ship chicken from certain approved countries (like the United States and a few others) to be processed in China and then re-exported to the United States.[82] The USDA is now considering allowing the import of chickens sourced and slaughtered in China.[83] It seems likely that eventually China will apply to export pork to the United States, and since the WH Group could export Smithfield-branded processed pork products, it would be difficult to know whether the product was from U.S. or Chinese processing plants — an especially difficult problem with the repeal of U.S. country-of-origin meat labeling after a WTO dispute.

Erosion of state sovereignty to facilitate Chinese takeovers: Many states prohibit the foreign and/or corporate ownership of farmland, including some states where Smithfield subsidiaries operate hog farms, including Missouri.[84] The Missouri legislature promptly passed two bills that would have allowed foreign companies to own approximately 300,000 acres of farmland, essentially a waiver for the Smithfield's Murphy-Brown of Missouri, LLC (formerly Premium Standard Farms) hog production facilities in that state.[85] The Missouri governor vetoed both bills but the legislature overrode the veto, allowing foreign ownership of one percent of Missouri's farmland.[86] In 2015, Missouri enacted a bill eased by nearly $400,000 in Smithfield campaign contributions that allowed foreign firms and individuals to buy farmland through a U.S. subsidiary without notifying the state agriculture department, eviscerating the one percent limitation.[87]

In 2016, Nebraska overturned a long-standing ban on meatpacker ownership of livestock, a key element of Smithfield's hog production operations.[88] The legislation was largely pushed by Smithfield.[89] Smithfield made over 20 campaign donations to legislators, the governor and attorney general of Nebraska.[90] Nebraska was the last state to ban packer ownership, which ensured that farmers could market or contract farmer-owned hogs to

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[80] Keefe, Lisa M. "Long-developing Smithfield deal to boost U.S. pork industry: Pope." May 29, 2013.
[81] Herzstein (June 1, 2013).
[82] Healy, Amber. "China moving closer to poultry equivalency." *Food Chemical News*. October 14, 2011; Wingfield, Brian and Shruit Date Singh. "Chicken processed in China triggers U.S. food safety protests." *Bloomberg News*. September 26, 2013.
[83] USDA. Food Safety and Inspection Service. Proposed Rule. "Eligibility of the People's Republic of China (PRC) for the importation into the United States of poultry products from birds slaughtered in China." RIN 0583-AD64. Fall 2016.
[84] Huffstutter, P.J. et al. "Exclusive: Smithfield deal may face state hurdles as Midwest laws eyed." *Reuters*. June 9, 2013.
[85] Baertlein, Lisa and P.J Huffstutter. "Missouri legislation may help Chinese Smithfield buy." *Reuters*. June 10, 2013.
[86] Baertlein, Lisa and P.J Huffstutter. "Missouri vetoes raise questions for Smithfield-China deal." *Reuters*. July 2, 2013; McDermott, Kevin. "Is Missouri's agricultural law being re-written in Hong Kong?" *St. Louis Post-Dispatch*. May 24, 2015.
[87] McDermott (2015).
[88] Gee, Kelsey. "Nebraska ends ban on meatpacking companies owning hogs." *Wall Street Journal*. February 13, 2016.
[89] Douglas, Leah. "Nebraska's livestock market faces death by big meat lobbying." *Fortune*. February 5, 2016.
[90] Schulte, Grant. "Lawmakers pass bill to end packer ban on meatpacker-owned hogs." *Associated Press State & Local*. February 5, 2016.

packers rather than raising Smithfield-owned hogs for a service fee. Nebraska Farmers Union president John Hansen noted, "the Legislature voted to help Chinese government-owned Smithfield Foods, Inc. take over hog production in Nebraska by allowing them to directly own the hogs. That vertically integrated packer-controlled system of one-sided take-it or leave-it contracts with no cash markets or competition is similar to the poultry system that has victimized broiler producers across the nation."[91]

The farmer protection legislation had persisted for years in Missouri and Nebraska even in the face of the pre-takeover Smithfield's opposition. Other state laws on corporate land ownership and county biotech crop cultivation bans could be vulnerable to this kind of foreign lobbying against local laws. The China-owned Smithfield seemed to exert greater pressure to overturn state laws than the big companies did before their takeover.

The food security and national security implications China's global food ambitions

Food security is a critical component of national security. The U.S. is fortunate in its current capacity to feed our nation and many others across the world. President Obama recognized that global food security is an important component of U.S. national security.[92] Senator Johnny Isakson (Oklahoma) noted that global food insecurity can impact U.S. national security because the "lack of access to affordable, nutritious food impacts not only developing nations' economies and productivity, but the international economy and U.S. national security."[93]

Major General Darren Owes (U.S. Army, Ret.) recently testified to Congress that "Without American agriculture providing adequate supplies of food and fiber at a reasonable cost we would all be dependent on other nations and that could place the food security and ultimately the security of the nation at risk."[94] These security implications are global. Maj. Gen. Owens further stated "A nation without food security has only one problem. That one problem has proven that it will escalate into many other problems destabilizing every aspect of an entire nation, and that impact can be felt on a global scale."[95]

The 2008 food crisis exacerbated food insecurity that undermined the tenuous civil stability in at least 33 countries.[96] Protests over the rapid escalation in food prices erupted across Africa, Latin America, the Caribbean, Asia and Eastern Europe.[97] In Africa, protests over food prices began in Senegal and Mauritania in late 2007 and spread to at

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[91] Shaffer, Erica. "Nebraska approves packer-owned hogs." *Meat+Poultry*. February 8, 2016.
[92] President of the United States. National Security Strategy. May 2010 at 5, 33-34, 39, and 46-47.
[93] Sen. Isakson, Johnny. [Press release]. "Isakson, Casey introduce legislation to combat global hunger, bolster U.S. national security." May 7, 2015.
[94] Major General Owens, Darren G. (USA, Ret.). The Interrelationship of a Comprehensive Farm Policy to national Food Security and National Security. Statement before the Committee on Agriculture. U.S. House of Representatives. July 7, 2016 at 1.
[95] *Ibid.* at 12.
[96] "As food prices soar, U.N. calls for international help." *NewsHour with Jim Lehrer*, April 23, 2008
[97] "Factbox: Food price rises spark protests, hoarding," *Reuters*, May 2, 2008.

least seven more countries. Demonstrators were killed in Senegal, Cameroon and Mozambique in 2008.[98] The Arab Spring uprising that ultimately contributed to the instability in Syria and beyond was both ignited and exacerbated by food insecurity and rising food prices throughout the region.[99]

Food security is a piece of our critical national security infrastructure. The Department of Homeland Security's 2003 National Strategy for Critical Infrastructures and Key Assets identified food and agriculture as a component of the critical infrastructure of the security of the United States. It specifically included crop production and seed, fertilizer and agrichemical supply chains in this critical infrastructure, stating, "the fundamental need for food, as well as great public sensitivity to food safety makes assuring the security of food production and processing a high priority."[100]

China's global food takeover strategy

Chinese agricultural investment in the United States is part of a strategy to lock up productive farmland, water and food processing assets worldwide to give China the global strength to be the driving force in food production. Experts expect China to pursue cattle, sheep and commodity crop assets in the future as agriculture replaces oil as the country's top takeover target.[101] In 2016, China announced that it aimed for its agricultural futures markets to be the "global pricing center for commodities."[102] The vice chairman of Cargill predicted that "China will be more integrated into the global commodities system on the agricultural side than they have ever been."[103]

The Chinese government and Chinese companies are aggressively purchasing farmland in the developing world to secure access to productive agricultural land and water resources.[104] Chinese sovereign wealth funds, Chinese government entities and Chinese companies have pursued or finalized more than 100 land deals in the developing world covering an estimated 5.2 million to 8.9 million acres between 2006 and 2014.[105] In Africa, there are at least one million Chinese farmers cultivating African land for export to the home country.[106] China's Cofco Corp. controls 90 percent of imported wheat and

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[98] Walt, Vivienne, "The world's growing food-price crisis." *Time*. February 27, 2008; *Reuters* (May 2, 2008).
[99] Cambanis, Thanassis. "The Arab Spring was a revolution of the hungry." *Boston Globe*. August 22, 2015; Perez, Ines. "Climate change and rising food prices heightened Arab Spring." *ClimateWire*. March 4, 2013.
[100] Department of Homeland Security. National Strategy for the Physical Protection of Critical Infrastructure and Key Assets. February 2003 at 36.
[101] Haas, Benjamin and Yuriy Humber. "Food replacing oil as China M&A commodity of choice." *Bloomberg*. May 30, 2014.
[102] Thoma, Tom. "China sets sights on setting global grain prices." *Mason City (IA) Globe Gazette*. June 4, 2016.
[103] Haas and Humber (May 30, 2014).
[104] Cotula, Lorenzo et al. "Land Grab or Development Opportuinity?" UN Food and Agriculture Organization/International Fund for Agricultural Development/International Institute for Environment and Development." 2009; Kugelman, Michael and Susan L. Levenstein (eds.). "Land Grab? The Race for the World's Farmland." Woodrow Wilson International Center for Scholars. 2009.
[105] GRAIN. [Press release]. "GRAIN releases data set with over 400 land grabs." February 23, 2012; Land Matrix. Online Public Database on Land Deals. Available at http://www.landmatrix.org/en/get-the-detail/by-investor-country/china/?order_by=.
[106] Navarro, Peter and Greg Autry. *Death by China: Confronting the Dragon — A Global Call to Action*. Saddle River (NJ): Prentice Hall. 2011 at Chapter 7.

purchased two international commodity firms (Nidera Holdings from the Netherlands and Noble Holdings Ltd. from Singapore) that included Argentine grain elevators, Brazilian sugar mills, and Ukrainian and South African soybean crushing plants.[107]

Oceana has been a prime target for China's agricultural ambitions. China investors bought approximately $400 million in Australian farmland between 2012 and 2015.[108] In April 2016, Australia rejected an effort by China-based Dakang to purchase a cattle operation that covered one percent of the nation's land; by October another Chinese firm offered to purchase a 50 percent stake in the same cattle ranch, which is still pending approval.[109] In 2016, a Chinese state-owned dairy company was the majority investor in a new $140 million milk processing plant in New Zealand to supply China with milk powder for infant formula.[110]

China has also aggressively pursued food processing. In 2013, Chinese investors bought $12.3 billion in global food, beverage and agricultural assets (including the Smithfield purchase) — the highest single year total purchase in a decade.[111] The state-owned enterprise Bright Food Group already owns the formerly British food manufacturer Weetabix and since 2014 has purchased a 50 percent stake in New Zealand's largest meatpacker and a controlling stake in Israel's largest dairy.[112] In late 2016, Bright Food announced it would sell Weetabix as global demand for breakfast cereal continued to slump, but Bright continued to pursue acquisition targets in the United States, Europe, Australia and New Zealand.[113]

The Smithfield and Syngenta mega-mergers with U.S. assets have broader, global food implications. The Smithfield takeover included agricultural and food processing assets outside the United States — Smithfield owns 7 hog processing plants and 227,000 hog producing sows in Mexico, Romania and Poland.[114] Syngenta operates in 90 countries across the world and ChemChina is the world's largest generic herbicide and insecticide producer with products and patents in 120 countries, suggesting the reach of its fertilizers and other agrichemical businesses.[115] Not only is Syngenta a global agrichemical firm,

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[107] Thakral, Naveen and Michael Flaherty. "China's Cofco to pay $1.5 billion for stake in Noble's agribusiness." *Reuters*. April 2, 2014; Haas and Humber (May 30, 2014).
[108] Cranston, Matthew, Angus Grigg and Lisa Murray. "Chinese investors heat up Australian farm buying spree." *Australian Financial Review*. September 27, 2015.
[109] Rapoza, Kenneth. "China stopped from buying 1% of Australia." *Forbes*. April 22, 2016; Ough, Tom. "Will Chinese have to ride into the sunset?" *Daily Telegraph (UK)*. October 31, 2016.
[110] Gray, Jamie. "Plans for new $200m dairy plant unveiled." *New Zealand Herald*. July 18, 2016; Federal Reserve Board. Foreign Exchange Rates. G.5A Annual. January 4, 2017.
[111] Haas and Humber (May 30, 2014).
[112] "Bright Food said to prepare IPO of $1 billion distribution arm." *Bloomberg News*. October 29, 2015; "China's Bright Food Group to buy 50% stake in New Zealand meat processor." *Reuters*. September 15, 2015; Astley, Mark. "Bright Food to acquire controlling stake in Israeli dairy Tnuva." *Dairy Reporter*. May 26, 2014.
[113] Daneshkhu, Scheherazade. "Weetabix set for sale by China's Bright Food." *Financial Times*. December 22, 2016; Ren, Daniel. "Bright Food stays on global acquisition push." *South China Morning Post*. October 26, 2016.
[114] Smithfield Foods. SEC 10-K filing. July 31, 2012 at 13, 24 to 25; "Top 25 U.S. Pork Powerhouses 2012." *Successful Farming*. December 2012.
[115] Syngenta Annual Review 2015 at iii; ChemChina. Products & Services. Agrochemicals. Available at http://www.chemchina.com.cn/en/cpyfw/ywbk/nyhx/A60180104web_1.htm. Accessed July 2016.

ChemChina had already purchased a French food ingredients company (Adisseo) and an Israeli pesticides manufacturer.[116]

By investing in agribusinesses, farmland and food processing, China and Chinese investors are increasing the nation's role on the global food landscape and providing a stronger and potentially more destabilizing impact on global food security. Stanford professor Peter Navarro wrote that "China's resource acquisition lockdown strategy is nothing more than a thinly disguised *de facto* embargo on natural resource access imposed on the rest of the world."[117] By controlling farm and food resources China is exacerbating the food insecurity in the investment areas. This can considerably contribute to civil instability during time of agricultural crises like drought, pestilence, disease or other production downturns that are becoming more frequent with climate change.

Current review of Chinese investments inadequate to assess national and economic security implications

Chinese acquisitions of U.S. farm and food assets are reviewed by the Committee on Foreign Investment in the United States (CFIUS). The statutes and regulations that govern the CFIUS review are appropriately targeted at assessing the national security implications of any foreign investment, but the apparent narrowness of this focus will miss legitimate national and economic security concerns, including the impact on U.S. food security and global food insecurity and civil instability.

CFIUS's mandate provides an open-ended and broad consideration of national security screening for proposed foreign direct investments.[118] CFIUS applies this consideration to "genuine national security concerns alone."[119] CFIUS is directed to "determine the effects of the transaction on the national security of the United States."[120] CFIUS must consider the "nature of the U.S. business" and whether a proposed deal "creates susceptibility to impairment of national security" and the "potential consequences" of that vulnerability.[121] The CFIUS national security review considers whether the foreign purchaser "might take action that threatens to impair U.S. national security" and has the capacity or intent to cause harm.[122] This is especially true for state-owned enterprises from foreign governments with a record of "other national security-related matters."[123]

The CFIUS review process completely lacks transparency and all parties are guaranteed total confidentiality.[124] The opaque nature of the CFIUS review makes it impossible to

[116] *Associated Press* (March 26, 2016); Wyant (February 3, 2016).
[117] Navarro and Autry (2011) at Chapter 7.
[118] Moran (2015) at 3.
[119] Department of the Treasury. Office of Investment Security. Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons. 31 CFR Part 800. 73 Fed. Reg. 226. November 21, 2008 at 70705.
[120] 50 USC App. §2170(b)(1)(A).
[121] 73 Fed. Reg. 236 at 74569.
[122] *Ibid*.
[123] *Ibid*. at 74571.
[124] Browning (June 14, 2016); Solomon, Steven Davidoff. "Chinese deals feel the chill from Washington." *New York Times*. February 23, 2016.

know what factors are considered, how various concerns are weighted and how the determination to approve or reject an investment is made. CFIUS does not comment on ongoing reviews, or even confirm whether a cross-border investment deal is being reviewed.[125]

The investments CFIUS has blocked or allowed with mitigation (either divestiture or behavioral remedies) suggest that there are two primary concerns that the Committee takes most seriously: an investment's proximity to U.S. military or classified assets that could pose a security risk and investments that touch upon certain technologies that could be transferred to the acquiring country. CFIUS mitigation agreements typically regulate the buyer's access to potentially sensitive information.[126] All of the 2014 mitigation measures were related to takeovers of software, technology and services industries.[127] The unconditional approval of the Syngenta takeover suggests that CFIUS did not consider the agricultural technology sufficient to warrant divestitures or other mitigations.

CFIUS appropriately gives close scrutiny to the proximity of the targeted investment to U.S. military facilities.[128] CFIUS reports "that foreign governments are extremely likely to continue to use a range of collection methods to obtain critical U.S. technologies."[129] This remains among CFIUS' primary concerns.[130]

CFIUS has denied or modified cross-border mergers that targeted firms with facilities close to military installations. In 2012, CFIUS blocked the sale of a U.S. windfarm to a Chinese company because it abutted the airspace of a Naval Weapons Systems Training Facility.[131] In 2013, a Chinese firm dropped its proposed purchase of a 60 percent stake in a U.S. mining company because during the pre-filing negotiations, CFIUS purportedly required the divestiture of certain assets near U.S. military facilities.[132] In 2013, CFIUS forced the Chinese state-owned oil company to divest oil platforms and oil leases in the Gulf of Mexico owned by takeover target Nexen because of proximity to the U.S. Naval Air Station in Belle Chase, Louisiana.[133] It is worth noting that most military facilities are in rural areas and so are most agricultural assets.

CFIUS technology transfer assessment does not appear to recognize import of agricultural technology

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[125] Browning (June 14, 2016).
[126] Skadden, Arps, Slate, Meagher & Flom LLP & Affliates (Skadden). "National security reviews of foreign investments in US businesses show no signs of slowdown in 2014." *Insights*. 2014.
[127] Committee on Foreign Investment in the United States (CFIUS). "Annual Report to Congress." Calendar Year 2014. February 2016 at 23.
[128] Held (2016).
[129] CFIUS (2016) at 32.
[130] Skadden (2014).
[131] Moran, Theodore H. Peterson Institute for International Economics. "Chinese Investment and CFIUS: Time for an Updated (and Revised) Perspective." No. PB15-17. September 2015 at 6.
[132] Skadden (2014).
[133] Penty, Rebecca and Sara Forden. "CNOOC said to cede control of Nexen's U.S. Gulf assets." *Bloomberg*. March 1, 2013.

Although the CFIUS statute addresses cross-border mergers that involve critical technologies, the review appears focused on technologies with obvious military, telecommunications or computational applications. But cross-border deals that transfer agricultural technologies should also receive close scrutiny. Deals like the proposed ChemChina-Syngenta deal could make other U.S. firms and farms more susceptible to commercial espionage. U.S. authorities have identified a pattern of Chinese nationals attempting to steal patented seed technology. In 2016, a Chinese businessman plead guilty to stealing patented corn seeds.[134] In 2013, two Chinese scientists were indicted for stealing patented rice seeds.[135] The FBI and Justice Department have stated that cases of espionage in the agriculture sector have been growing and U.S. companies, government research facilities and universities have all been targeted.[136] The patented corn trade secrets case implicated a Chinese state-owned enterprise.[137]

CFIUS should scrutinize transactions that effectively transfer advanced, confidential or sensitive information to foreign companies or foreign state-owned enterprises.[138] The ChemChina takeover of Syngenta would include its portfolio of high-tech agrichemicals, including pesticides, crop protection products, seeds and advanced fertilizers.[139] Syngenta is "a leading player in seed treatment and genetically modified traits," has the "highest rate of trait innovation in the industry" and its research is "unique in combining chemistry, genetics, breeding and computational science to develop new products and solutions."[140]

Theoretically, the statute and regulations direct CFIUS to consider the national security implications of technology transfers which include "select agents and toxins" among critical technologies acquired by foreigners to receive special scrutiny.[141] The CFIUS regulations refer to federal statutory provisions that include biotechnology products and other research among these agents and toxins, explicitly listing genetic elements, recombinant and/or synthetic nucleic acids, and recombinant and/or synthetic organisms in the cross-referenced statutes.[142] CFIUS should more closely assess the impact of cross-border mergers that transfer agricultural technologies.

CFIUS should consider takeover effects on the food supply as "critical infrastructure"

Foreign investments in food, farm and agricultural assets could disrupt the critical infrastructure and systems of the U.S. food supply, agricultural land and rural economies. The CFIUS statute identifies transactions that would create national security risks from the foreign control of critical infrastructure. The Foreign Investment and National Security Act of 2007 (FINSA) regulations define critical infrastructure as any "system or

[134] Rodgers, Grant. "Chinese businessman gets deal in seed theft case." *Des Moines Register*. January 27, 2016.
[135] Rodgers, Grant. "FBI treats trade secrets as a national security issue." *Des Moines Register*. March 29, 2015.
[136] Edwards, Julia. "In Iowa corn fields, Chinese national's seed vulnerability." *Reuters*. April 11, 2016.
[137] Rodgers (January 27, 2016).
[138] Skadden (2014).
[139] *Associated Pres*s (March 26, 2016).
[140] Syngenta Annual Review 2015 at 8 to 10.
[141] Referencing 7 CFR §331 and 9 CFR §121; CFIUS (2016) at 37 and 38.
[142] 7 CFR §331.3(c); 9 CFR §121.3(c); 42 CFR §73.3(c).

asset" that is "so vital to the United States that the incapacity or destruction of the particular asset" by the foreign purchasing company "would have a debilitating impact on national security."[143] Moreover, the statute gives CFIUS wide latitude to consider cross-border purchases that deliver "the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States."[144]

There are security concerns in FINSA that potentially include the impact of takeovers of food and agricultural assets. The law requires CFIUS to take into account the potential impact on domestic production to meet domestic military requirements.[145] The Smithfield and Syngenta deal represent significant portions of the food supply — one fourth of the pork and about 10 percent of soybean and corn production. These products end up in military mess halls and PX retailers. And both the Smithfield and Syngenta takeovers included facilities within ten miles of significant military facilities, but CFIUS approved both deals.

Currently, CFIUS does not appear to consider agriculture or the food system a critical infrastructure asset. CFIUS unconditionally approved the Smithfield and Syngenta takeovers despite the central role these two firms play in agricultural production, the food supply and the rural economy in the United States. Food & Water Watch believes that the integrity of the food supply and food security should properly be considered part of both a critical infrastructure system and a domestic industry that could affect the capability of the United States.

Australia's review of cross-border investments allows a broader review of potential mergers on economic security and well-being. In 2013, Australia blocked the proposed Archer Daniels Midland (ADM) $2 billion takeover of Australia's GrainCorp because it would disrupt the domestic grain supply.[146] GrainCorp controlled three-quarters of Western Australia's grain marketing and the purchase would have impeded farmers access to markets, storage and distribution.[147] One farm organization stated that GrainCorp essentially had a monopoly on infrastructure, and foreign ownership would have "distorting impacts" on the industry.[148] When Australia's investment committee (akin to CFIUS but with a mandate broader than national security alone) deadlocked on the ADM takeover bid, Australia's Treasurer determined that the purchase was not in the public interest and stopped the deal.[149]

The CFIUS statute and regulations should be amended to include a more encompassing assessment of national security, critical infrastructure and effects on the capacity and

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143 §800.208. 73 Fed. Reg. 226. November 21, 2008; 50 USC App. §2170(a)(6).
144 50 USC App. §2170(f)(3).
145 50 USC App.2170(f)(1-2).
146 Scott, Jason and Behrmann, Elisabeth. "ADM's $2 billion GrainCorp bid blocked by Australia." *Bloomberg*. November 29, 2013; Gough, Neil and Matt Siegel. "Australia Blocks A.D.M.'s $2.7 Billion Bid for GrainCorp." *New York Times*. November 28, 2013.
147 Gough and Siegel (2013).
148 McRobert, Katie. "A 'David and Goliath' win." *Farm Weekly*. November 30, 2013.
149 Scott, Jason and Behrmann, Elisabeth. "ADM's $2 billion GrainCorp bid blocked by Australia." *Bloomberg*. November 29, 2013.

capability of the United States. In 2016, Senator Chuck Grassley (Iowa) introduced legislation to strengthen the CFIUS review of foreign investment that could undermine food security. The Securing American Food Equity (SAFE) Act would ensure that the Secretary of U.S. Department of Agriculture was permanently included in the CFIUS review process and specify that agricultural assets were included in the definition of critical national security infrastructure.[150] Food & Water Watch supports this commonsense clarification of CFIUS to more appropriately address the unique aspects of cross-border farm and food mergers.

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China's investment in U.S. farm, food and agricultural assets poses unique challenges. Unlike other cross-border investments into the United States, takeovers by Chinese private and state-owned enterprises further a strategy to develop food export platforms and secure agricultural technology for the Chinese market. Investments that are designed to extract agricultural economic value inherently distort the U.S. farm economy and food supply as well as undermine domestic and global food security. As a result, these cross-border food and farm investments warrant much closer scrutiny by federal regulators who should consider food and farm assets as part of critical infrastructure and weigh the impacts of an acquisition on the capability of the United States.

[150] S. 3161. Securing American Food Equity (SAFE) Act. 114th Congress. July 12, 2016.

OPENING STATEMENT OF MR. PATRICK JENEVEIN
CEO, TANG ENERGY GROUP AND CHAIRMAN, WATTSTOCK LLC

MR. JENEVEIN: Chairman, commissioners, thank you for the invitation to testify today. My remarks aim to offer a frontline business perspective on the financial, political and legal challenges American companies face when working with and, more importantly, resolving disputes with state-owned enterprises from the People's Republic of China.

I have more than 20 years of experience working with Chinese state-owned enterprises, most notably the Aviation Industry Corporation of China, and an intimate understanding of the characteristics of and drivers behind Chinese SOEs in the United States. That experience and understanding helped make Tang Energy Group the only U.S. company that has won a significant arbitration award against a PRC-owned company.

Over the last two years, Tang has been litigating against our partner, AVIC, in Dallas, after learning AVIC was violating and continued to violate our operating agreement for our wind energy joint venture, Soaring Wind Energy.

As the lead in our arbitration award win against AVIC and the personal target of AVIC's retaliation, our story illuminates challenges American businesses face litigating against PRC-owned or controlled firms in U.S. courts.

The largest of 12 Chinese defense industry groups and the sole supplier of military aircraft to the People's Liberation Army, AVIC sits at the center of China's military-industrial complex and takes directives from the Chinese Communist Party through agencies such as SASTIND and directives from the PLA as well.

In fact, after initiating legal proceedings in Dallas, Tang discovered that AVIC entered the wind industry business in the United States only after SASTIND issued a directive for them to do so.

Since 2008, AVIC has invested more than $2 billion in U.S. firms in the U.S., acquiring well-known automotive and aviation firms like Cirrus Aircraft, Continental Motors, and Nexteer Automotive. According to data compiled by Rhodium Group, we understand that AVIC is the largest PRC employer in the United States.

As well as addressing supply chain, skill, and quality control gaps, AVIC's investments focus on acquiring dual-use technologies that can be leveraged for both civilian and military use.

Back to the legal front. American companies are facing significant challenges pursuing claims against Chinese state-owned or state-controlled firms in U.S. courts. Though the cases differ, U.S. litigants face similar challenges because Chinese entities involved deploy similar techniques.

For instance, when litigating against Chinese firms, American companies are forced to navigate opaque complex multinational corporate structures that limit liability for bad behavior, obfuscate ownership, and add degrees of separation between a Chinese firm's U.S. subsidiaries and their ultimate controlling parent, which is almost always based in China.

Due to China's mixed fulfillment of its obligations, serving Chinese-based companies and executives through The Hague Convention becomes practically impossible. In the Tang case, Chinese authorities rejected our attempts to serve AVIC and its subsidiaries claiming that our Chinese translations weren't good enough.

Chinese state-owned firms are also using U.S. laws in ways they were never intended. In a growing number of cases, including Tang's, Chinese firms use the Foreign Sovereign Immunities Act to seek immunity from findings by U.S. courts. This abuse creates costly delays and additional legal fees that, in the words of one lawyer, have a chilling effect on the American plaintiff's case.

With access to China's treasury, Chinese firms command significant financial and political resources that produce material imbalances favoring them against U.S. companies during legal proceedings in America.

Since Tang initiated arbitration, AVIC has taken actions that others have described as "lawfare": disregarding subpoenas and other directions from the International Center for Dispute Resolution under the American Arbitration Association; pursuing separate legal actions against Tang's CEO--me--in both Delaware and California; and retaliating against our joint venture interests in China. This includes destroying the value of Tang's interest in AVIC HT Blade, which AVIC formerly valued at $1.8 billion, to virtually zero today.

With Chinese investment in the U.S. growing rapidly and the Chinese government's insistence that its state-owned firms function as extensions of the Party-state, cases like Tang's will become more common.

Knowing this, the United States must respond to protect American jobs, companies and consumers while also stepping up review of Chinese state-owned companies' investments in the U.S.

First, CFIUS should begin considering the legal risks of Chinese transactions. For example, ChemChina-Syngenta acquisition, CFIUS should have considered the transaction's legal risks to the ongoing "Syngenta GMO Corn Litigation" and ensured credibly sufficient protections were put in place to provide recourse to U.S. farmers. This was not done despite public concerns that ChemChina may claim sovereign immunity after CFIUS approval.

Second, before approving any transaction, CFIUS should require the Chinese acquirer to waive sovereign immunity and establish an agent for the receipt of legal service in the U.S.

Third, Congress should consider establishing a pathway for American plaintiffs to receive support from the U.S. government once a PRC SOE claims sovereign immunity in U.S. legal proceedings to act as a counterweight to the SOE's PRC provided resources.

And finally, a protocol should be established to allow CFIUS or other government body to periodically re-review approved Chinese transactions. This will help to ensure PRC acquired firms maintain their commercial integrity and intent, and that their activities do not present new national security risks.

Thank you for the opportunity to testify here today. Look forward to answering any questions you might have.

PREPARED STATEMENT OF MR. PATRICK JENEVEIN
CEO, TANG ENERGY GROUP AND CHAIRMAN, WATTSTOCK LLC

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

Patrick Jenevein

CEO, Tang Energy Group and Chairman, WattStock LLC

Thank you for the opportunity to testify today on issues that are vital to U.S. economic interests and rule of law. In our testimony today, we will provide a frontline business perspective of the real financial, political, and legal imbalances U.S. firms face when working with, and resolving disputes against, Chinese firms—notably national-level Chinese state owned enterprises (SOEs)—in the United States.

Dallas-based Tang Energy Group ("Tang") invests in and develops clean energy projects around the world and has been active in China since 1996. For over two decades, Tang has cultivated deep, strong, and lasting relationships with Chinese business and government leaders. These relationships, combined with our business management capabilities, have been vital to Tang's commercial successes in China.

Tang has participated in the financing and development of energy projects in Xinjiang, Gansu, Hebei, and Shanxi provinces. Our project partners have ranged from provincial Chinese government entities to large Chinese SOEs, including the China National Petroleum Corporation (CNPC) and the Aviation Industry Corporation of China (AVIC).[1]

In 2008, after years of success in China, Tang and AVIC established U.S.-based Soaring Wind Energy ("Soaring Wind") to identify, finance, market and develop wind energy projects worldwide. AVIC committed to providing $600 million in financing to the venture.

However, after launching Soaring Wind, Tang discovered that AVIC was establishing separate companies to develop wind energy projects around the world in contravention of the exclusivity provisions within the Soaring Wind joint venture agreement ("Soaring Wind Agreement"). After numerous attempts to resolve AVIC's wrongful conduct failed,

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[1] Following the practice of official Chinese sources, which are careful to designate the "Group" company when referring to the top-level organization of national-level Chinese SOEs, the apex organization of AVIC will be referred to as "AVIC Group HQ." To avert confusion, AVIC Group's subordinate "business units" will be referred to as "AVIC subsidiaries" or, when appropriate, by their full company name. "AVIC" will be used to refer to AVIC Group HQ and its subsidiaries collectively.

Tang was forced to initiate arbitration proceedings in June 2014 (the "Tang Case"). In December 2015, a panel from the American Arbitration Association's International Centre for Dispute Resolution found in favor of Tang and Soaring Wind, awarding them substantial monetary relief approximating $70 million.[2]

Tang's ongoing experience underscores key challenges U.S. companies face litigating against Chinese firms in the U.S. This includes navigating opaque and complex multinational corporate structures that limit liability, obfuscate ownership, and add degrees of separation between a Chinese firm's U.S. subsidiaries and its ultimate controlling parent, which is almost always based in China. In some cases, including the Tang Case, Chinese SOEs have refused to recognize the jurisdiction of U.S. courts and arbitrators, even asserting sovereign immunity.

Establishing *Alter-Ego* and the Singularity of Chinese SOEs

A key challenge when litigating against Chinese companies in the U.S., especially SOEs, is establishing the interconnectivity amongst corporate entities involved in the dispute. The concept in U.S. law known as *alter ego* provides the rigorous principles required for determining this interconnectivity, which often focuses on the relationship between a parent company and its subsidiaries.[3]

In Tang's case, nine jurists determined that AVIC Group HQ and its related subsidiaries[4] operated as a single entity and that it used its control over its subsidiaries to commit a fraud and work an injustice on Tang. U.S. litigants must meet the *alter ego* requirements to determine what entity or entities are liable for damages.

Complex Multinational Corporate Structures

Chinese firms investing in the U.S. often use a complex web of multinational corporate structures that obfuscate ownership and enable evasion of U.S. legal and regulatory reach. Chinese secrecy laws and the government's mixed interpretation of its obligations under the Hague Convention makes obtaining evidence and serving legal documents against offshore Chinese firms and their executives, especially SOEs, nearly impossible. [5]

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[2] The Final Award from the International Centre for Dispute Resolution, International Arbitration Tribunal is publicly available as a filing with the United States District Court for the Northern District of Texas as part of *Soaring Wind Energy LLC et al v. Catic USA Inc et al*. Also, see Matt Miller, *China's AVIC ordered to pay $70 million to U.S. wind firm*, Reuters, 22 December 2015, http://www.reuters.com/article/us-usa-aviation-ind-idUSKBN0U50GZ20151222

[3] The determination of whether one entity is the alter ego of another is a complex and multi-faceted undertaking that can be highly fact specific. Under federal common law, alter ego can be shown based upona finding that (1) the non-signatory exercised complete control over the signatory with respect to the transaction at issue, and (2) such control was used to commit a fraud or wrong that injured the claimants. Bridas S.A.P.I.C. v. Gov't of Turkmenistan, 345 F.3d 347, 359 (5th Cir. 2003) (Bridas I). Delaware law is substantially similar.

[4] The AVIC subsidiaries named in the Tang Case (collectively referred to as the "Respondents"), include the Aviation Industry Corporation of China, CATIC USA, Inc., A/K/A AVIC International USA, Inc., AVIC International Holding Corp., China Aviation Industry General Aircraft Co., Ltd., AVIC International Renewable Energy Corp., Ascendant Renewable Energy Corp., and AVIC International Trade & Economic Development.

[5] For a more in-depth overview of the hurdles U.S. companies face serving Chinese firms through the Hague Convention and the Chinese government's interpretation of its obligations see Kevin Rosier, "*China's Great Legal Firewall: Extraterritoriality of Chinese Firms in the United State,*" The US-China Economic and Security Review Commission, May 5, 2015.

In the Tang Case, initial efforts to serve AVIC and its China-based subsidiaries through The Hague Convention were rejected by Chinese authorities who claimed the Chinese translations of the U.S. legal documents were not “good enough.” These factors combine to hinder U.S. firms’ attempts to obtain justice while reducing the potential recovery of damages.

Cascading Command and Control Structure

Although U.S. firms may face substantial difficulties in proving the existence of *alter ego* relationships between or among Chinese subsidiaries and their ultimate parents, our working knowledge and experience with Chinese laws and practice demonstrates that this relationship is fundamental to the Chinese system. For instance, Chinese law governing the overseas investments of national-level SOEs (e.g. *The Interim Measures for the Supervision and Administration of the Outbound Investments by Central State-owned Enterprises)* requires the ultimate parent or group company, along with the State-owned Assets Supervision and Administration Commission (SASAC), to be in charge of supervising and administering SOEs’ overseas investments.[6]

The corporate structure of China’s national-level SOEs reflect the centrally controlled, top-down Chinese Party-state system.[7] Following Party directives, SOEs design corporate structures to place all significant revenue-earning activities under first level or Tier 1 subsidiaries with the Group holding company sitting at the apex exercising direct control and oversight of its subsidiaries. Ownership allows control; enabling Chinese SOE parent companies to direct the subsidiaries’ commercial strategy, personnel appointments, and business operations.

- This top-down corporate structure replicates itself in the interaction between Tier 1 SOE enterprises and their own respective subsidiaries, including those in the U.S.

Within this construct, the U.S.-based Chinese SOE is oftentimes a shell company with little to no assets, even though this entity, more often than not, serves as the legally binding signatory in U.S. commercial ventures. Thus, when a dispute arises, the U.S. partner faces the additional legal obstacle of establishing *alter ego* between the signatory and the non-signatory SOE parent, which approved the transaction as required under Chinese law, to obtain relief.

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http://origin.www.uscc.gov/sites/default/files/Research/Extraterritoriality%20of%20Chinese%20Firms_Research%20Report_0.pdf

[6] For more information on SASAC’s regulations governing the overseas investments of central level SOEs see “China issues new rules on outbound investments by centrally administered state-owned enterprises,” Hogan Lovells, April 25, 2012. http://www.lexology.com/library/detail.aspx?g=994616a7-3296-4f93-8eb1-670ca18708fa and “*New regulations for SOEs’ overseas deals,*” Global Times, January 18, 2017. http://www.globaltimes.cn/content/1029539.shtml

[7] The hierarchal leadership structures within and across Chinese SOEs come into focus when one considers the role of the Chinese Communist Party (CCP) within SOEs. For additional information on the role of the CCP in Chinese SOEs see Jonathan G. S. Koppell, “*Political Control for China’s State-Owned Enterprises: Lessons from America’s Experience with Hybrid Organizations,*” Governance: An International Journal of Policy, Administration, and Institutions, Vol. 20, No.2, April 2007. http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0491.2007.00356.x/abstract

Tang confronted this scenario when initiating legal proceedings against AVIC in mid-2014. Ultimately, after significant expenditure of time and resources, including hiring experts to work with our legal team to uncover evidence regarding AVIC subsidiaries and activities, Tang established—per the findings of the arbitration tribunal—that AVIC Group HQ and its subsidiaries involved in the case were *alter egos* of one another. In its Final Award, the arbitration panel concluded that:

- AVIC Group HQ "exercises such complete dominion and control over the other AVIC Respondents that they all operate as a single economic entity" and that AVIC Group HQ "used its control over its subsidiaries to commit a fraud and work an injustice" against Tang and its affiliates, including creating "additional subsidiaries in an attempt to get around its promises made" in the Soaring Wind Agreement.[8]

- AVIC's U.S. subsidiaries readily and repeatedly acknowledge that they are agents of AVIC Group HQ. For example, China Aviation Industry General Aircraft (CAIGA), the parent company of Minnesota-based Cirrus Aircraft, publicly reports that it operates "under the strategic guidance of AVIC," and that it is controlled by its majority shareholder, AVIC Group HQ.

The Foreign Sovereign Immunities Act (FSIA)

Though undeniably engaged in commercial activities within the United States, Chinese SOEs attempt to wield the FSIA, in many cases, as a tool to skirt their legal responsibilities and delay legal proceedings. The FSIA provides the basis for obtaining jurisdiction over a foreign state and includes a commercial "carve out" or exception. [9]

Noah Feldman, a professor of constitutional and international law at Harvard University, describes how Chinese companies exploit the FSIA to their benefit.[10]According to Feldman, this misuse exists because of "the innovative way the Chinese government organizes its state-owned enterprises" and their complex, opaque operating posture.

In the Tang Case, AVIC Group HQ and its subsidiary, CAIGA, are asserting immunity from suit under the FSIA.[11] Chinese SOEs, including AVIC have made similar claims in other recent commercial cases in U.S. courts, including:

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[8] It is highly likely that AVIC Group HQ's International Department exercises administrative responsibility over AVIC International and other selected entities with an overseas presence. The AVIC International Department trains personnel assigned overseas, including providing instruction on AVIC Group's internationalization strategy ((国际化发展战略), overseas management structure (外机构职责要求), overseas "social security" (境外社会安全), and overseas organizational secrecy management (境外机构保密管理). "中航工业组织境外派驻人员集中培训," China Aviation News, May 12, 2015. http://www.cannews.com.cn/2015/0512/125887.shtml

[9] For a legal definition see 28 U.S. Code § 1605 – General exceptions to the jurisdictional immunity of a foreign state. https://www.law.cornell.edu/uscode/text/28/1605

[10] Noah Feldman, "*Gap in U.S. law helps Chinese companies, for now,*" Bloomberg View, May 15, 2016. http://origin-www.bloombergview.com/articles/2016-05-15/gap-in-u-s-law-helps-chinese-companies-for-now

[11] Matthew Miller and Michael Martina, *"Chinese state entities argue they have 'sovereign immunity' in U.S. courts,"* Reuters, May 11, 2016. http://www.reuters.com/article/us-china-usa-companies-lawsuits-idUSKCN0Y2131

- **Global Technology, Inc. v. Yubei (XinXiang) Power Steering System Co. ("Yubei XinXiang")[12]—** A 2012 breach of contract dispute against AVIC subsidiary Yubei XinXiang relating to its acquisition of Nexteer Automotive.[13] The case settled privately in August 2016.

- **Chinese Manufactured Drywall Products Liability Litigation MDL 2047 ("Chinese Drywall Case")[14]—**China National Building Materials Group Corp. is arguing that it is immune from U.S. courts in the Chinese Drywall Case.[15]

Describing the "real-life" impact of the FSIA on U.S. legal proceedings illuminates its attractiveness and utility to foreign state-owned commercial entities. The simple act of "asserting" sovereign immunity in U.S. court proceedings initiates a mandatory and time consuming back-and-forth legal process to determine the FSIA's applicability. In fact, once a defendant asserts sovereign immunity "the burden shifts to the party opposing immunity to present evidence that one of the exceptions to immunity applies."[16]

In the words of Victoria A. Valentine, an attorney who represented Global Technology Inc. in its lawsuit against AVIC Group HQ and its subsidiary Yubei XinXiang, "this strenuous mandatory determination of litigating whether a foreign sovereign's or foreign state's activity was legally commercial, even when the actions are undeniably commercial, is often accompanied by the halting of discovery during the appeal process. Delay, together with the prolonged and increased cost of litigation, has a chilling effect on pursuing a plaintiff's legal rights."[17]

Parent Company and Government Support in Legal Cases

When Chinese SOEs are involved, the financial and political resources at the SOEs disposal makes the material impact to a U.S. company's legal case, especially small and medium sized firms, all the more disproportionate. For example, during the Tang Case, Tang discovered that AVIC Group HQ was providing material support to AVIC International USA, including directing its U.S. attorney to draft AVIC International USA's legal motions. AVIC Group HQ provided this support while claiming it was not participating in the proceedings despite being a named party.

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[12] See United States Court of Appeals for the Sixth Circuit, *Global Technology, Inc. v. Yubei (XinXiang) Power Steering System Co., Ltd., a People's Republic of China corporation et al,* December 7, 2015. http://www.opn.ca6.uscourts.gov/opinions.pdf/15a0287p-06.pdf

[13] See *Global Technology, Inc. v. Yubei (XinXiang) Power Steering System Co., Ltd., a People's Republic of China corporation et al,* United States Court of Appeals for the Sixth Circuit, December 7, 2015. http://www.opn.ca6.uscourts.gov/opinions.pdf/15a0287p-06.pdf

[14] Related case developments can be found on the United State District Court for the Eastern District of Louisiana website at http://www.laed.uscourts.gov/case-information/mdl-mass-class-action/drywall

[15] See Sindhu Sundar, "*Chinese Co. Fights to Duck Claims in Drywall MDL,*" Law360, December 8, 2015. https://www.law360.com/articles/735534/chinese-co-fights-to-duck-claims-in-drywall-mdl

[16] See Kelly v. Syria Shell Petroleum Dev. B.V., 213 F. 3d 841, 847 (5th Cir. 2000).

[17] See Victoria A. Valentine et al, *The Foreign Sovereign Immunities Act's Crippling Effect on United States Businesses*, Michigan State International Law Review, Vol. 24, Issue 3 (2015). http://digitalcommons.law.msu.edu/cgi/viewcontent.cgi?article=1196&context=ilr

The Chinese government has also attempted to exert political pressure to influence U.S. judicial proceedings against Chinese SOEs. In October 2015, China's Ministry of Foreign Affairs (MOFA) submitted a letter to the U.S. Department of State expressing its "strong discontent" and "resolute objection" to the courts acceptance of the Chinese Drywall Case. The MOFA letter concludes that it expects "a statement of interest be issued to the court to stop the abuse of judicial procedures, so as to avoid any disruption or damage to the U.S.-China Relationship, as well as the economic and trade ties between the two nations."[18]

Asymmetric "Lawfare"

Throughout the course of the Tang Case, AVIC has executed a coordinated campaign to exert financial pressure on Tang and its affiliates through legal and commercial actions that others have described as "lawfare." These ongoing actions range from lawsuits to the transfer of assets and the obstruction of normal business activities within AVIC-Tang joint ventures in China. As a result, AVIC has exponentially increased Tang's time and expense to exercise its legal rights and erased the value of its investment holdings in China.

- **Attempts to Delegitimize Arbitration Proceedings—**AVIC and its attorneys sought to undermine the arbitration proceedings by alleging that the panel, constituted in accordance with the Soaring Wind Agreement AVIC signed, amounted to a "stacked deck" against it.[19] AVIC International and its subsidiaries also claimed that the arbitration panel engaged in misconduct.
    - In addition, AVIC subsidiaries in China refused to produce evidence and contravened orders from the nine-member American Arbitration Association panel acting under the International Center for Dispute Resolution.
    - AVIC's actions turned what should have been a speedy arbitration process into an 18-month ordeal.
- **Asymmetric Lawsuits—**AVIC, through its U.S. attorneys, is pursuing litigation against Tang's CEO in both Delaware and California.
    - In California, AVIC initiated a suit against Tang's CEO personally alleging invasion of privacy.

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[18] See United States District Court for the Eastern District of Louisiana, *In re: Chinese Manufactured Drywall Products Liability Litigation,* Document 19965, Filed on January 12, 2016.
[19] For more information on AVIC's legal arguments regarding the composition of the arbitration panel and subsequent court rulings on the matter see Christopher S. Moore, *"District Court Rejects Pre-Award "Stacked Deck" Challenge to Arbitrator Selection Process,"* American Bar Association, February 26, 2015.
http://www.americanbar.org/publications/litigation-committees/alternative-dispute-resolution/practice/2015/district-court-rejects-pre-award-stacked-deck-challenge-to-arbitrator-selection-process.html
and Jacob Fischler, *"Court Can't Step into $2B Row's Arbitration, 5th Circ. Says,"* Law360, August 26, 2015.
https://www.law360.com/aerospace/articles/695465/court-can-t-step-into-2b-row-s-arbitration-5th-circ-says

  - In Delaware, AVIC is alleging that Tang's CEO breached his fiduciary duties to Soaring Wind by initiating the arbitration claims that will substantially benefit Soaring Wind when the arbitration award is collected.

- **Destroying the Value of Tang Interests in China—**In retaliation for Tang's initiating legal action, AVIC is transferring or withholding assets from two China-based joint venture companies in which Tang owns minority stakes.

  - Since initiating arbitration proceedings, executives at AVIC-Tang joint venture AVIC HT Blade have refused to comply with requests by Tang or its legal representatives for corporate information, including financial documents and business contracts. AVIC HT Blade is also liquidating and transferring company assets to other AVIC-owned entities.

  - In 2009, Guoxin Securities reported AVIC HT Blade's market value at $1.8 billion, placing Tang's 25 percent interest at $450 million. Since then, AVIC has valued Tang's interest at 1 RMB (USD 15 cents).

  - Since mid-2015, deliberate inaction by AVIC subsidiaries has obstructed the sale of Tang's minority interest in Shanxi Zhonghang Tengjin Energy Co., a Tang-AVIC joint venture company. This includes preventing Tang legal representatives from signing sale-closing documents and alleging that Tang's CEO must personally travel to Shanxi to finalize the sale. AVIC reports the current value of Tang's interest in the venture is $3 million.

Key Recommendations

With the rapid uptick in Chinese investment in the U.S., disputes between Chinese and U.S. firms in U.S. courts will likely rise. U.S. companies are already beginning to seek protections in commercial agreements in response to growing legal and commercial risks posed by Chinese firms. This includes requiring Chinese acquirers to provide sovereign immunity waivers.[20] Congress should consider implementing practical measures that ensure a level playing field between U.S. and Chinese companies in the United States. Key recommendations include:

- Requiring all majority-owned or controlled Chinese companies, especially SOEs, operating in the United States to waive claims of sovereign immunity in U.S. courts and establish an agent for the receipt of legal service. This should be required as part of Committee on Foreign Investment in the United States ("CFIUS") reviews.

[20] Fairchild Semiconductor International Inc.'s December 2015 Schedule 14D-9 filing with the U.S. Securities and Exchange Commission includes a provision that its proposed Chinese acquirers, China Resources Holdings Limited and Hua Capital Management, provide "a waiver of sovereign immunity and establish a process agent in the U.S. for the receipt of legal service." The filing can be accessed at https://www.sec.gov/Archives/edgar/data/1036960/000119312516463934/d22910dsc14d9a.htm

- Establishing a pathway for U.S. plaintiffs to receive support from the U.S. government once an SOE claims sovereign immunity in U.S. legal proceedings. Given recent public pronouncements by Chinese leaders that SOEs should implement decisions of the CCP, including defense and intelligence directives,[21] this pathway may best be established within the Department of Justice, the National Security Council, or the recently announced National Trade Council.

- Advising CFIUS to assess and consider the legal risks posed to U.S. consumers and companies in its review of Chinese transactions.

- Establishing a protocol for CFIUS to periodically re-review approved Chinese transactions to ensure the acquired entities activities do not present new national security risks.

We hope that other U.S. firms will benefit from Tang's experiences and that these recommendations provide lawmakers a practical basis for implementing regulations that protect U.S. businesses and consumers, while ensuring the U.S. remains open to Chinese investment.

[21] See "Xi stresses CPC leadership of state-owned enterprises," Xinhua News Agency, October 11, 2016. http://news.xinhuanet.com/english/2016-10/11/c_135746608.htm

PANEL II QUESTION AND ANSWER

HEARING CO-CHAIR WESSEL: Thank you all, and Mr. Jenevein, thank you for your general observations based on personal experience. It's very helpful to us. So thank you for being here today.

Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: Thank you all for your testimony.

Mr. Woodall, I'd like to start with you. I am concerned about food safety, and the melamine case years ago with China is a good example of some of the risks, and I'm particularly concerned in the context of the risk of the WH Group processing and re-exporting pork to the United States. But that said, I'm kind of struggling with trying to balance what we constantly focus on, which is we want to see more exports to China rather than they're simply exporting here.

And it seems to me in the case of Smithfield, you know, they're hiring Americans, paying American taxes, so there are some benefits to that deal, and you point out that if there's a net increase in exports, hog farmer prices-- something I never thought I'd say out loud--will go up by three percent.

So I'm struggling to find the balance of why isn't that good for the American hog farmer and what's the fundamental risk when it comes to food safety, which you talk about in your testimony, of Smithfield's being owned by the Chinese? Can you talk a little bit more about that, please?

MR. WOODALL: Sure. Let me talk a little bit about the farmer and on the export end. So I think one thing to consider is that the effect of concentration in the agricultural market is incredibly important. We now live in a world where there are 60,000 hog farmers and the top two buyers slaughter half the hogs. One is Smithfield and one is the Brazilian-owned JBS.

So when you have two buyers and 60,000 sellers, the ability to push down on price is intense, and I think over the long term the real price of hogs has come down, and a lot of this we believe is because of monopoly power. One of the witnesses this morning said that part of the acquisition strategy is to secure monopoly power and exercise it. So we believe that when bigger buyers are able to exert monopoly power and push down on prices.

This year CFIUS also approved Smithfield's acquisition of the Clougherty group, right, so that makes Smithfield even bigger. They're now 28 percent of the U.S. slaughter market if you count the facilities in California. So ultimately I think this has effects on the farmers themselves and that is going to sort of compensate in some respects for the increase in exports.

The other thing to consider is that now the WH Group has the Smithfield brand, and they are more ideally situated to export that Smithfield brand to the Pacific Rim, to South Korea, to China, to Southeast Asia. And so potentially--and we have a situation now where 97 percent of the exports to China are from Smithfield. So really it's a situation where a Chinese company is just shipping its own products to itself. So it's slightly different than the exports of corn or wheat to China. So I think that's one thing to consider. There's probably a balance on this, and I'm not sure exactly where it falls.

On the food safety issue, we share your grave concerns. Right. China's food safety system is a Wild West go-go capitalism with many, many known problems that are manifest that end up on our shores currently. We are concerned that in the long run it's possible for Chinese firms to buy up U.S. brands like Smithfield and produce them under worse conditions in China and export them to the United States.

Currently,China is not legally eligible to ship pork to the United States, but they are aggressively moving to get permission to ship poultry that was raised in China, slaughtered in China, to come here, and already they can export chicken that is processed in China but not actually produced there.

So we're concerned about that for consumers. If they were go into a store, they wouldn't necessarily be able to tell if Smithfield bacon came from North Carolina or whether it came from China if China was eligible to export pork products. So we're considerably concerned about that.

HEARING CO-CHAIR CLEVELAND: Thank you. Helpful.

Can I ask Mr. Jenevein, one of your recommendations is that we require all majority owned or Chinese companies, especially SOEs, to waive claims of sovereign immunity. Are you suggesting that we do that just for China? Or are you saying that any SOEs since there are SOEs from many countries that invest? And if you're suggesting that we just apply this approach to China, on what legal basis or how would we differentiate? What would the justification be?

MR. JENEVEIN: Well, first, my experience is with China, and I only understand the others theoretically, and I'm not a lawyer. That said, we know the intent of Chinese companies coming to the United States is decided in Beijing, and so there's a fundamental difference.

The companies coming from China have a different sense of the purpose of law than we do. We've got to recognize this fundamental difference. We as Americans look at law as an institution, a construct to protect individuals. China looks at-- or not the Chinese--the PRC, the CCP look at laws as a way to protect above the state and above the companies, and that puts American companies and jobs and consumers at the very bottom rung.

HEARING CO-CHAIR WESSEL: Thank you.

A couple of questions starting with Mr. Woodall. 97 percent of the exports of pork emanate from the Smithfield brand. Some of that is the result of ractopamine-free. You know I support your analysis, but some of that is the result of ractopamine.

But for years, we've been trying to get pork into the Chinese market. At a point several years ago, their incomes rose to a point where they could afford more protein and pork is their number one source. Rather than opening their market to U.S. products broadly, they come in and buy one of our preeminent firms.

What impact do you think that has long term on other sectors where we've been seeking access? That's number one.

Number two, how on earth can it be profitable for the Chinese to import broiler chickens, whatever it is, process them and send them back and sell them to the American public? I'm still amazed by that and can't understand the economics. Can you respond to those two?

MR. WOODALL: I can try.

[Laughter.]

MR. WOODALL: I think on the first, I think this really exemplifies the real mercantilist relationship between the U.S. and China on the economic front. So exports are routinely traded on--sort of swapped for one for the other. So we see this in agriculture often where things are held up on one side in exchange for another.

I think there is evidence that the approval of processed chicken exports to the U.S. was really a condition of getting greater beef access, U.S. market access on beef. So those kinds of things are perhaps some things that people should ponder as there's more investment in other sectors where that kind of investment, the market access that's offered may only go to the Chinese invested firm in the U.S. and not more broadly to the economy.

It may be a more narrow mercantilist swap so that all of that benefit goes to a Chinese-owned firm. So it's perhaps a cautionary tale. I think the ractopamine was part of it, but Smithfield was not the hugest promoter of ractopamine-free pork before its acquisition so it bought the biggest pork processor in the U.S., changed its production methods so that it could meet that market, and then it's not that other producers weren't producing ractopamine-free pork in the U.S. Many were. But still 97 percent of these exports are going to Smithfield, and so this is a situation where I think it warrants concern for other pork producers in the U.S. and for other exporters, and obviously we're competing. Now we have a situation where those exports are competing with other producers and other companies here in the U.S.

On the economics of broiler processing, it is highly suggestive that a couple of things: maybe that the labor conditions and prices in the Chinese broiler processing market are considerably lower even than in Arkansas and Mississippi and Alabama where our processing plants currently are.

I think largely this was--

HEARING CO-CHAIR WESSEL: I understand that, but how does that overcome the shipping costs, bilateral shipping costs?

MR. WOODALL: I think ultimately that we believe that this regulatory approach was the first one they could get, and so what they needed was to get approval that some of these processing plants were up to USDA standards and could receive equivalence from that processing plant, and they could take the chicken portion of the question out of the equation.

They're currently applying to process Chinese-raised chicken. So that will actually, instead of just processing, involve the slaughter of chickens and--

HEARING CO-CHAIR WESSEL: So taking a loss so that they can get access and certainty or confidence in the U.S. market?

MR. WOODALL: I think taking a loss so that they could actually further this equivalence process, that it will be easier to get equivalence for processing where you don't have the slaughter portion involved, where there's considerably greater interest in the kind of hygiene and food safety element, and then later they could add the slaughter element, and then they could bring in Chinese birds that are both slaughtered and processed in China.

Our belief is that it was the easiest way for them to get the ultimate goal, which was to export Chinese-slaughtered and processed chickens.

HEARING CO-CHAIR WESSEL: Okay.

Rob, I've known you 15, 20 years. Today's testimony was a little different than what I heard 15, 20 years ago. What's changed?

HEARING CO-CHAIR CLEVELAND: In seven seconds.

[Laughter.]

HEARING CO-CHAIR WESSEL: Prerogative of the chair.

DR. ATKINSON: You have a better memory than I do.

[Laughter.]

DR. ATKINSON: But I think one thing that's changed is it's become clear that the path we thought China was going on, which was hopeful that they would become more market-oriented, more rule of law, more respectful of IP, and less mercantilist, that path just simply didn't emerge. In fact, you could argue there's a significant amount of backsliding.

Not only that, but really doubling down on a different strategy, and I think this is the part that I think not enough people understand. The old strategy was about gaining commodity production, largely in manufacturing, largely through low cost, largely through inducing U.S. firms and others to go there. And that was very successful, as the work from David Autor and others, including ITIF, has shown.

The new strategy is to go after our core competencies and technology. That's a very different strategy. We could have a trade balance with China tomorrow, and it wouldn't address that problem, which is going after the kinds of advanced industries that the U.S. is still competitive in. I think that's the new war, if you will. That's the new game that's underfoot, and so I think that's a very concerning issue, and that's why we have the position now that we do.

HEARING CO-CHAIR WESSEL: Thank you.

Commissioner Shea.

VICE CHAIRMAN SHEA: Well, thank you. I haven't known Rob for that long, but I know that the ITIF does great work so thank you.

And I want to direct my question to you, Rob. I heard you say that the Chinese government is doubling down on indigenous innovation strategy. It's seeking to destroy the market share of U.S. and western companies and has a long-term strategy to take over key parts of the high tech area. Is that fair? Did I capture you right?

DR. ATKINSON: Yes, you did.

VICE CHAIRMAN SHEA: Okay. Great. Now, last year, that is one end of the spectrum. Last year, Xi Jinping came to Washington State, I believe, and all the U.S. CEOs of the big high-tech companies were there lined up with him, taking pictures. He's the leader of a country that has the largest Internet censorship apparatus in the world, and he's out there, as you suggest, or the Chinese state is out to limit their market share in China.

So there's a complete disconnect between that image and what you just said to me, said here today. So I was wondering if you could explain the disconnect?

DR. ATKINSON: Sure. It reminds me a little bit of one of my favorite artists, John Fogerty. Fogerty has a song called "The Gunslinger," and he talks about we need somebody tough to come in and tame this town because all the citizens are being roughed up by these outlaws that have come into town.

And I think that's a good analogy for what's happening here today. The Chinese government has sent a very clear message to U.S. technology companies: if you raise your head, you will get hit. We saw that after President Obama took the case against the People's Army for cybersecurity, and quite soon after that Microsoft was attacked on bogus antitrust charges.

So technology companies know that there's essentially no rule of law in China, that if they raise their head, they will be attacked, and they will be hurt. And so it's just better for them to kind of go along.

Now I think one of the things that's happened in the last couple of years, at least from my experience, is technology companies are a lot more concerned. They can see the end game. And they're more willing, I think, to support tougher actions. But I think at the end of the day, we need a gunslinger, if you will. In other words, we need the U.S. government to be the gunslinger and to be tough, and if they do that, then I think it will be easier for U.S. companies to support those actions.

VICE CHAIRMAN SHEA: Well, Mr. Jenevein is perhaps an example that they could follow. He's raising his head and speaking out so I appreciate your comments, sir.

Another question. You mentioned Europe, and I agree that best if U.S. policy is in sync with European policy. I was wondering if the Europeans are on to what you're saying?

I was very much struck by the Mercator Institute study, which came out in December, which basically said what you said, that the Chinese government has a long-term strategy to dominate key parts of the high-tech industry, and they even used the four-letter word "reciprocity" in that report, suggested that as a tool.

So I was curious, is there a sea change? Is that a difference of opinion now appearing in European capitals?

DR. ATKINSON: Yeah, that's for sure. I think there is a gradual change emerging in Europe. Three or four years ago the European strategy was let the U.S. take all the lumps, and we'll come in afterwards and we'll curry favor with the Chinese government and we'll get all the benefits.

You see recently the German Minister of Commerce--I'm not sure of the exact title--went to China, was very, very concerned about the Chinese government or state-owned companies coming in and buying advanced mittelstadt companies, robotics companies and others in Germany. You see the same thing with some other countries.

So I think that there's an opening in Europe now where many European countries see this as a potential threat, but I just don't see them stepping up to the plate until there is U.S. leadership, and I think there is potential here for a good sort of diplomacy by the Trump administration to go over there and line up our allies ahead of time, and I think maybe three years ago it wouldn't have worked. I think it's certainly possible that it will work today.

VICE CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR WESSEL: Senator Dorgan.

COMMISSIONER DORGAN: Thank you very much.

Mr. Jenevein, was Tang and AVIC a joint venture?

MR. JENEVEIN: Tang is a Texas company from putting Tritech and Nolan Group together. Tang then formed a joint venture with AVIC in the United States.

COMMISSIONER DORGAN: In the U.S.

MR. JENEVEIN: Yes.

COMMISSIONER DORGAN: What? Is it a 50/50 equity?

MR. JENEVEIN: Yes, it was.

COMMISSIONER DORGAN: Okay.

MR. JENEVEIN: AVIC owned 50 percent and we and some of our affiliates own the other 50.

COMMISSIONER DORGAN: And you indicated that you had done business in China for over 20 years. You said that Tang has cultivated deep, strong and lasting relationships with Chinese business and government leaders and so on.

And then you proceeded to tell us a story which describes doing business with a

Chinese company that in the U.S., at least, is only a shell and is not very interested in being subject to U.S. laws and things. And so your story is that your company was defrauded by this AVIC, and you were awarded through arbitration $70 million; is that correct?

MR. JENEVEIN: It was not a fraud case in the legal sense.

COMMISSIONER DORGAN: Uh-huh.

MR. JENEVEIN: It was a breach of contract case, but you're correct.

COMMISSIONER DORGAN: Okay. So you haven't seen the $70 million, though, right?

MR. JENEVEIN: No, sir.

COMMISSIONER DORGAN: Uh-huh. Is there jeopardy for you? You have these long-established, deep, strong, lasting relationships with Chinese business and government leaders. Is there jeopardy for you and a company you're involved in to be speaking publicly about this?

MR. JENEVEIN: Very much so. And already AVIC has sued me personally in California for invasion of privacy and in Delaware for breaching my fiduciary duty to bring value to the joint venture company we have in the U.S., and in China, they're withholding dividends payable, and they are taking assets, or they're liquidating our joint venture company's assets into other AVIC companies and other Chinese companies.

COMMISSIONER DORGAN: Yeah. Central control is fairly absolute, isn't it, and we have two different systems here, and in the larger sense, we're kind of taking a look at shiny hubcaps and not so much the whole vehicle today. And that's important.

From the standpoint of the entirety of our trade relationship, in our report last year, we pointed out that in the last 15 years with China, we have a $3.5 trillion aggregated trade debt with China. That is hardly described as mutually beneficial, in my judgment.

But we're talking about more specifics today, and that's important. And Dr. Atkinson, you talked about the economic issues and trying to create some sort of economic test rather than just a national security test. Hard to do perhaps, but I happen to think it's worth trying. Are you going to describe that in some more detail?

DR. ATKINSON: Sure. I think the way that we look at this issue is that the FDI tactic is a component of a broader strategy we have to think about. If it was just this FDI issue, okay, but it's really part of a much broader strategy, as you all have documented in your annual reports, about forced tech transfer, standards manipulation, IP theft, et cetera, et cetera.

And therefore it, I think, should be very clear to the U.S. government that China just simply is not a normal country in the sense of playing by the rules, being market driven, having rule--they're not a normal country in that regard.

And so I think it behooves us to use investment review as a tool to push back against the Chinese policy here. I mean whether Mr. Trump, President Trump, excuse me, puts in place tariffs or not, whatever we do here we should be thinking about tools to get the Chinese government to roll back their innovation mercantilism.

So to me, this is just simply a tool, and if they were to sort of roll back and go back to being more normal in that sense, then you would take it away and go back to normal.

COMMISSIONER DORGAN: Thank you very much.

Just, finally, Mr. Woodall, I don't have the time to ask some questions, but I come from a farm state, and your testimony and the description of the Syngenta transaction and others is really, really important, really excellent testimony, and we appreciate that.

HEARING CO-CHAIR WESSEL: Senator Talent.

COMMISSIONER TALENT: Dr. Atkinson, I want to ask you a question. I don't know if it's really in your bailiwick, but one of my concerns is that as the Chinese economy more broadly slows down, which I think it pretty clearly is, and the leadership is faced with one of two choices, and again in the broadest sense, either to actually start implementing free market reforms to the finance system or the rest of it--you mentioned before that's what we all hoped they, the path they would take--or to try and get growth through other means.

And I don't think they're going to do the free market reforms. That doesn't mean they're going to give up on trying to grow, and so there may be even a broader reason why all this activity is intensifying, because they've got to be able to deliver economically. They're not going to go down the path of the free market policies. And so they're going to intensify all this outlier mercantile type activity.

Would you care to comment? Or really anybody can because it's a broader sort of what direction is China going to go in, but I thought about because you said we'd hoped that they would go down this one way and then they're not.

DR. ATKINSON: Yeah. Well, thanks, Senator.

It's a really critical question because the Chinese government uses this as an excuse to justify their mercantilist behavior. They argue, well, we have to grow because we got a lot of people coming off the farm, and if we don't grow, we'll have disruption, et cetera, et cetera.

I think that's just a completely false view, that the notion that you have to grow through exports and moving radically up the value chain by IP theft has just simply been shown by the World Bank, a number of international economists, there's zero correlation between your export performance--in other words, are you running a trade deficit--and job growth. Zero relationship.

One of the statistics we showed was that when the Chinese were implementing their SEI program, Strategic and Emerging Industries program, if you gave them the most generous sort of benefit of the doubt on the benefits of productivity, the value added that they would get by spending $800 billion, that was equivalent to about 16 months of Chinese productivity growth.

So the way China needs to grow--I exactly agree with you--is open up their markets more, have more market orientation and get real competition in their domestic sectors like banking and insurance and logistics, and drive productivity growth in their domestic sectors. That's the way the Chinese economy will grow in a robust way.

At one level I don't really buy that what China is doing in their technology and advanced industries strategy is really about economic growth. I think it has more connection to national security and global power. So I think the economic argument they use is somewhat of a red herring.

COMMISSIONER TALENT: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Stivers.

COMMISSIONER STIVERS: Thank you. Thank you all for being here this afternoon.

Following up on Senator Dorgan's question, Dr. Atkinson, you mentioned that the net benefits test in Canada and Australia was too broad, and it should be more targeted.

How can you target this in an objective manner so it gets away from some of the subjective decisions that are being made?

Can you describe what criteria possibly you could use there because as Congress hopefully considers legislation on this, I think that criteria is the heart of the matter of what this Commission needs to recommend to the Congress?

DR. ATKINSON: Yeah, thank you, Commissioner.

We, ITIF, issued a report, perhaps about two years ago. It was essentially something--I don't remember the exact title, but it was something, Creating a Global Mercantilist Index, and we tested out a methodology where we looked at about 55 countries on six different variables of how mercantilist economies work.

Not surprisingly, United States wasn't too mercantilist. Sweden wasn't too mercantilist. You go down the list, you get worse and worse and worse. Out of 56 countries, the Chinese were 55th. And this was certainly a replicable methodology that at the time we recommended that USTR issue a report like this every year, sort of like a super 301 Report, if you will, only not just about IP but about a lot of these other factors like forced tech transfer, SOEs, other things, standards manipulation.

So I think there's a methodology that if it were done carefully and objectively, you would find certain countries go over this threshold in a pretty clear way, and then you could say, okay, for these countries, particularly where you see evidence of SOEs and big subsidies, you could say they're going to be in this investment review regime, but everybody else wouldn't be.

And you've had a threshold that would be pretty high because I agree, it could be easy to sort of just succumb to protectionist pressures there.

COMMISSIONER STIVERS: Thank you.

And Mr. Woodall how long has it been since the Smithfield acquisition? A year, two years?

MR. WOODALL: Four years.

COMMISSIONER STIVERS: Four years now.

MR. WOODALL: It was 2013.

COMMISSIONER STIVERS: 2013.

MR. WOODALL: So it's three-and-a-half.

COMMISSIONER STIVERS: 2017 already. Can we quantify the economic impact from that acquisition yet in terms of have U.S. jobs been gained or lost or how much did the executives make out of that acquisition? Do we have any kind of tangible statistics about the economic impact?

MR. WOODALL: So it's a little hard to tell because the period before the acquisition Smithfield wasn't doing that great financially, and it was during the economic downturn, and people eat less meat during the economic downturn. So all the companies that sold more expensive things on the food spectrum did a little worse.

So the company is doing a little bit better than it did before, but we have very little points of comparison because we only have really two years of post-takeover data, and there are some portion of what we used to be able to see that isn't actually as public as it used to be.

So I think it appears the company is doing better, but it's impossible to tell what that's related to. I think a lot of it is related to the change in the economic climate and more than it is to the transfer and ownership. Does that make sense?

COMMISSIONER STIVERS: Yes, thank you.

HEARING CO-CHAIR WESSEL: Commissioner Slane.

COMMISSIONER SLANE: Mr. Woodall, would you agree that the acquisition of Smithfield was just the beginning of a wave of China trying to acquire American food processors?

MR. WOODALL: I agree that it's part of a broader wave of Chinese cross-border acquisitions in the food and farm and agribusiness space. I mean, Smithfield is the biggest purchase here. Obviously, Syngenta includes substantial assets in America. There are a lot of Syngenta plants here. I think it's not just food processing. It's land, it is agricultural technology, it is food processing companies like Bright Food, which is a state-owned company that owns Weetabix currently but is planning to sell Weetabix, but they're in a lot of other food processing spaces. It is dairy farms, cattle ranches. It's a lot of things. It's not just food processing.

COMMISSIONER SLANE: And you talked about acquired monopoly power. I mean Syngenta seems to be the prime example of that. I mean is Monsanto the only other competitor in that?

MR. WOODALL: So in the seed universe, ChemChina-Syngenta merger is happening in the landscape of two other seed mega mergers, Bayer and Monsanto, and Dow and DuPont. It's a world where we go from six seed manufacturers and technology companies to four.

I think farmers are rightly concerned that the prices they pay for seeds will go up considerably, and the real concern with the Syngenta, that ChemChina owns Syngenta, is that the question of whether they will cross-license their technology to other seed companies, whether they will exclude other seed companies from access to their developments, and whether or not the Chinese government, which approves the importation of biotechnology crops, will suddenly have an epiphany and approve Syngenta seeds but not approve imports from non-Syngenta products.

So those are real considerations. The monopoly portion, I think, is one that we are very concerned with, and I think a lot of farm organizations are considerably concerned about these mergers. But the state-owned corporation element is extremely concerning because not only will they have monopoly power, they have an incentive to actually shield their market from imports from non-Syngenta products, which is extremely problematic.

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you. Thank you all.

Our 2016 report had a recommendation, which when we presented our findings for last year's research to Congress, it was picked up, and since then it's been on the senators' and congresspeople's minds. It relates to strengthening CFIUS. And each of you has spoken about that here today.

I want to direct a question to Dr. Atkinson because one of your thoughts on the strengthening of CFIUS related to working with our allies. You also said that Japan has been effective in protecting their own crown jewels.

I'm wondering if you could give us a broader description of what they have done, how it has worked, and to what extent you think there would be elements of that that would strengthen our approach?

DR. ATKINSON: Yes, well, thank you.

I'd be happy to answer that, but also I'd be happy to answer in a longer, written version later.

I think Taiwan, South Korea, and Japan, they have all seen the direct threat to their technology industries from Chinese acquisition. The Chinese are targeting major companies in each of those three economies, and by and large, their governments have said just no, you cannot have that. This is core to our future, and we're just not going to let you buy these companies.

I don't know exactly what the review process is. Is strong enough to where they can just do that to anybody, and they choose to focus on the Chinese because they see it as a threat? And historically, Japan has not been open to acquisition anyway, and so it's--

COMMISSIONER TOBIN: Right.

DR. ATKINSON: --consistent with their overall history. But it is striking that their view is much stricter than ours. They don't have this view that there's going to be sort of comparative advantage and maybe this could help us and all. It's just, it's very much you cannot buy our technology companies.

So I think it would be useful for us to learn more about exactly what is the legal and administrative process by which they do that, and that I don't know.

COMMISSIONER TOBIN: And it can be useful too because as we move forward, our U.S.-Japan alliance, now that we have a new administration, needs to stay strong. So I would welcome hearing more--

DR. ATKINSON: Okay.

COMMISSIONER TOBIN: --beyond today. Thank you.

HEARING CO-CHAIR WESSEL: Chairwoman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thanks very much. Dr. Atkinson, since you opened the door on popular culture, I'll just mention, Mr. Woodall, that every time I hear about monopolization of seeds, I think, although I've been unable to read dystopian novels lately, of a book by Paolo Bacigalupi called The Windup Girl, which moves us forward into thinking about what indeed could happen. It's kind of a terrifying book.

But Mr. Jenevein, thank you so much for coming today because you have so much at stake, personally and financially in doing this. Senator Dorgan mentioned, you know, you raise your head, you have it cut off, so we really appreciate it. I think one of the issues we've been dealing with over the past several decades is that U.S. companies have been afraid to speak out about what they've experienced because there is blowback on them. So thank you for doing that.

I'd like everybody, you know, we talk about the disadvantages and the consequences for U.S. companies. I'd like to focus specifically on small and medium companies in this country. So, Mr. Jenevein, you mentioned about getting the U.S. government involved establishing a pathway for plaintiffs, but this is only in the foreign sovereign immunities cases.

What can the U.S. government do to help small and medium companies with the fact that they don't have the deep pockets that our major companies do in order to bring cases where they're being treated unfairly by Chinese companies? Is there anything the U.S. government can do to help out?

MR. JENEVEIN: Well, there's a lot. Very good question. Great area. There's a lot, but as somebody mentioned before, some of it is anathema to our American sense of who we are, and I want to protect that because long run, that's what wins.

We do face this enormous imbalance. When a Chinese company, state-controlled, PRC-controlled, CCP-directed, comes to the United States with access to China's treasury and works with U.S. companies, and when they buy Cirrus, they're getting technology to make stealth aircraft, what the FAA calls "technically advanced aircraft." When they buy Continental Motors, and then go and then use Continental Motors to buy Thielert, the German company that used to make engines for our U.S. drones, there is a huge imbalance in intent and resource.

We fundamentally work for capital efficiency. The Chinese companies work for political superiority or strategic superiority, driven by political views in Beijing at the time, and one of the answers to Dr. Atkinson's questions I think has to do with what changed? Leadership changes. When leadership changes in China, anything can change, and to drive home that maybe too much, we have AVIC officials telling us why did they breach our contract? Because the leaders changed, the leadership changed, and when one leader comes in, they completely disregard the commitments that previous leaders had made. That's a problem.

But back to the imbalance, resources, political directive from Beijing versus what we do on our own as essentially a private company, if there's a way to either take those advantages away, like access to China's treasury, or to make sure that in litigation, the U.S. company has access to China's treasury, if the Chinese SOE is accessing China's treasury, so in litigation, if we win, we should have that same access.

So there's, as Americans, we don't want to involve our government, just at our own core sense of who we are, as you've noted earlier, we don't want our government to be that involved with U.S. companies. However, then that leaves you the choice of restricting the access that Chinese companies have.

CHAIRMAN BARTHOLOMEW: That imbalance is really difficult because we have for several decades now gone along staying committed to our principles and seeing any number of small and medium-size enterprises go under because of unfair practices by the Chinese government, and I'll mention in the first panel, of course, we heard about a strategy of driving the value of U.S. companies down.

I just wonder if anybody has looked at the way that U.S. companies cannot grow through acquisitions because they are competing against companies that have access to the deep pockets of the Chinese government, and so I mean what kind of premiums are Chinese companies paying to do these acquisitions that U.S. companies could never compete against in the first place?

Dr. Atkinson, do you know if anybody has looked at that?

DR. ATKINSON: We've only looked at that informally at deals here, deals there, and I'm just going to guesstimate that roughly it seems like a 30 to 40 percent price premium, and if you're the CEO or you're the board of directors, it's really hard to say no to that.

You're sort of between a rock and a hard place, and it's hard for competitors to make the bid that would win in the other case.

CHAIRMAN BARTHOLOMEW: Yeah. I can certainly understand how you can't turn down a 30 to 40 percent premium, but the ability of other U.S. companies to do an acquisition that would allow them to grow is really hampered when that's taking place. And again, I just wondered if anybody was really looking at that?

DR. ATKINSON: I would just offer no other company would want to make a 30, 40 percent--

CHAIRMAN BARTHOLOMEW: Right. Right.

DR. ATKINSON: --price premium because it's not worth 30 to 40 percent--

CHAIRMAN BARTHOLOMEW: Correct. Right.

DR. ATKINSON: --on commercial grounds.

CHAIRMAN BARTHOLOMEW: So it's skewing. It's skewing a lot of things--

DR. ATKINSON: Yes.

CHAIRMAN BARTHOLOMEW: --by them doing that?

DR. ATKINSON: Yeah.

CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Cleveland for a clarification.

HEARING CO-CHAIR CLEVELAND: Mr. Jenevein, when you said it's because leaders change, did you mean leaders of the company or the country or both?

MR. JENEVEIN: In China, it's leaders of, it's political leaders. So Xi Jinping is a very different leader than Hu Jintao. And the leadership changes that start in Beijing filter through the PRC-controlled companies.

HEARING CO-CHAIR CLEVELAND: So that leadership change is why AVIC said their approach changed? Xi Jinping?

MR. JENEVEIN: The AVIC officer that told me that was actually referring to a leadership change within AVIC--

HEARING CO-CHAIR CLEVELAND: That's what I was--

MR. JENEVEIN: --and it was specifically AVIC International, which is a publicly listed, yet PRC-controlled, CCP-directed company. It's publicly listed in Hong Kong.

HEARING CO-CHAIR CLEVELAND: Okay. That's what I was trying to clarify. Thank you.

HEARING CO-CHAIR WESSEL: Senator Goodwin.

COMMISSIONER GOODWIN: Thank you.

Dr. Atkinson, in your written testimony, you very briefly discuss the need to rethink our antitrust regulations to take into account the efforts of Chinese companies worldwide, specifically referencing this NXP acquisition of Freescale Semiconductor, I think an outfit based in Texas, where the Federal Trade Commission forced NXP to divest itself of its RF power business with the result being that this technology and its capabilities went to China.

And as you note, it's somewhat of a disturbing trend that has a historical precedent, going back several decades with forced and compulsory licenses under similar antitrust, anticompetitive reviews. But it occurs to me that it places our antitrust regulators in somewhat of a tough spot and a conundrum when they're presented with a proposed acquisition and a merger that would give the resulting entity 60 percent of the market in what is already, as they said in that case, a highly concentrated global marketplace.

So how would you rethink their approach to assessing those sorts of mergers and what would you do to allow them to take into account Chinese state-sponsored competition while at the same time protecting a vibrant and competitive marketplace?

DR. ATKINSON: Yeah. Well, thank you, Commissioner.

So I think the core problem is that our antitrust bureaus and agencies, they fundamentally don't think about competitiveness. We saw that--I mentioned in my testimony, we gave away, we forced U.S. leading technology companies in the '50s and '60s to license their technology to the Japanese. Essentially that's what we did. We did it with RCA. We did it with Xerox. We did it with a number of technologies because it was this view that more competition was better.

In fact, at one point, the FTC said it was good that the Japanese gained market share in the printer market and the copier market because consumers would do better. And I think we're facing a similar challenge today where we're seeing a country that has no real anti--I mean they have an anti-monopoly law, but it's not what we would call competition policy.

I think we have to recognize in this case we could end up being worse off so the Chinese acquire the power system there, and they become the dominant global monopoly, and there's no anti-monopoly law in China to stop them from doing that, and so U.S. consumers in ten years could be actually much worse off.

So it's not to say by any stretch of the imagination we should just sort of, you know, willy-nilly get rid of competition review, but we should add a component of that review to understand who we're competing against and what the competitive impacts of that might be.

COMMISSIONER GOODWIN: Thank you. That's it.

HEARING CO-CHAIR WESSEL: Senator Dorgan.

COMMISSIONER DORGAN: Mr. Chairman, thank you very much, and again, Mr. Woodall, thank you.

I'd like to ask a specific question about food inspection to the extent that you know it in China. My understanding is that we now eat salmon and some other products that are processed, seafood products that are processed in China, sent to the U.S.

And about a year ago, I saw a New York Times report that they had discovered in China I think it was a thousand tons of frozen pork, beef, and chicken wings that was up to 40 years old, and one other thing--I just pulled it up because I have the report that I've always kept because one of the experts that was quoted by China Daily said when they found this smuggled meat, half a billion dollars' worth, they said, he said as long as frozen meat shows no signs of thawing, consumers can't tell fresh meat from frozen meat that's decades old.

So I'm thinking there might be a different standard there. Can you tell me a bit about what kind of standard exists with respect to food inspection? Because if chicken is going to make a 14,000 mile trip to be processed in China and sent back to American consumers, we have a lot at stake.

MR. WOODALL: So China has revisited its food safety law several times with the crises since basically 2008 with the melamine, and subsequently we believe that the Chinese oversight continues to be inexact, imprecise, haphazard and subject to regulatory capture by the companies, that the entire food industry is rife with real concerns on the food safety side, that there is tremendous interest in pursuing the kind of alignment between the provincial governments to pursue economic output and the companies to cut corners creates very strange disincentives for close oversight.

The story you're referring to is sadly not extremely uncommon, and if you look at the kind of news coverage of Chinese food safety lapses, they are truly horrifying and cover a range of food products and problems that you would never have anticipated.

So currently we export salmon and lots of people export salmon to China where it is flash-frozen at sea, processed or canned in China and shipped back here. We are--we approved the shipment of processed chicken from approved countries that's processed in China. And the inspection rate on--so very little on the meat and poultry side is even approved to come to America from China.

On the FDA side, there are significant problems, and we know that there are significant problems on things like seafood where there are a ton of import alerts. I testified on seafood safety. We have testified here, in Iowa, on food safety, including many of these truly disturbing reports on the kind of conditions in the marketplace.

So this is something we're extremely concerned about. One of the things about the cross-border mergers that troubles us is that we cannot, if it has a U.S. brand on it, consumers are going to have a difficult time knowing, especially if it is a processed food product, knowing whether it is made here under U.S. standards and U.S. oversight or made in China under indifferent standards, nonexistent oversight, and extremely weak--China's own FDA continues to say that it has very weak oversight of a very terrible system. So that's the way it is.

COMMISSIONER DORGAN: Thank you very much. Commissioner Bartholomew did what I should have done and also said thank you to Mr. Jenevein. It's not easy, I'm sure, to come here and do what you have just done today because there is jeopardy, and we appreciate your doing that.

MR. JENEVEIN: Thank you, sir. Appreciate that.

HEARING CO-CHAIR WESSEL: Mr. Woodall, a couple of quick questions if I could. Number one, help me through the GMO seed issue and the repercussions of Syngenta, et cetera, and I am not a farmer.

My understanding is that if a farmer uses a GMO seed, number one, there are some seeds that they must buy again the next year because they don't get any seed that is, in fact, tillable, that will grow new crops the next year, number one, or in a lot of instances where a farmer would have to buy seed because of licensing, et cetera.

The second part certainly bothers me, but less in a national security sense, you know, that China controls all the seed. If we have some kind of confrontation, we just will not worry about paying our licensing fees, and we can grow corn and soy, et cetera. But on those instances where crops won't grow the next year, China's acquisition of these major firms and control of seed has serious repercussions for countries around the globe that they could starve them.

I think you said a country or an army travels on its stomach. You know, if they buy up and control significant amounts of seed stock for critical crops, they can starve all of us. Am I getting that right?

MR. WOODALL: So I think the implication is right, and I think so--

HEARING CO-CHAIR WESSEL: But am I also right about the licensing versus the second generation?

MR. WOODALL: So the patent control issue is true for all GMO seeds. Most of them are really designed to be used for a single season now. Although you can save some seeds, they are generally less productive than new bred seed. So it is, it is true.

I think the real concern is the dominance in the seed market and its ability to make choices about what farmers grow worldwide. These patents are really contracts between the farmer and the seed company that are binding and set standards for how the farmers are going to raise their crops in a situation where most of the seeds that are bought in America come with patents from all the seed companies.

So they cross license their traits with one another and then a Monsanto seed will have a DuPont and a Syngenta trait and a Monsanto trait in it. We're particularly concerned that Syngenta may take the technology and no longer cross-license the traits that it has, potentially making, giving farmers less ability to access those traits, and we're concerned that Syngenta may cross-create traits that are designed to work only with ChemChina agrichemicals and forcing farmers to make a choice to buy, if you buy Syngenta, you have to also buy the ChemChina chemical, which is sort of a tying problem.

And then we're concerned that China, which makes its decisions on whether or not they're going to approve any particular crop, will decide to approve crops grown with Syngenta seeds but not crops grown with other seeds. Right now Syngenta has--I may get this backwards--I think ten percent of the soybean market, six percent of the corn market, but obviously if China opened up the export door solely for Syngenta seeds, their ability to capture more of the U.S. market, I think would definitely go up.

So those are the kind of things we're concerned about from the farmer perspective. I think from the food security perspective, all these things work together, so they have the agrichemicals and the pesticides, they have the seeds, they have the food processing, they have the land, and together this creates lots and lots of kind of food security and ultimately insecurity problems.

HEARING CO-CHAIR WESSEL: Let me ask one other quick question relating to your testimony, and you said although wages were generally higher than the U.S. average at jobs at companies owned by foreign investors, the wages at China-owned employers were a third lower than at average foreign-owned firms. And you based this on--what is it--BEA material.

Is that as a result of you or your colleagues being cleared contractors at BEA or is that publicly available?

MR. WOODALL: It's publicly available. I did basic arithmetic.

[Laughter.]

HEARING CO-CHAIR WESSEL: Okay. Because that's a startling figure that a $30,000 discount, if you will. So thank you for that.

Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: I just got an email from my staff telling me to stop texting and because it appears rude. I want you to know I'm not texting. I was looking up "ractomine"?

HEARING CO-CHAIR WESSEL: Ractopamine.

HEARING CO-CHAIR CLEVELAND: Ractopamine. There are a lot of terms here today that are unfamiliar to me.

HEARING CO-CHAIR WESSEL: And I'm not a farmer.

HEARING CO-CHAIR CLEVELAND: Yeah. And hog prices. So Mr. Atkinson, in your testimony, you say that CFIUS has worked pretty effectively in some areas, especially semiconductors, and then note that a Chinese investor group was able to buy the firm ISSI.

That would suggest that that was something that you think should not have happened, and if so, can you sort of talk through why that one slipped through?

DR. ATKINSON: So I think a couple of things. By the way, just the fact that CFIUS has done a reasonable job in the last year, year-and-a-half, on this doesn't mean they will in the future. So could imagine an administration that would come in and have a more lenient view of all of this.

So I think in that sense we need something that is more rigorous. Perhaps one of the reasons that got--I don't know that deal per se, exactly why and how, but perhaps it was a little earlier in the process and it became clear, it really, in my view, it wasn't quite clear until the Western Digital case came about, and then we saw the big IC fund, really what the end game was.

So it's possible this was just seen as a one-off, and that's the other challenge with CFIUS is they can't really review these things in a systemic way. They have to look at each individual deal, but collectively the puzzle becomes clearer.

One interesting thing, by the way, just on the Western Digital case, I thought was striking. Western Digital had bought Hitachi Digital, which by the way to Senator Goodwin's point, one of my other reasons to think about antitrust on this is we are going to have to beef up our companies to be able to beat their beefed up companies. I just think that's a reality. We're going to need to match scale with scale.

But they bought Western Digital. Western Digital bought Hitachi Digital. It cleared merger review in Europe, Japan, here, except in China, it wasn't approved. And it was costing them millions, hundreds of millions of dollars a year. Less than a week after they wanted to, they tried to acquire ten percent of Western Digital, I think it was MIIT approved the merger.

So very clear what the deal here was. You play ball. You let us buy into your company, and we'll approve these kind--that's the third deal the Chinese have done on technology companies where they approved mergers after acquisitions. So I think, I think that just, again, suggests that we need to be really careful about this essentially what I would call the "technology taking strategy."

HEARING CO-CHAIR CLEVELAND: And in the next paragraph, when you pointed out that CFIUS has worked well on semiconductors, you talk about the charter of CFIUS needing to be updated to allow reviewers to move beyond case-by-case examinations and look at, assess more broadly systemic threats in a broader context.

What prevents them from doing that now, if anything?

DR. ATKINSON: My understanding from talking to some people in the process was that I don't know whether it's a legislative or administrative proc--but there is something in how they operate that has them look deal-by-deal. Again, I don't know whether that's something the President could just change or whether it needs a rewrite of the act. I'm not sure exactly on that.

HEARING CO-CHAIR CLEVELAND: Having been part of the process a long, long time ago, I don't recall that there was any kind of sort of structural reason why you couldn't look at it so it's a good suggestion, and perhaps they can proceed as you suggest.

HEARING CO-CHAIR WESSEL: Commissioner Shea.

VICE CHAIRMAN SHEA: Just a couple quick questions. Mr. Woodall, you mentioned the FDA and a few years ago we looked at this issue of FDA inspectors in China, and there was concern that the numbers, visas were not being issued to FDA inspectors to allow more to come in there, and what is the status of that? What is the FDA's capacity in China? And can they do on-site without-notice inspections of food facilities, food production facilities?

MR. WOODALL: So I think some of the visa access problems have been somewhat resolved. There are more inspectors than there were, but it's still a tiny, tiny number. So they are, I think, they are working with authorities to get into plants, but I don't think they have the authority to do spot inspections on their own.

So it is, and it's a tiny number of inspectors for a huge, the world's biggest food economy. So it would be difficult to imagine that it was sufficient. I think it is headed--it is much better than it was say six or seven years ago. I can get you more specific information on that.

VICE CHAIRMAN SHEA: That would be useful.

MR. WOODALL: Yeah, absolutely.

VICE CHAIRMAN SHEA: And then one thing, Dr. Atkinson, in your testimony, this really struck me, you said: There's no entity analyzing China--in the U.S. government--analyzing China's capacity to absorb knowledge, understand their determination to do something with it, understand the source of their technology, and how determined their foreign technology partners are to help them.

And a glaring example of this is that it took the U.S. government four years to recognize that China had articulated, and then to get it translated into English, the National Medium-and-Long-term Program for Science and Technology Development, the MLP, which was a major Chinese program.

Is this an endemic problem? Do we, is there just a simple lack of translations of key government, Chinese government documents that we need to address?

DR. ATKINSON: No, Commissioner. It goes much, much beyond that. We have formed essentially the executive branch international apparatus in the post-war period really to look at first kind of big military threats and now alternative threats like terrorism.

It really--we just never imagined that one of the threats would be essentially state-directed technology-based mercantilism. So the entire enterprise is not set up in a systemic way to analyze that. There is no body, there is no person, there is no entity, whose responsibility is to analyze how this is playing out and what the effect will be.

What you have are different people in different agencies who occasionally will think about something and ask questions about something, and I won't say the agency, but there was an agency that called us or reached out to us a couple of years ago, and they wanted to know something that was going on in China with regard to some particular technology, and I was amazed that they were asking us.

We were actually able to give them a pretty good answer, but I was struck by the fact that I thought you should--don't you already know that? And I, one of the things that we would recommend would be that there be some body, what we call the White House Industrial Intelligence Council, to be created whose job would be to look at questions about industrial intelligence, not other kinds of, you know, state intelligence.

VICE CHAIRMAN SHEA: Okay. Thank you.

HEARING CO-CHAIR WESSEL: He meant executive branch agencies, not the Commission, of course.

DR. ATKINSON: You could do that, too.

[Laughter.]

VICE CHAIRMAN SHEA: Well, I'm just struck by the lack of translation. I mean I've heard this in a few other circumstances where key documents just simply haven't been translated into English.

HEARING CO-CHAIR WESSEL: Understand.

COMMISSIONER TOBIN: Yes, year after year.

HEARING CO-CHAIR WESSEL: Correct, correct.

DR. ATKINSON: Well, just on that, I've talked to political appointees during the Obama administration who complained that there were certain parts of the long-term strategy where they have specific plans now about the medical device industry and this and that, and there were plans there that we did not know what they said even though they were targeting core technologies.

HEARING CO-CHAIR WESSEL: Commissioner Tobin for the last question.

COMMISSIONER TOBIN: Great. Today, we're focused on foreign direct investment, but as we were speaking throughout the morning on protecting our crown jewels, I couldn't help but think of the United States research universities that often work in tandem with cutting edge businesses, be it energy, food, or high tech.

Could you comment on--each of you briefly--whether there's awareness, whether there are issues that you're hearing from for example the MIT’s, the University of Chicago, or critical research labs, like Brookhaven National Laboratory? I'll be interested to hear what each of you have to say.

MR. JENEVEIN: That's a really important point. I'll talk about one anecdote. We're aware of AVIC going into Oak Ridge National Laboratory to learn 3D printing or additive manufacturing through an acquisition company.

COMMISSIONER TOBIN: Thank you. And would you have a sense, too, on whether or not there is awareness on what is needed?

MR. JENEVEIN: The fact that we're allowing PRC employees essentially to go into ORNL to work on research for 3D manufacturing--

COMMISSIONER TOBIN: Yes.

MR. JENEVEIN: --which is critical to making some of our most important technologies--

COMMISSIONER TOBIN: Right.

MR. JENEVEIN: --concerns many people that I've talked to.

COMMISSIONER TOBIN: I think we'll need to fold this into our thinking. Mr. Woodall?

MR. WOODALL: So a lot of the agricultural and food research is done cooperatively with America's land-grant colleges. So that we know that a certain portion of the Smithfield assets include things like hog genetics and construction and those--that research was taken to China basically. And so there is an interplay where--and because many of the grants are joint between Syngenta and a state university, that technology is developed by both, and these purchases, these cross-border purchases, essentially acquire those publicly-financed research and licensed material which will be taken back to the Chinese-owned company.

So I don't know that there is great knowledge within the research institutions that if they're working with a company that is purchased by--

COMMISSIONER TOBIN: Right.

MR. WOODALL: --an overseas entity, that that is going to go overseas, but I do think that there's broad knowledge within the agricultural community that there's a lot of cooperatively funded public-private investment in agricultural and food research.

COMMISSIONER TOBIN: Thank you.

DR. ATKINSON: So I think this is very similar to the FDI question. When our companies go overseas and they buy other companies, other, the Germans, or the Brits, or whoever comes here and buys ours. We see the same thing in R&D. U.S. companies partner at foreign universities to get access to knowledge and to contribute knowledge. Other countries, the Germans, the Canadians, they partner with our universities.

From a university perspective, they're indifferent to whether it's a German or a Chinese. They're indifferent to what the underlying strategy is, and more importantly, given the fact that federal R&D budgets are down--

COMMISSIONER TOBIN: Right.

DR. ATKINSON: --to the lowest level as a share of a GDP since before Sputnik, our U.S. universities are highly incented now to go to getting any deal they can get.

COMMISSIONER TOBIN: Right.

DR. ATKINSON: And then on top of that, as I said before, there's no, who's telling that story about why this could be a problem? What's the entity in the U.S. government that's telling that narrative and going out and speaking to all the associations of land-grant colleges to say here's what you need to be aware of, and by the way, if you do that, it has these implications? At least we could be talking about it in a more clear and strategic way than we are right now.

COMMISSIONER TOBIN: Thank you. I think we'll want to keep this in mind as we're writing our report.

HEARING CO-CHAIR WESSEL: Thank you for your testimony. Appreciate your being here. We may have some follow-up questions, which we hope you'll be able to help us on. And we will stand in recess until 1:30.

[Whereupon, at 12:32 p.m., the hearing recessed, to reconvene at 1:33 p.m., this same day.]

PANEL III INTRODUCTION BY COMMISSIONER ROBIN CLEVELAND

HEARING CO-CHAIR CLEVELAND: It's 1:30. Welcome. This is our third and final panel today. We will explore the activities of Chinese companies listed on the U.S. stock exchanges and the impact on U.S. investors and the economy at large.

First, we'll hear from Mr. Shaswat Das, Senior Attorney at Hunton & Williams. He's previously worked in various capacities at the U.S. Securities and Exchange Commission, the Federal Reserve and Treasury Department.

Mr. Das also served as an Associate Director at the Public Company Accounting Oversight Board, where he negotiated numerous bilateral agreements with foreign regulators for cross-border audit oversight.

Additionally, he served as the chief negotiator with Chinese regulators on cross-border cooperation and inspections of PCAOB-registered audit firms in China.

Mr. Das holds a J.D. from Northeastern and received his B.A. from the University of Virginia.

We're also joined by Dr. Paul Gillis, a Professor of Practice and Co-Director of their IMBA program at Beijing University's Guanghua School of Management. A certified public accountant from the U.S., Dr. Gillis is a leading expert on accounting and auditing issues in China.

He also runs the popular China Accounting Blog website, which covers accounting and financing news in China. Before joining Beijing University, Dr. Gillis was a partner with PricewaterhouseCoopers in the U.S., Singapore and China for 28 years. You don't look that old.

He was also a member of the Standing Advisory Group for the PCAOB. Dr. Gillis received his Ph.D. at the Macquarie Graduate School of Management in Australia and testified in 2013.

Did you actually testify? Or were you snowed out?

DR. GILLIS: I was snowed out.

HEARING CO-CHAIR CLEVELAND: That's what I thought. When I read this, I thought no, you were someplace. We missed you in 2013. I think we had your testimony on record.

And finally we have Mr. Peter Halesworth, founder and portfolio manager of the Boston asset management firm Heng Ren Partners. Heng Ren focuses on Chinese companies not researched by Wall Street banks, engaging several Chinese companies as an activist investor.

Mr. Halesworth is also the author of the 2016 white paper Chinese "Squeeze Outs" in American Stock Markets and the Need to Protect U.S. Investors. This report assesses the regulatory gaps exploited by foreign issuers on U.S. stock exchanges, implications for investors in American stock markets, and recommendations on how to close those gaps.

Mr. Halesworth received his bachelor's from Vassar.

We're happy the three of you could join us today. So we will ask you to hold your opening remarks to about seven minutes so that we can quiz you.

Thank you. Mr. Das, we'll start with you.

OPENING STATEMENT OF MR. SHASWAT DAS
SENIOR ATTORNEY, HUNTON & WILLIAMS LLP

MR. DAS: Thank you very much. First, I want to say it's an honor to be presenting before this Commission on the very important topic of Chinese investment and listings in the United States.

Before joining private practice, almost a year ago, as was mentioned, I spent five years at the Public Company Accounting Oversight Board, or the PCAOB, in its International Affairs Department and more than 20 years working for financial regulators.

Among other responsibilities at the PCAOB, I served as the organization's chief negotiator with the Chinese regulators on cross-border cooperation and inspections of PCAOB-registered audit firms in China. In this capacity I worked closely with the SEC and U.S. Treasury Department. I should note at the outset that the views I express herein today are my views and do not necessarily reflect the views of my colleagues or firm.

While my written statement provides a history of Chinese listings in the U.S., including outlining what I would say is the precipitous decline in Chinese listings from the period of 2011 to present, today in my remarks I will focus on the current regulatory landscape and some possible recommendations going forward.

First, I would like to address the role that the SEC plays in regulating Chinese companies listed on U.S. exchanges. I know this question was posed this morning. I think this is probably the appropriate panel to address that issue.

The SEC requires Chinese companies seeking to list in the U.S. to include risk disclosures in their filings where either their primary auditor or an auditor of a substantial portion of their financial statements has not been inspected by the PCAOB. That said, the SEC does not evaluate or otherwise opine on a company's quality during the IPO review process. The operational risk of a company does not necessarily move in lockstep with the static indicators such as financial data.

As noted in a speech that SEC Chair White gave last fall before the International Bar Association, she stressed the importance of cross-border regulatory cooperation. Chair White commented that the SEC has over 75 formal cooperative arrangements with foreign regulators and law enforcement agencies and is a signatory to the IOSCO Multilateral Memorandum of Understanding on enforcement cooperation, to which there are now over 100 signatories.

All of these arrangements facilitate sharing critical enforcement and supervisory information. And the SEC and other countries make extensive use of them--most recently entering into an agreement providing for enforcement cooperation with the Hong Kong securities regulator just last week.

While the SEC and DOJ are increasingly working with their foreign counterparts in such areas as FCPA enforcement to accounting fraud, U.S. regulators and law enforcement agencies must contend with foreign privacy and data protection laws that complicate cross-border data transfers.

Various country laws, including blocking statutes, privacy, bank secrecy, state secrecy laws, are designed to advance important national objectives but may create barriers to cross-border flows of information between regulators and foreign-domiciled registrants.

Having served as the PCAOB's chief negotiator at the staff level with the Chinese regulators, I know firsthand the challenge the PCAOB faces with respect to the ongoing impasse between the PCAOB and the Chinese regulators on an agreement that would facilitate inspections of audit firms in mainland China.

The Ministry of Finance, the Chinese Regulatory Commission, and China Institute of Certified Public Accountants all have oversight responsibilities over the accounting profession in China.

They conduct inspections of audit firms by examining firms' quality control procedures as well as inspecting their engagement audit work papers. Administrative penalties are the most common sanctions imposed in China.

While I led the PCAOB negotiations for a number of years, which resulted in an agreement on enforcement cooperation in 2013, negotiations on an agreement providing for cross-border inspections stalled at the end of 2015 due to a dispute regarding the issuer audits that would be inspected by the PCAOB. We sought to inspect the audits of Alibaba and Baidu, but the Chinese securities regulator and Ministry of Finance indicated that further approvals were needed from other relevant ministries before that could be conducted.

This past year and after almost a decade of negotiations, the PCAOB has been largely silent on the progress of its negotiations with the Chinese regulators, only commenting that they continue to work on reaching an agreement.

One report suggested that the PCAOB inspectors obtained access to audit work papers of Baidu during the summer of 2016, but that its review was hampered by the lack of access to firm personnel and extensive redactions such that the PCAOB could not conduct a meaningful inspection.

Last year, two PCAOB-registered firms based in Hong Kong had their registrations revoked for violations of PCAOB audit standards and failure to cooperate with PCAOB investigations.

This gap in the PCAOB's inspection program exposes not only U.S. investors to uncertainty regarding the quality of the audits being performed in China but also U.S. companies with growing subsidiary and joint venture activity in China.

Until the PCAOB satisfactorily resolves the Chinese inspection issue, U.S. investors and companies face uncertainty regarding the quality of the audits being conducted on the financial statements of Chinese issuers listed on U.S. exchanges.

Recently the PCAOB staff issued guidance regarding the obligations of audit firms located outside of mainland China that audit China-based issuers on U.S. exchanges. Effectively, this guidance instructs PCAOB-registered audit firms to disregard, arguably violate, Chinese law governing foreign regulatory access to audit work papers, ignoring long-standing principles of international comity.

It will be interesting to see whether this staff guidance is enforced by the PCAOB and how the PCAOB will address such conflict of law concerns. To date, this particular issue has not been litigated in a U.S. federal court.

In addition to sovereignty concerns, another obstacle, though not insurmountable, confronting U.S. regulators is the issue of state secrets. State secrecy laws in China are well-known for their vague language and lack of clarification. State secrets broadly can be defined as encompassing those matters involving state security and national interests.

In 2009, the securities regulator issued an agency rule jointly with the State Secrecy Bureau, commonly referred to as a Notice 29. The rule addresses the obligations of accounting firms with respect to the transfer of audit work papers and effectively provides that audit work papers can be transmitted outside of China to foreign regulators with the approval of the relevant Chinese authorities.

The rule concludes by reminding accounting firms of the liabilities, including criminal consequences, they may incur if they violate the rule. However, Notice 29 contemplates that with the approval of the competent authorities, information that is not legitimately deemed a state secret can be disclosed to foreign regulators.

I believe that the current laws available to U.S. law enforcement and regulators are sufficient. Before 2002 and the passage of the Sarbanes-Oxley Act, the SEC did not have meaningful enforcement tools.

Section 106 of the Sarbanes-Oxley Act increased the authority of the SEC and the PCAOB to compel the production of audit work papers of foreign accounting firms by making such firms subject to the jurisdiction of U.S. courts for purposes of enforcement and requiring U.S. registered public accounting firms to secure the agreement of any foreign accounting firm upon which it relies in its audit to produce the work papers of that firm.

The Act also permits foreign public accounting firms to produce work papers through alternative means such as through foreign securities regulators.

HEARING CO-CHAIR WESSEL: Mr. Das, if you could summarize and finish up, please.

MR. DAS: Okay. Let me just move on a little bit here. I think this Commission is well aware of this conflict and long-standing issue. The most formidable issue I think in front of U.S. regulators is the one of conflicting laws between the U.S. and foreign jurisdictions.

I'll move ahead and offer a few recommendations. With regard to the agreements that the SEC has signed with the Chinese regulators and other foreign counterparts, as well as the 22 some agreements that PCAOB has entered into with its foreign counterparts, there needs to be a regulatory framework that provides transparency and protects investors, a professional services environment that provides effective quality control for listings, and an investor base with knowledge and capabilities to understand their businesses properly.

An equity market is really more than just an exchange. Investors rely on a broad interactive system of professional advisors, equity analysts, brokers, and regulators who perform quality control on the companies that list there.

Neither the PCAOB nor the SEC has published information pertaining to the risks posed by Chinese listings since 2011. To my knowledge, the U.S. Office of Financial Research has yet to conduct a study addressing this topic.

Also gaps in regulatory supervision, as I've highlighted throughout my remarks, must be resolved. The PCAOB, in particular, should redouble its efforts to reach an agreement with its foreign counterparts in China and offer more transparency regarding the prospects of doing so than they have exhibited in the last year.

The PCAOB could consider partnering with the Chinese regulators in conducting its inspections so long as it can issue an independent inspection report or a joint report that reflects the views of both regulators or that is the product of a collaborative dialogue. Some creativity is very much required here.

Just a few more recommendations, and I will wrap up. China implements a system of "prudential oversight" over its markets rather than practicing "capital market oversight." This regulatory approach in China has been a fundamental problem causing instability within the Chinese capital markets. Regulators and governments will keep listed companies afloat in China to ensure investor protection so there's little incentive for investors to focus on listed companies' governance, transparency, and management performance.

U.S. regulators should initiate further education of their counterparts in China on capital market principles and oversight and how those principles differ from prudential oversight.

In addition, the National Development and Reform Commission is a powerful agency that is in charge of reforms throughout central and local governments in China and includes within its remit capital market reform, cross-border cooperation, and economic reform. Finding and establishing a channel to the National Development and Reform Commission should be a high priority.

Finally, I would say, having worked at the Treasury Department and at the PCAOB, I have participated in a number of the U.S.-China Strategic and Economic Dialogues, which as I think everyone here recognizes is the premier bilateral dialogue on financial and economic and trade issues. Often what we see that comes out of those dialogues is a list of outcomes, very broadly and vaguely written. I would suggest that there needs to be more accountability, and after each of these dialogues, there need to be more concrete action items that both parties need to take before the next dialogue.

With that, I will turn it over.

PREPARED STATEMENT OF MR. SHASWAT DAS
SENIOR ATTORNEY, HUNTON & WILLIAMS LLP

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

Shaswat Das

Senior Attorney

Hunton & Williams LLP

Introduction

My name is Shas Das and it is an honor to be presenting before this commission on the important topic of Chinese investment in the U.S. Before joining private practice almost a year ago, I spent five years at the PCAOB in its international affairs department and more than 20 years working for financial regulators. Among other responsibilities at the PCAOB, I served as the organization's chief negotiator with the Chinese regulators on cross-border cooperation and inspections of PCAOB-registered audit firms based in China. In this capacity, I worked closely with the SEC and U.S. Treasury Department. I should note at the outset that the views expressed herein are my views and do not necessarily reflect the views of my colleagues or firm.

Chinese listings in the U.S. and risks posed

Before addressing the current landscape and some possible recommendations for the Commission's consideration, I think it's worth recounting some of the history of Chinese listings in the U.S. When Chinese companies began to first list in the United States, they generally came in three waves between 1990 and 2010.[1] The first listings occurred in the 1990s after privatization and at the direction of Chinese regulators, who recognized that the largest and most prestigious Chinese companies would benefit from the capital and governance standards that an embryonic domestic market in China could not offer.[2] The hope was that listing in Hong Kong or New York would enable Chinese companies to transition from government controlled entities into fully functional corporations that had boards, and imposed U.S.-style corporate governance standards. With its robust

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[1] How they fell: The collapse of Chinese cross-border listings, December 2013, McKinsey & Company, December 2013.

[2] Today, the Shanghai and Shenzhen stock exchanges are the world's third- and fifth-largest stock exchanges, respectively, based on domestic market capitalization. Both were established in 1990 as part the Chinese government's effort to move toward a market-based economy. Only domestic Chinese firms are listed on these exchanges. Foreign ownership of Chinese equities is relatively small and strictly regulated.

governance standards, New York was a highly sought after listing destination.

The second wave of listings included more state-owned enterprises, as well as an increasing number of private companies, many from China's growing technology sector, including Baidu. These companies viewed the U.S. capital markets as offering the best environment for their needs, given their concentration of analysts and experience with technology listings. Combined, these first two waves comprised around 100 companies with an average market capitalization of $24 billion as of 2013, representing 48 percent of the total value of Chinese companies listed in New York.

The third wave of listings was larger by number—around 500 companies—though the companies themselves were much smaller, with an average market cap of less than $5 billion. Unable to compete for capital in the domestic stock markets with the larger private and state-owned enterprises, many of them sought to list instead in New York where they found ready access to U.S. capital markets and investors who had developed a considerable appetite for U.S.-listed Chinese companies and the China growth story.

The New York Stock Exchange maintained the prestige and brand that had attracted the first wave of listings, with a ready infrastructure in place to support these IPOs. Most major U.S. law firms and investment banks had a presence in China, as did a group of smaller advisory firms specializing in reverse-merger listings, where an unlisted company acquires a shell that is already listed and registered with the U.S. SEC, bypassing the more rigorous scrutiny of a standard IPO. These tended to be much smaller in size: as the crisis hit, companies listed by reverse merger had an average market capitalization of only $68 million and represented less than 1 percent of total market capitalization of all New York–listed Chinese companies.

By early 2011, a series of scandals had developed around companies from the latest wave of listings. Many involved fraud with features that presented particular problems for investors. Many involved misrepresentations in financial reporting that would have been missed by a standard audit. Many involved falsification of the underlying documents on which audits relied, particularly commercial banks' transaction records. This could be detected by a forensic audit or due diligence, which are typically only conducted by exception. Many of the scandals involved companies that had listed by reverse merger. By June 2011, the SEC had issued an investor bulletin discussing the risks of reverse mergers[3] and about two dozen companies had been hit with SEC fraud or financial reporting charges. Some of the investigations stalled because the companies' audit papers are located in China – beyond the SEC's reach.

The Chinese reverse merger fraud crisis resulted in more than 100 U.S. listed Chinese companies that were either delisted or halted from trading in 2011 and 2012 based on claims of fraud and other violations of U.S. securities laws, including the failure to file timely financial reports. A number of others were the target of short

[3] See Investor Bulletin: Reverse Mergers, U.S. Securities and Exchange Commission, June 9, 2011, https://www.sec.gov/news/press/2011/2011-123.htm

sellers and changed auditors more than once in some cases. These companies took advantage of a legal regime in the U.S. so they could merge with American shell companies. By doing so, they eluded much of the SEC oversight that comes from selling shares on U.S. markets for the first time accompanied by an IPO subject to SEC registration requirements.[4]

In a speech given by PCAOB Board member Lew Ferguson in 2012, he noted that "[b]illions of dollars of market capitalization of such companies have been lost in U.S. securities markets and it is fair to say that all of these smaller China-based companies listed on U.S. securities exchanges have suffered serious losses of both market value and investor confidence as a result of the problems of other companies."[5] U.S. shareholders face major risks from the complexity and purpose of the VIE structure. For example, the legal contracts that serve as the basis of the structure are enforceable only in China, where rule of law remains elusive. Though listing VIEs on U.S. exchanges is legal in the U.S., they can be considered illegal in China. Internet giants Alibaba, Baidu, and Tencent all listed via the VIE structure.

In response to this crisis, in 2011, the SEC required the major stock exchanges in the U.S. to impose rules making it harder for companies going public to use reverse mergers to qualify for listings on their exchanges. Among those new standards that were implemented by the SEC was a requirement that reverse merger companies, before applying for a listing on the NASDAQ, NYSE, or AMEX, complete a one year "seasoning period" by trading on an over the counter market or another U.S. or foreign exchange and maintain a minimum, requisite share price for a sustained period for at least 30-60 days prior to listing.[6]

In total today, as of January 2017, there are approximately 136 China-based companies listed on the NASDAQ, NYSE, and AMEX exchanges. Out of the 136 companies, 91 are in the form of American Depositary Receipts,[7] with the remaining in the form of ordinary shares and listed through reverse merger transactions.

Role the SEC plays in regulating Chinese companies listed on U.S. stock exchanges

The SEC requires companies to include risk disclosures in their filings of Chinese companies seeking to list in the U.S. that either their primary auditor or an auditor of a substantial portion of their financial statements has not been inspected by the PCAOB. That said, the SEC does not evaluate or otherwise opine on a company's quality through an IPO review. The operational risk of a company does not necessarily move in lock step with static indicators like financial data.

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[4] While the public shell company is required to report the reverse merger in a Form 8-K filing with the SEC, there are no registration requirements under the Securities Act of 1933 as there would be for an IPO.
[5] Investor Protection through Audit Oversight, Sept. 21, 2002, https://pcaobus.org/News/Speech/Pages/09212012_FergusonCalState.aspx
[6] SEC approves New Rules to Toughen Listing Standards for Reverse Merger Companies, November 9, 2011 https://www.**sec**.gov/news/press/2011/2011-235.htm
[7] ADRs are securities that trade in the United States but represent a specified number of shares in a foreign corporation. ADRs are bought and sold on American markets just like regular stocks and are issued/sponsored in the U.S. by a bank or brokerage

- As noted in a speech that SEC Chair White gave last fall before the International Bar Association, she stressed the importance of cross-border regulatory cooperation.[8] She noted that the SEC has over seventy five formal cooperative arrangements with foreign regulators and law enforcement agencies and is a signatory to the IOSCO Multilateral Memorandum of Understanding on enforcement cooperation, to which there are now over 100 signatories. All of these arrangements facilitate sharing critical enforcement and supervisory information. And the SEC and other countries make extensive use of them – most recently entering into an agreement providing for enforcement cooperation with the Hong Kong securities regulator last week.[9]
- While the SEC and DOJ are increasingly working with their foreign counterparts in such areas as FCPA enforcement to accounting fraud, U.S. regulators and law enforcement agencies must contend with foreign privacy and data protection laws that complicate cross-border data transfers.[10] Various country laws, including blocking statutes, privacy, bank secrecy, and state secrecy laws are designed to advance important national objective but may create barriers to cross-border flows of information between regulators and foreign domiciled registrants.

Status of the Public Company Accounting Oversight Board's negotiations with its Chinese counterparts

- Having served as the PCAOB's chief negotiator at the staff level with the Chinese regulators, I know first-hand the challenges the PCAOB faces with respect to the ongoing impasse between the PCAOB and the Chinese regulators on an agreement that would facilitate PCAOB inspections of audit firms based in China. The Ministry of Finance, China Securities and Regulatory Commission, and China Institute of Certified Public Accountants all have oversight responsibilities over the accounting profession. They conduct inspections of audit firms by examining firms' quality control procedures as well as inspect the engagement audit work papers. Administrative penalties are the most common sanctions in China.
- While I led the PCAOB negotiations for a number of years, which resulted in an agreement on enforcement cooperation in 2013, negotiations on an agreement providing for cross-border inspections stalled at the end of 2015 due to a dispute regarding the issuer audits that would be inspected by the PCAOB. We sought to inspect Alibaba and Baidu but the Chinese securities regulator and Ministry of Finance indicated that approvals from other relevant ministries needed to be obtained before the PCAOB could gain access to the audit work papers of those companies; at the time, the Chinese authorities were amenable to the PCAOB inspecting issuer audits that posed less concern or in other words were deemed to be less sensitive from a national security or technological standpoint. This past year, and after almost a decade of negotiations, the PCAOB has been largely

[8] Securities Regulation in the Interconnected, Global Marketplace, September 21, 2016, International Bar Association.
[9] SEC Establishes Supervisory Cooperation Arrangement with Hong Kong SFC, available at https://www.sec.gov/news/pressrelease/2017-26.html
[10] As the SEC broadens international enforcement focus, compliance efforts must adapt, January 18, 2017, Compliance Week.

silent on the progress of its discussions with the Chinese regulators, only commenting that they continue to work on reaching an agreement. One report suggested that PCAOB inspectors obtained access to audit work papers of Baidu during the summer of 2016 but that it's review was hampered by the lack of access to firm personnel and extensive redactions such that the PCAOB could not conduct a meaningful inspection.[11] Last year, two PCAOB-registered firms based in Hong Kong had their registrations revoked for violations of PCAOB audit standards and failure to cooperate with PCAOB investigations.[12]

This gap in the PCAOB's inspection program exposes not only U.S. investors to uncertainty regarding the quality of the audits being performed in China, but also U.S. companies with growing subsidiary and joint venture activity in China. Until the PCAOB satisfactorily resolves the Chinese inspection issue, U.S. investors and companies face uncertainty regarding the quality of the audits being conducted on the financial statements of Chinese issuers listed on U.S. exchanges. The PCAOB should redouble its efforts to reach an agreement with the relevant Chinese authorities on cross-border inspections. Recently, the PCAOB issued staff guidance regarding the obligations of audit firms located outside of mainland China that audit China-based issuers listed on U.S. exchanges. Effectively, this guidance instructs PCAOB-registered audit firms to disregard – arguably violate – Chinese law governing foreign regulatory access to audit work papers, ignoring long-standing principles of international comity.[13] It will be interesting to see whether this staff guidance is enforced by the PCAOB and how the PCAOB will address such conflict of law concerns. To date, this particular issue has not been litigated in a U.S. federal court.[14]

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[11] Pilot Inspection Begins for EY's Chinese Affiliate, Thompson Reuters, August 4, 2016.

[12] PCAOB Sanctions Hong Kong Audit Firm and Three Individuals For Failing to Cooperate with Board Investigation, available at https://pcaobus.org/News/Releases/Pages/PKF-Hong-Kong-enforcement-1-13-16.aspx; PCAOB Sanctions Hong Kong Audit Firm, its New York Affiliate, and Four Individuals, available at https://pcaobus.org/News/Releases/Pages/PCAOB-sanctions-hong-kong-audit-firm-new-york-affiliate-four-individuals.aspx.

[13] See **Staff** Questions and Answers – Audits of Mainland **China** Issuers by Registered Firms Outside of Mainland **China.** The Q&A responds to the circular entitled *Notice of the Ministry of Finance on* Issuing the *Interim Provisions on Auditing Operations Conducted by Accounting Firms Concerning the Overseas Listing of Domestic Chinese Companies* (see attached) issued by China's Ministry of Finance (the "MOF Rule"), which applies to audits of U.S. listed Chinese companies by overseas accounting firms. The MOF Rule includes provisions related to the conduct of auditors based outside of mainland China that perform audit work in mainland China. In particular, Article 12 of the Interim Provisions stipulates that where the listing of a mainland company becomes the subject of legal action or other matter and an overseas judicial or regulatory authority requires access to the audit working papers relating to that company, or where an overseas regulatory authority requires access to the audit working papers for a mainland company, access should be sought in accordance with the relevant supervision agreement entered into between the regulatory authorities of Mainland China and the relevant overseas jurisdiction. Notwithstanding and in spite of this regulation/directive, and in the absence of such a supervision agreement, the PCAOB Q&A provides that registered auditors must make working papers accessible to the PCAOB upon demand in accordance with Section 106 of the Sarbanes-Oxley Act. Violation of the pertinent provisions of the Sarbanes-Oxley Act may result in the deregistration of the audit firm; it could also result in the ban from auditing the financial statements of any companies with China operations, either directly or indirectly through subsidiaries, that are listed or plan to list in the U.S., effectively cutting off Chinese companies, e.g., Alibaba, from the U.S. capital markets. In addition to smaller audit firms in the U.S. and elsewhere (outside of mainland China), this guidance potentially affects all Fortune 500 U.S. public companies that have operations in China.

[14] The principles of international comity have been historically applied by U.S. courts whenever it has been determined

In addition to sovereignty concerns, one obstacle, though not insurmountable, confronting U.S. regulators is the issue of state secrets. State secrecy laws in China are well known for their vague language and lack of clarification; state secrets broadly can be defined as encompassing those matters involving state security and national interests. Although the relevant statute goes on to provide a list of major state secret matters, which includes "activities related to foreign countries" and "national economic and social development," there is a catch-all provision that authorizes agencies administering the protection of state secrets to identify matters not listed in the statute as state secrets. Under the implementing regulation, the State Secrecy Bureau is responsible for designing national policy on protection of state secrets, while central government agencies may separately or jointly with the State Secrecy Bureau identify matters that are "within their respective administrative areas" as state secrets.

The CSRC followed through in 2009 when it issued an agency rule jointly with the State Secrecy Bureau – commonly referred to as Notice 29.[15] The rule creates two obligations for accounting firms with respect to transfer of audit work papers. First, audit work papers that "involve any state secrets" cannot be transmitted outside China without the approval of "relevant in-charge authorities." Second, accounting firms must report "any matter involving state secrets" to "in-charge authorities . . . for approval" when "overseas securities regulatory authorities . . . propose to conduct offsite inspection." The rule concludes by reminding accounting firms of the liabilities, including criminal ones, they may incur if they violate the rule. However, Notice 29 expressly contemplates that, with the approval of the competent authorities, information that is not legitimately a state secret can be disclosed to foreign regulators.

Effectiveness of the tools and resources available to U.S. law enforcement and other relevant agencies for addressing fraud by Chinese companies listed in the United States

I believe that the current laws available to U.S. law enforcement and regulators are

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that there if a conflict between enforcing an obligation under U.S. law to produce evidence or other documentation from a foreign jurisdiction when such obligation conflicts with the laws of that jurisdiction. For example, the U.S. Second Circuit Court of Appeals, In re Vitamin C Litigation, 13-4791-cv (2nd Cir., September 20, 2016) vacated a $147 million judgment and injunctive relief by the federal district court, ruling that Chinese vitamin C sellers were not liable for violating US antitrust law because they were compelled by the Chinese government to set prices and reduce quantities for the vitamin. The Chinese government filed a formal statement, indicating that Chinese law required the companies, Hebei Welcome Pharmaceutical and North China Pharmaceutical Group, to set prices and lower quantities of vitamin C sold abroad. The court ruled that, because the companies "could not simultaneously comply with Chinese law and U.S. antitrust laws, the principles of international comity required the district court to abstain from exercising jurisdiction in this case." The court further ruled that the lower court should have abstained from exercising jurisdiction on comity grounds because "there is a true conflict between U.S. law and Chinese law in this case" and articulated the following position with regard to the degree of deference that should be afforded to a foreign nation's interpretation of its own laws: "[w]e reaffirm the principle that when a foreign government, acting through counsel or otherwise, directly participates in U.S. court proceedings by providing a sworn evidentiary proffer regarding the construction and effect of its laws and regulations, which is reasonable under the circumstances presented, a U.S. court is bound to defer to those statements." The court noted that a contrary ruling "disregards and unravels the tradition of according respect to a foreign government's explication of its own laws, the same respect and treatment that we would expect our government to receive in comparable matters before a foreign court." The court also noted that "[t]he official statements of the Ministry should be credited and accorded deference."

[15] Provisions on Strengthening Confidentiality and Archives Administration in Overseas Issuance and Listing of Securities (promulgated by the China Sec. Regulatory Commission, State Secrecy Bureau, and State Archives Admin., Oct. 20, 2009) (China) (hereinafter Notice or Circular 29).

sufficient. Before 2002 and the passage of the Sarbanes-Oxley Act, the SEC did not have meaningful enforcement tools. Section 106 of the Sarbanes-Oxley Act increased the authority of the SEC and the PCAOB to compel the production to them of audit work papers of foreign private accounting firms by making such firms subject to the jurisdiction of U.S. courts for purposes of enforcement, requiring U.S. registered public accounting firms to secure the agreement of any foreign accounting firm upon which it relies in its audit to produce the work papers of that firm. The Act permits a foreign public accounting firm to produce work papers through alternate means, such as through foreign securities regulators.

The most formidable legal obstacle is conflicting non-U.S. laws. A foreign jurisdiction may restrict or even prohibit the transfer of certain audit work papers out of the jurisdiction with various civil or criminal liabilities that will attach if an accounting firm violates the restriction or prohibition. Foreign accounting firms can contest an SEC subpoena or document request, that complying with the request or subpoena will force them to violate a foreign law.

Over the years, the SEC has signed enforcement Memoranda of Understanding ("MOUs") with more than 75 foreign counterparts and through these MOUs the SEC sends out over 600 requests annually for assistance to foreign regulators. Though empirical evidence of the MOUs' effectiveness is lacking, the fact that the SEC continues to promote such MOUs and that such requests typically are not denied serves as testimony to their success. Indeed, on its website, the SEC has listed notable enforcement cases that are the fruits of assistance provided by foreign regulators. One of the underpinnings of such MOUs is the SEC's respect for foreign sovereignty. In virtually all enforcement MOUs, including the multilateral IOSCO MOU signed by most signatories, there is a clause that permits a foreign regulator to deny an assistance request if it would require the foreign regulator to "act in a manner that would violate the laws of the [foreign country]" or if accommodating the request would be contrary to the foreign country's "public interest" or "national security." PCAOB agreements with foreign audit regulators contain similar language.

Recommendations

For such listings to work there needs to be a regulatory framework that provides transparency and protects investors, a professional-services environment that provides effective quality control for listings, and an investor base with the knowledge and capabilities to understand the businesses properly. If regulators and investors are serious about avoiding similar crises in the future—involving companies from China or elsewhere—there are several lessons to learn.

An equity market is more than just an exchange. Investors rely on a broad, interactive system of professional advisers, equity analysts, brokers, and regulators who perform quality control on the companies that list there. The dangers come when the system takes on issues that it is not prepared to evaluate. In the major global equity markets, investors take the high standards of this ecosystem for granted, when in fact relying on audited financials and company representations alone is insufficient in many markets.

The companies involved in this case happened to be Chinese, but the elements that led to fraud there are visible in many other emerging markets, as well as in some developed ones. The lack of quality control is especially concerning with regard to companies originally listed by reverse merger, since this route to market continues to be used. Indeed, on U.S. exchanges, there have been nearly as many reverse mergers per year involving non-Chinese companies after 2011 as in the preceding five years. Investors need to be aware of the shortcomings of reporting and find ways to fill the gaps, such as through analysts doing investigative diligence, academic research, or even the regulatory bodies themselves. The last research or advisory that the PCAOB or SEC for that matter published in this area was 2011; to my knowledge, the U.S. Office of Financial Research has yet to conduct a study regarding the risks posed by Chinese listings in the U.S.

Gaps in regulatory supervision must be closed. The SEC and PCAOB don't face a problem just with Chinese audit firms but potentially with any audit firm outside its regulatory purview. And the SEC is not the only regulatory agency facing this problem, since every other major capital market could face the same experience, particularly given the growing competition among stock exchanges. The PCAOB in particular should redouble its efforts to reach an agreement with its foreign counterparts in China and offer more transparency regarding the prospects of doing so than they have shown in the last year. The PCAOB could consider partnering with the Chinese regulators in conducting its inspections so long as it can issue an independent inspection report (or joint report that reflects the views of both regulators). Some creativity is required here.

Cross-border listings play an increasingly important and valuable role for companies and investors in an ever changing global economy—and they promote the mobility of capital, competition between exchanges, and greater strategic flexibility for companies. As of 2015, U.S. investors held nearly $9.6 trillion in foreign securities and foreign holdings of U.S. securities were over $17.1 trillion.[16] The cornerstone of federal securities law is disclosure and the SEC can amend Regulation S-K[17] to require issuers to disclose the fact that foreign accounting firms performing audit work for the issuer may, under certain circumstances, be unable to comply with an SEC Section 106 request due to conflicting non-U.S. laws. Of course, the disclosure should be sufficiently detailed, and should include, but not be limited to, a description of the pertinent foreign laws at issue so that U.S. investors can appreciate the significance of the conflicts.

Companies and/or audit firms themselves may also address this issue through their own risk management procedures. Once an issuer is aware of an increased risk, like the lack of a PCAOB inspected audit firm, it may be prudent to implement compensating controls to the extent feasible. A company or audit firm that is

[16] *See Securities (c): Annual Cross-U.S. Border Portfolio Holdings*, Report of the Department of the Treasury, *available at* https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx#usclaims.
[17] Regulation S-K, 17 C.F.R. pt. 229 (2014) (covering the form and content of, and requirements for, non-financial statements information under the federal securities law).

aware that all or a portion of an audit is being conducted by a firm that has not been inspected should consider implementing additional procedures and/or controls over that portion of the financial statement or audit in order to address this increased risk.

Other recommendations.

- China implements “prudential oversight” over its markets rather than practicing “capital market oversight”. This regulatory approach in China has been the fundamental problem causing instability within the Chinese capital markets. Regulators and governments will keep the listed companies afloat to ensure investor protection, so there is little incentive for investors to focus on listed companies’ governance, transparency, and management performance. U.S. regulators should initiate further education of their counterparts on capital market oversight versus prudential oversight including the general principles of each oversight framework, differences, and intended results, and why each may not work if applied incorrectly.

- The National Development and Reform Commission is a powerful agency that is in charge of reforms throughout all the central and local government in China, including capital market reform, cross-border cooperation and economic reform. Finding and establishing a channel to the National Development and Reform Commission should be a high priority.

Thank you again for the opportunity to appear before you here today, along with a distinguished group of panelists.

OPENING STATEMENT OF DR. PAUL GILLIS
PROFESSOR OF PRACTICE, GUANGHUA SCHOOL OF MANAGEMENT, PEKING UNIVERSITY

DR. GILLIS: Thank you. I'd like to thank the commissioners for the opportunity to testify before you today.

China has made major use of U.S. capital markets, often to the disadvantage of U.S. investors. Initially, Zhu Rongji, the former Premier of China, used U.S. capital markets to help reform, restructure and reform SOEs, state-owned enterprises, in order to prepare them for the challenges that they were going to face following WTO.

And 12 major SOEs are listed on the U.S. stock exchange, the New York Stock Exchange. The last listing of a major SOE was in 2003. That was China Life, which immediately ran into accounting problems that apparently discouraged China from listing any more SOEs in the United States.

The second group is private companies like Alibaba and Baidu. These companies use offshore holding companies and a VIE structure in large part to get around Chinese regulation that would restrict their overseas offerings. Those offshore holding companies and VIE structures create risks that we'll be discussing some today.

There's 135 of these companies on NASDAQ and New York Stock Exchange today, down from over 200 a few years ago, due to privatization that the next panelist, Peter Halesworth, will be discussing.

A major attraction for the U.S. markets for these companies is relaxed rules in the U.S. on control structures. These companies like to follow a structure which keeps the founders in control of the company even while they sell down a majority of the interest in the company, a structure that was widely adopted in U.S. technology companies after Steve Jobs got thrown out of Apple by his board and the same structure is now used by most of the Chinese companies.

The third group of companies is reverse mergers. A reverse merger is a situation where a company that has a public registration in the United States that has gone dormant merges with a Chinese company, a larger Chinese company, the shareholders of the Chinese company go in control, and then they try to uplist those companies to one of the major exchanges.

These, that structure was preferred because it requires much less due diligence and is a much easier process than doing an initial public offering in the United States.

In 2011, the exchanges with the support of the SEC cracked down on reverse mergers requiring them to go through a seasoning period before they could upgrade to a listing on a major exchange, and they have largely disappeared from the picture. At one point there were over 500 of these companies listed.

Many of them have gone dark, meaning they've stopped communicating with the SEC and with shareholders, wiping out the shareholders. Those that remain are traded thinly, if at all, on the over-the-counter markets.

Fraud has been a pervasive problem with listings of Chinese companies in the United States. And short sellers have outed many of these frauds. There have been 199 attacks against overseas listed Chinese companies by short sellers.

The fraud triangle, which is used to explain the conditions necessary to have fraud, said you have to have need, opportunity, and justification in order to commit fraud. And these companies obviously had the opportunity to commit fraud. The justification often came because many Chinese feel that America is trying to hold them down, and that was enough justification for them to feel that they could rip off U.S. shareholders.

Now if you do set out to commit a fraud, to commit a crime, probably the best place to do it is in a place that doesn't have any cops. And it turned out that U.S. markets were a place with no cops. There are two regulators that have a primary role with respect to Chinese listings in the United States. One is the Securities and Exchange Commission. The other, the Public Company Accounting Oversight Board.

The SEC has been challenged to get documents out of China and to get access to people in China that might have committed securities fraud.

The Public Company Accounting Oversight Board has three roles: it sets the rules for how companies ought to be audited; it inspects firms to make sure that they have followed those rules; and then it enforces the rules against those who don't follow the rules.

Auditors are really the primary means of defense for investors to make certain that they're getting adequate information on companies.

The Sarbanes-Oxley set up the Public Accounting Oversight Board and commanded that they do inspections of all accounting firms, including overseas accounting firms, including those accounting firms in China, and there are about 50 in China and 50 in Hong Kong that do audits of U.S. listed Chinese companies.

China, however, rapidly, quickly blocked the SEC from doing inspections in China, arguing that to allow such inspections might result in the disclosure of state secrets, and it also would impinge upon China's national sovereignty.

China instead has insisted that the SEC or the PCAOB offer regulatory equivalency. That is to accept the work of the Chinese regulators as if it were its own. The European Union has accepted regulatory equivalency with respect to audits of Chinese companies, but the PCAOB has been unwilling to reach that.

My recommendations are that the law, that being Sarbanes-Oxley, ought to be amended to go one of two ways. Either to allow for regulatory equivalency and to get the Chinese to agree on a process that would allow the U.S. to inspect the inspectors to make sure that the Chinese actually do what they're required to do. I'm skeptical that the Chinese have much interest in inspecting overseas listed Chinese companies.

Or, alternatively, they could terminate the registration of accounting firms that they're unable to inspect. Now this option has been available since the inception of this. The PCAOB has been unwilling to terminate the registration of accounting firms it cannot inspect. It now will no longer register accounting firms that it cannot inspect. However, that one was a bit too late because we've already got enough accounting firms registered to do these particular inspections.

Termination of registrations is a big step however. It would lead to--the deregistration of the audit firms would quickly lead to the delisting of all Chinese companies listed in the United States. That is because you need to have an audit by a PCAOB-registered firm in order to be listed in the United States. Companies that were delisted are likely to move their listings to Hong Kong in order to deal with that.

With that, I'll pass my comments on to the next speaker. Peter.

PREPARED STATEMENT OF DR. PAUL GILLIS
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"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

Paul Gillis

Professor of Practice

Guanghua School of Management, Peking University

Co-chairpersons Cleveland and Wessel, and members of the Commission, I thank you for the opportunity to appear before you today. My name is Paul Gillis and I am a professor at Peking University in Beijing. I am an American who was formerly a partner with PricewaterhouseCoopers and have lived in China for nearly 20 years.

China's Capital Markets

China is a socialist market economy. Ideologically, China is argued to be in the primary stage of socialism, and at that early stage certain capitalistic techniques must be deployed. China's capital markets are perhaps the most powerful of capitalistic techniques. While the Chinese conception of a socialist market economy is based on the primacy of a large, state-owned sector, the private sector now accounts for three-fifths of China's GDP and four-fifths of its workforce.

China's stock markets closed after the 1949 revolution and were not reopened until 1990. Initially, the reopened markets were used primarily to corporatize and raise capital for state owned enterprises.

At first, China's own stock exchanges were not friendly to privately held enterprises, with private companies raising only 8% of the capital that was raised on Chinese stock exchanges in 2000. Chinese stock markets opened more widely to private investment with the opening of an SME board in Shenzhen in 2005 and more significantly with the opening of ChiNext, China's version of NASDAQ in 2009. By 2009, private companies raised 67% of the capital raised on Chinese stock exchanges[1].

China's stock markets have grown significantly as its economy expanded. At present the Shanghai and Shenzhen stock exchanges list 1,161 and 1,847 companies respectively, while the NYSE lists 1,839 and NASDAQ lists 2,439 companies[2]. China has also opened a "third board" – the National Equities Exchange and Quotation (NEEQ), which has

[1] Source: CCER
[2] Source: Stock exchanges

listed over 10,000 smaller companies which trade over the counter.

Foreigners are generally not permitted to purchase shares of Chinese companies through China’s stock exchanges. Until China removes foreign exchange restrictions it is unlikely that these restrictions can be removed. China has tried several approaches to allowing foreigners to trade stocks listed on Chinese exchanges.

For a time, several Chinese companies issued B shares, which were denominated in dollars and available only to foreign investors through the Shanghai Stock Exchange. B shares tended to trade at a significant discount to the A shares sold to Chinese. There are approximately 200 Chinese companies that have issued B shares. Chinese citizens are now permitted to purchase B shares but they have largely fallen out of favor.

Since 2003 China has had a scheme under which foreign institutional investors are permitted to trade in Chinese securities. The Qualified Foreign Investor program (QFII) was established in 2003 and was replaced by the RMB Qualified Foreign Investor Program (RQFII) in 2011. The program establishes quotas for each institutional investor.

The Shanghai-Hong Kong stock connect opened in 2014 to allow foreign investors to purchase shares of Chinese companies listed on the Shanghai Stock Exchange and to allow Chinese citizens to purchase shares listed on the Hong Kong Stock Exchange. The connect was extended to the Shenzhen Stock Exchange in 2016. Other “connects” have been suggested for London and Singapore. The connects represent an opening up of China’s markets without relaxing currency controls.

The primary means for foreigners to purchase shares of Chinese companies has been to purchase shares on foreign exchanges. Starting in 1992 China allowed certain State owned enterprises (SOEs) to sell shares in Hong Kong as “H” shares. There are presently 241 H shares traded in Hong Kong. There are also 153 red chips listed in Hong Kong. Red Chips are offshore companies that are incorporated internationally but hold primarily mainland assets. In addition to Hong Kong, Chinese companies have listed on most of the world’s stock exchanges, although Shanghai, Shenzhen, Hong Kong and the United States remain the primary destinations.

US listing of Chinese companies

China has made extensive use of U.S. capital markets in its process of opening up. That is mainly because China’s own stock markets were inadequate to meet the needs of China’s companies. The first Chinese company to list in the U.S. was Brilliance China Automotive Holdings which listed on the New York Stock Exchange on October 8, 1992 and was delisted in 2007.

There were three groups of Chinese companies that chose to list in the United States.

1) *Large State-Owned Enterprises (SOEs)*

In preparation for China entering the World Trade Organization in 2001, several large SOEs did initial public offerings in the United States both to raise capital for modernization as well as to import foreign corporate governance. There are presently 12 large SOEs that trades so-called N shares on the New York Stock Exchange (NYSE). The companies include several whose IPO made a list of the largest IPOs in history and several are among the largest companies in the world. Most of these companies are cross-listed in Hong Kong and Shanghai. The last NYSE IPO of a major SOE was the December 17, 2003 IPO of China Life. Since 2003, China's SOEs have listed in Hong Kong instead of the U.S.

One reason the large SOEs listed in the United States was that the Hong Kong Stock Exchange was not sufficiently developed to provide liquidity for these companies. After 2003, most SOEs listed either on mainland exchanges or in Hong Kong, which had developed sufficiently to handle large companies

Another reason why large SOEs stopped listing in New York may be because of the difficulties faced by China Life following its IPO. Shortly after the IPO there was an SEC investigation and class action law suit concerning potential accounting irregularities. Some have argued that the difficulties faced by China Life soured Chinese bureaucrats on US listings.

2) *Private company IPOs*

The United States became the primary destination for IPOs of privately held Chinese companies. Although the private sector has had increasing significance to China's economy, it found access to credit and capital in China to be difficult. 98% of China's 40+ million small and medium sized enterprises could not obtain bank loans in China in 2006[1].

The first meaningful wave of US listings of Chinese companies came during the dotcom boom and bubble of 1995-2001. The first listings were internet companies that were essentially clones of US internet pioneers. These companies chose to list in the U.S. for several reasons.

At present, there are 135 Chinese companies listed on major US stock exchanges[3]

Listings of Chinese Companies on U.S. exchanges (January 2017)

NASDAQ	90
NYSE	42
AMEX	3
Total	135

While far more companies have listed on Chinese stock exchanges the largest and best known companies have tended to list in the US. Alibaba is listed on the New York Stock Exchange and has a market capitalization of $242 billion. By contrast, the market capitalization of the entire ChiNext is $744 billion, evidencing that the Chinese stock markets may not yet be sufficiently large to handle some of China's largest private companies.

Listings on major Chinese stock exchanges

Exchange	Companies listed
Shenzhen ChiNext	578
SME Shenzhen	825
Main Board Shenzhen	478
Shanghai	1,194

[3] Source: Nasdaq.com

Total	3,075

IPOs of private Chinese companies in the U.S. have slowed in recent years. The primary reason for the slowdown is the more attractive valuations available on Chinese exchanges. However, the listing process for Chinese exchanges is opaque, foreigners are restricted in participating in Chinese IPOs, and the popular control structures and VIEs are not permitted. Consequentially, I expect we will continue to see some private Chinese companies continuing to use the U.S. for IPOs, but I expect these numbers to further decline as China's stock markets develop.

3) R*everse mergers*

A reverse merger is a merger of a larger company into a smaller company, with the shareholders of the larger company controlling the merged entity. Because of relaxed U.S. regulatory requirements for reverse mergers, the technique became a popular way to "backdoor" list private Chinese companies. Over 500 Chinese companies are said to have sought US listings through reverse mergers. Most planned to raise additional capital following the reverse merger and then to seek a listing on NASDAQ or the NYSE.

Most reverse mergers involved the merger of a private Chinese company into a shell company that was already registered with the SEC. Many of these shell companies had gone bankrupt but the SEC registered shell company remained alive. The transactions were typically promoted by small U.S. investment banking firms many of which have fallen into regulatory difficulty with the SEC.

The primary advantage of a reverse merger is that it was a cheap and fast way to list a company in the U.S. Unlike an IPO, there was no SEC review prior to the transaction and auditors, investment bankers and securities lawyers were often uninvolved.

Unsurprisingly, the lack of regulation and oversight led many of these reverse mergers to collapse under fraud allegations. Both the NYSE and NASDAQ implemented rules in 2011 to require 'seasoning periods" for reverse mergers, and these rules removed the advantage of reverse mergers and they have substantially disappeared from the market.

Some reverse merger companies were successful at obtaining a listing on a major exchange. Others are traded, if at all, on over-the counter markets such as OTCBB and the Pink Sheets. Many have gone dark, where they stop communicating with shareholders and stop filing with the SEC. The failure to file ultimately leads the SEC to revoke the company's registration and the shareholder's investment is typically lost.

The reverse merger problem was caused by weak regulation but has been largely cured through regulatory action by the stock exchanges.

Why do Chinese companies list in the United States?

The size and liquidity of U.S. markets initially attracted the large SOE listings as well as early private companies. In the past 20 years both China and Hong Kong stock exchanges have grown significantly and this is no longer a compelling reason.

The U.S. permits owners to use control structures that keep voting power in the hands of founders. Most markets (including China and Hong Kong) do not allow these structures.

Ever since Steve Jobs was forced from Apple by its board, technology entrepreneurs have often used two classes of stock to keep control in the hands of founders. Chinese companies have tended to follow this practice, giving voting shares to founders and non-voting shares to investors. The Hong Kong Stock Exchange rejected a request from Jack Ma to modify its rules to allow a control structure for Alibaba, and consequently lost the listing to the New York Stock Exchange.

Overseas listings may provide opportunities for Chinese owners to obtain access to foreign currency. Concerns over capital flight have led to a crackdown on practices designed to circumvent China's currency controls.

Accounting Fraud

Starting in 2009, activist short sellers began to target overseas listed Chinese companies. Short sellers borrow and sell shares in target companies, publish negative research, and then hope to repurchase and return borrowed shares at lower prices. There have been 199 short campaigns against overseas listed Chinese companies since 2009, with activity peaking in 2011 with 65 campaigns returning 36.24% to the short sellers.

Short sellers found a target rich environment among U.S. listed Chinese companies. While some of the companies were clearly fraudsters preying on investors, others appear to have been unprepared for the challenges of reporting as a public company.

Short selling campaigns against Chinese companies

Year	Number of campaigns China & Hong Kong HQ	Campaign Returns (%)
2009	4	21.11
2010	19	80.52
2011	65	36.24
2012	19	-51.94
2013	12	-59.45
2014	28	14.71
2015	30	15.3
2016	22	13.09
Totals	**199**	

Source: Activist Insight

Privatization

High levels of fraud among U.S. listed Chinese companies led to a significant decline in market values for these companies, with many trading below the price of the initial public offering. At the same time, values of shares traded on the Chinese stock exchanges rose to extremely high values.

Over 50 U.S. listed Chinese companies have announced or completed plans to delist from U.S. stock exchanges by repurchasing outstanding shares. These companies then restructure and relist on Chinese stock exchanges, often through a reverse merger transaction. Only a few transactions have been completed all the way through relisting. A good example is Focus Media, which delisted from NASDAQ in 2013 at a value of $3.7 billion and then relisted in Shenzhen in 2015 at a value of $7.2 billion.

Curiously, before U.S. listed companies can relist in China, Chinese regulators require that the company eliminate three of the issues that have led to many problems for U.S. shareholders - offshore holding companies, variable interest entity structures, and control structures that keep insiders in control. These features are all permitted in the U.S. but not in China.

U.S. shareholders in companies facing a privatization offer are often disadvantaged. Although companies typically obtain fairness opinions on the transactions, shareholders are often concerned that the privatization offers are underpriced. Most U.S. listed Chinese companies are listed in Cayman Islands and there is significantly less investor protection available in Cayman Islands compared to typical U.S. state laws. There have been concerns that some companies may be adjusting earnings downward to justify lower going-private prices.

Variable Interest Entities

Somewhat unique to China is the extensive use of a corporate structure known as the variable interest entity (VIE)[2]. A VIE is an arrangement where a company is controlled through contracts instead of through ownership. Contracts are an inferior form of ownership compared to direct ownership of shares.

VIE structures take advantage of U.S. accounting rules that were designed to stop the abuses of Enron by requiring companies to put off balance sheet debt back on the balance sheet. Chinese companies have cleverly used these rules in a new way – to put assets that are not actually owned by the company on the balance sheet.

China restricts foreign investment in many sectors, including the internet sector that is the most popular among U.S. listed Chinese companies. The VIE structure provides a work around for these restrictions. Activities that cannot be owned by foreigners are put in a domestic company that is owned by a Chinese individual, typically the CEO of the company. This company is then put under the contractual control of the offshore public company. This allows the company to tell its story in two ways: to domestic regulators it claims to be locally owned and not subject to foreign investment restrictions, while foreign investors are led to believe that they own the entire business.

Investors have lost significant sums when VIE arrangements have failed. There have been instances where the VIE shareholder simply absconds with the VIE. Attempts to enforce the contractual arrangements have generally failed since China's Supreme Court and arbitrators have held that the VIE contracts are not enforceable under Chinese law because they attempt an illegal work around the foreign investment restrictions.

Chinese regulators are aware of the use of variable interest entities, and last year proposed legislation that would make clear that VIE arrangements were not acceptable, yet providing an exception for those VIE arrangements where a Chinese national was effectively in control of the company (such as through use of control structures that give Chinese founders control of voting). Regulations issued in October did not contain these provisions, but do require the disclosure of controlling interests.

The extensive use of VIEs by U.S. listed Chinese companies is a major source of risk for investors. The SEC has done a good job requiring companies to significantly expand disclosures. "While companies already disclose those material risks in technical compliance with relevant SEC rules, the disclosure is often lengthy, difficult to understand, and effectively buried under pages of dense, boilerplate language"[3]. While disclosures identify the risks, it is unclear whether investors fully understand them. Analysts say that U.S. listed Chinese stocks usually trade at a discount when compared to peer companies in the U.S. That discount is likely because of the risks of the VIE structure and the higher incidence of accounting fraud among U.S. listed Chinese companies. Reforms that reduced these risks should lead to higher valuations in these stocks, benefiting American investors.

PCAOB Inspections

The Public Company Accounting Oversight Board (PCAOB) was established by the Sarbanes Oxley act. The PCAOB has three primary functions. 1) The PCAOB sets the rules for auditing U.S. listed companies, a task formerly done by the American Institute of CPAs; 2) The PCAOB inspects accounting firms that audit U.S. listed companies to determine whether they are complying with the rules; and 3) The PCAOB investigates and disciplines auditors who do not follow the rules. Arguably the most important function of the PCAOB is inspections.

Every accounting firm registered with the PCAOB is to be inspected at least every three years (annually for those firms auditing over 100 issuers). There are currently 43 Chinese CPA firms and 36 Hong Kong CPA firms [4] (including affiliates of global CPA firms) that have registered with the PCAOB. When the PCAOB attempted to inspect Chinese and Hong Kong CPA firms that had registered with the PCAOB, they were blocked by Chinese regulators who argued that these inspections would impinge on China's national sovereignty and risk disclosure of state secrets.

Negotiations between Chinese regulators and the PCAOB have continued for over ten years. In 2013 the PCAOB reached agreement with Chinese regulators with respect to cooperation on investigative activities of the PCAOB. No agreement has been reached with respect to the more important inspections. Recent negotiations on a potential pilot program for inspections appear to have stalled over disputes over which companies can be inspected.

The PCAOB has reached agreements with 22 countries and territories that establish a protocol for PCAOB activities in those countries and territories. China has insisted that the PCAOB follow the lead of the European Union, which granted regulatory equivalency to China with respect to audit regulation. Regulatory equivalency allows European regulators to rely on the work of Chinese regulators as if it were their own. The PCAOB has not accepted the concept of regulatory equivalency, insisting instead on at least joint inspections. There is valid concern that foreign regulators may not have the expertise or interest in reviewing the audits of U.S. listed companies.

Inspections are the primary protection for investors from shoddy audits. Research indicates that investors are unable to distinguish between good Chinese firms and bad Chinese firms based on traditional signals of firm quality including a firm's stock returns, earnings performance, accounting quality, and external monitoring mechanisms such as auditor and underwriter quality[5]. Certainly, the information about auditor quality that would be available from PCAOB inspections would help investors to identify risk and to differentiate between good and bad Chinese firms.

Recently the PCAOB found serious problems with audits done by Deloitte affiliates in Brazil and Mexico that led to significant fines on the firms. Without inspections of firms auditing U.S. listed Chinese companies, it is not possible for investors to assess the quality of audits.

Research suggests it is in China's interest to allow PCAOB inspections. Professor Shroff of MIT examined the clients of non-U.S. auditors that were inspected by the PCAOB and found that audit quality on all of their clients improved, not just those listed in the U.S. and subject to PCAOB and SEC jurisdiction [6]. In other words, there is a spillover effect. PCAOB inspections improve all audits done by a firm in a country, not just U.S. audits that are subject to PCAOB inspection.

SEC Regulation

The SEC has brought several actions related to Chinese stocks listed in the U.S., including suits against gatekeepers like investment bankers. The SEC's Cross-Border Working Group targets companies with substantial foreign operations that are publicly traded in the U.S. Since its inception, the Working Group has been behind the SEC's filing of fraud cases against more than 65 foreign issuers or executives and deregistration of the securities of more than 50 companies[7]. The biggest case brought by the SEC was against the Chinese member firms of the Big Four accounting firms and BDO. The case charged the firms will failing to comply with a Sarbanes Oxley provision that requires the firms to provide working papers to the SEC. The firms argued that to do so would violate Chinese laws related to state secrets. An administrative trial judge banned the firms from practice for six months. That judgment was later settled with a fine of $500,000 per firm.

The SEC has had a formal information sharing agreement with China since 1994. Both China and the United States have signed the International Organization of Securities

Commissions' (IOSCO) Multilateral Memorandum of Understanding Concerning Consultation and Exchange of Information. It is not clear how well these agreements are functioning to allow the SEC access to people and documents inside China. The testimony at the Big Four administrative trial judge proceeding documented a sorry tale of China promising but not delivering documents to the SEC. SEC criminal prosecutions have been successful only against individuals present in the United States. I am unaware of any situation where China has commenced criminal prosecution for crimes committed related to overseas listed Chinese companies, even where the alleged crime is clearly a crime under China's statutes. China's securities regulators have indicated that Public Security officials have exercised their prosecutorial discretion to not focus on those crimes.

The regulation of the U.S. securities market is heavily based on disclosure of risks by issuers. The SEC has done a commendable job improving risk disclosures on U.S. listed Chinese companies, particularly the risks associated with variable interest entities. The risk disclosures have become so extensive and so boilerplate in nature that many investors overlook them. That said, analysts argue there is awareness of the risks in these stocks, evidenced by the lower values these stocks obtain in the market compared to U.S. based peers.

Recommendations

In my opinion, the major problem with respect to U.S. listed Chinese companies is the inability of the PCAOB to conduct inspections of China based accounting firms. This has resulted in a situation where there is a double standard in regulation. All auditors of companies listed in the U.S. must be inspected, except for auditors of Chinese companies (and companies of a few other minor countries), which are not inspected. While this fact is routinely disclosed in the issuer's filings, the double standard makes a mockery of U.S. regulation.

In my view, there are two alternatives to eliminate the double standards. First, Sarbanes Oxley could be amended to remove the requirement that the PCAOB inspect foreign accounting firms. Instead, the PCAOB could follow the lead of the European Union and negotiate regulatory equivalency under which the PCAOB would accept the work of Chinese regulators as their own. I do not think this is the best option, since I think it is unlikely that Chinese regulators will rigorously examine overseas listed companies nor do they have the necessary expertise in U.S. accounting and auditing rules.

The second option is to terminate the registration with the PCAOB of any auditors that the PCAOB is unable to inspect. The U.S. should require companies that seek to list in the U.S. to agree to follow all U.S. laws. If China determines that a company has state secrets that cannot be disclosed, a company with such secrets should not be permitted to list in the U.S.

Termination of accounting firm registrations would lead to the delisting of shares of companies audited by the deregistered firms, since financial statements audited by a PCAOB registered accounting firm are a requirement for continued listing. Delisted companies are likely to seek to relist in China or Hong Kong, although they may be required to restructure to eliminate control structures and/or variable interest entity arrangements that may not be permitted in the other jurisdiction. The PCAOB has so far been unwilling to go this far, likely due to opposition from capital markets.

Another problem with U.S. regulation is the overlapping jurisdiction of financial regulators. There is little secret that there is considerable tension between the SEC and the PCAOB. I believe this both confuses Chinese regulators as well as creating opportunities for Chinese bureaucrats to play one regulator off the other. I think Congress should consider abolishing the PCAOB, transferring the inspection and enforcement activities to the SEC and sending standard setting back to the American Institute of CPAs.

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OPENING STATEMENT OF MR. PETE HALESWORTH
MANAGING PARTNER, HENG REN PARTNERS

MR. HALESWORTH: Thank you, Paul.

Greetings and it's an honor to be here. I would ask the Commission to guess in what country the following scenario occurs:

An investor is told they must sell a company's stock. The stock is down more than 50 percent since the IPO three years ago and at a record low. The chairman and insiders, unseen since the IPO, control the company and offer to pay a 16 percent premium.

The investor will lose 42 percent on their investment. Meanwhile, since IPO, the company has grown its cash balance by 400 percent and its total assets by 800 percent.

The investor believes the buyout offer is too low, feels ripped off and wants to challenge the company's lowball squeeze out. However, it's proving to be impossible because the stock exchange won't review it because of the company's extralegal status. The company's chairman and "independent" directors ignore investor grievances. The courts don't recognize the investor because they have no legal standing. Regulators simply shrug. There is no time for abuse that's technically not illegal.

The investor publishes a letter in the media protesting this lowball squeeze out. Soon the investor is threatened with a defamation lawsuit by a company director, who also is a foreign government official. The legal bill starts at $100,000 in a foreign court.

The investor is intimidated into suffering in silence against this powerful company. Adding insult to injury, there is news the company is planning a future IPO in another stock market at a mark-up of four to five times the value the company will pay the investor to regain full control.

In what country is this happening? Considering the lack of legal protection and individual rights, it resembles an authoritarian government with an unregulated stock market; right?

Wrong. It's happening in America. Our stock markets are havens for poor corporate governance exported to U.S. investors. Even worse, the U.S. unwittingly incentivizes foreign issuers to become predators.

How did we get here? U.S. laws allow foreign private issuers, FPIs, to raise capital in our financial markets, primarily obligated not to U.S. laws but instead their home laws.

In the globalization of America's stock markets, the first wave was from Canada, the UK, Europe, and then Israel. Today its Chinese companies, incorporated in offshore jurisdictions. The next wave could be from India, Russia or Nigeria. What is more relevant than where these FPIs are from is closing the regulatory gap that allows FPIs to raise capital in American financial markets without accountability to American investors.

I ask the Commission and our Congress, do we permit foreign bank branches or offices to operate under their home laws in the U.S. or foreign investment companies and funds? Of course not. It's nonsense to forfeit U.S. jurisdiction over the protection of American's money in our own country. Yet FPIs set up shop in America's financial markets by the hundreds to sell securities, collect billions of dollars from U.S. investors, and if challenged for misconduct, basically enjoy diplomatic immunity.

It's time for us to come to our senses. It's important to state that we're not China bashing. Heng Ren invests exclusively in companies operating in China for a reason.

We are optimistic about the future of Chinese companies, entrepreneurs and investors. We find most companies we invest in to be ethical and law abiding. However, as in any country, there are unethical business people, and increasingly when we see such FPIs hurt American investors, they are shielded from accountability by crafty legal barriers, starting with their extralegal status.

Small wonder this legal loophole is bustling. The biggest growth in FPI since 2000 has been companies incorporated in offshore jurisdictions. Hundreds of issuers hungry for the investment capital are nourished in the world's wealthiest financial market, and as a bonus are largely freed of the burdens of U.S. laws and regulations.

The cost of this legal loophole for U.S. financial markets is increasing. Lower corporate governance standards are taking root in U.S. financial markets and eroding the confidence in the integrity of our financial markets as in the case of these lowball squeeze outs.

Disadvantaged U.S. investors find little legal and regulatory support while they witness known violators of the Foreign Corrupt Practices Act (FCPA) trade openly on U.S. stock exchanges. Chinese investors who have high expectation of legal rights and protections here are stunned to find they have no recourse.

I don't believe this is the outcome U.S. investors expected when purchasing stocks trading on the platforms of the NASDAQ and the NYSE. Increasingly, purchasers discover they're not shareholders but mere holders of "depositary receipts" with no legal standing in our own courts.

In these times when businessmen are calling for less regulation and citizens seek to lower the cost of globalization's weaknesses, Heng Ren offers the Commission six recommendations readily available to solve this problem.

First, if foreign companies raise capital in the U.S., the issuer, their officers and directors must be legally accountable in the U.S. And if harmonization of laws is too heavy a lift, and believe me we have low expectations, despite its simple rationale, then provide checks and balances, in particular during buyouts, such as: the SEC should monitor the activities of an FPI during a buyout; the SEC should also actively solicit the large non-management shareholders for an opinion on the fairness of the buyout offer; special committees evaluating buyouts of FPIs need to be composed solely of valuation experts appointed by the exchanges and paid for by the companies; a majority of minority shareholders should be required to approve a management buyout transaction by an FPI. This should be part of the listing requirements of the NYSE and NASDAQ.

And if checks and balances fail to be implemented, then give investors a chance with truth in advertising. An FPI stock ticker should include an explicit warning label similar to the U.S. Surgeon General's warning on smoking.

In conclusion, I want to state I believe in globalization, and the aim to globalize our stock markets to reflect the global economy is admirable. I have witnessed and enjoyed its benefits, but the regulatory and legal gaps outlined show flaws that are endured by investors in U.S. financial markets at an increasingly heavy cost. Let's correct it. And it's on us. It's not on China.

Thank you.

PREPARED STATEMENT OF MR. PETE HALESWORTH
MANAGING PARTNER, HENG REN PARTNERS LLC

"Chinese Investment in the United States: Impacts and Issues for Policymakers"

Testimony before
The U.S.-China Economic and Security Review Commission

January 26, 2017

Pete Halesworth

Managing Partner

Heng Ren Partners LLC

Greetings,

I would ask the Commission to guess in what country the following scenario occurs.

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The investor will lose 42% on their investment. Meanwhile, since IPO the company has grown its cash balance by 400%, and its total assets by 800%. (Appendix, Figures 1, 2)

The investor believes the buyout offer is too low, feels ripped off, and wants to challenge the company's lowball squeeze out. However, it's proving to be impossible, because:

- The Stock Exchange won't review it because of the company's extralegal status.
- The company's Chairman and "independent" directors ignore investor grievances.
- The courts don't recognize the investor because they have no legal standing.
- Regulators simply shrug. There's no time for abuse that's technically not illegal.

The investor publishes a letter in the media protesting this lowball squeeze out. Soon, the investor is threatened with a defamation lawsuit by a company director, who also is a foreign government official. The legal bill starts at US$100,000 in a foreign court.

The investor is intimidated into suffering in silence against this powerful company. Adding insult to injury, there is news the company is planning a future IPO in another stock market at a mark up of 4x-5x the value the company will pay the investor for full control. (Figure 3)

In what country is this happening? Considering the lack of legal protection and individual rights, it resembles an authoritarian government with an unregulated stock market, right?

Wrong. It is happening in America. Our stock markets are havens for poor corporate governance exported to U.S. investors. Even worse, the U.S. unwittingly incentivizes foreign issuers to become predators.

How did we get here? U.S. laws allow foreign private issuers (FPIs) to raise capital in our financial markets primarily obligated not to U.S. laws, but instead their home laws.

In the globalization of America's stock markets, the first wave was from Canada, the U.K. and Europe, and then Israel. Today it's Chinese companies incorporated in offshore jurisdictions. The next wave may be from India, Russia, or Africa. What is more relevant than where these FPIs are from is closing this regulatory gap allowing FPIs to raise capital in American financial markets without accountability to American investors.

I ask the Commission and our Congress, "Do we permit foreign bank branches or offices to operate under their home laws in the U.S.? Or foreign investment companies and funds?" Of course not. It's nonsense to forfeit U.S. jurisdiction over the protection of Americans' money in our own country. Yet FPIs set up shop in America's financial markets by the hundreds to sell securities, collect billions of dollars from U.S. investors, and if challenged for misconduct, enjoy diplomatic immunity. It is time for us to come to our senses.

It is important to state we are not China-bashing. Heng Ren invests exclusively in companies operating in China for a reason - we are optimistic about the future of Chinese companies, entrepreneurs, and investors. We find most companies we invest in to be ethical and law abiding. However, as in any country there are unethical businesspeople. Increasingly, when we see such FPIs hurt American investors, they are shielded from accountability by crafty legal barriers, starting with their extralegal status.

Small wonder this legal loophole is bustling. The biggest growth in FPIs since 2000 has been companies incorporated in offshore jurisdictions (Figure 4). Hundreds of issuers hungry for the investment capital are nourished in the world's wealthiest financial markets – and as a bonus are largely freed of the burdens of U.S. laws and regulations.

The cost of this legal loophole for U.S. financial markets is increasing. Lower corporate governance standards take root in U.S. financial markets and erode confidence in the integrity of our financial markets, as in the case of lowball squeeze outs (Figure 6). Disadvantaged U.S. investors find little legal and regulatory support while they witness known violators of the Foreign Corrupt Practices Act trade openly on U.S. stock exchanges. Chinese investors, with high expectations of legal rights and protections here, are stunned to find they have no recourse.

I don't believe this is the outcome U.S. investors expected when purchasing stocks trading on the platforms of the NASDAQ and the New York Stock Exchange (NYSE). Increasingly purchasers discover they are not shareholders but mere holders of "depositary receipts" with no legal standing in our own courts. (Figures 7, 8)

In these times when businessmen are calling for less regulation, and citizens to lower the costs of globalization's weaknesses, Heng Ren offers the Commission six recommendations readily available for a solution:

1. If foreign companies raise capital in the U.S., the issuer, their officers, and directors, must be legally accountable in the U.S.

If harmonization of laws is too heavy a lift, despite its simple rationale, then provide checks and balances, in particular during buyouts:

2. The Securities and Exchange Commission (SEC) should monitor the activities of an FPI during a buyout.

3. The SEC should actively solicit the largest non-management shareholders for an opinion on the fairness of the buyout offer.

4. Special committees evaluating buyouts of FPIs need to be composed solely of valuation experts appointed by the exchanges and paid for by the companies.

5. A majority of minority shareholders should be required to approve a management buyout transaction by an FPI. This should be part of the listing requirements of the NYSE and NASDAQ.

If checks and balances fail to be implemented, then give investors a chance with truth in advertising:

6. An FPI's stock ticker should include an explicit warning label similar to the U.S. Surgeon General's warning on smoking.

In conclusion, I want to state I believe in globalization. The aim to globalize our stock markets to reflect a global economy is admirable. I have witnessed and enjoyed its benefits. But the regulatory and legal gaps outlined show flaws that are endured by investors in U.S. financial markets at an increasingly heavy cost. Let's correct it.

Thank you.

PANEL III QUESTION AND ANSWER

HEARING CO-CHAIR CLEVELAND: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you all for being here and your testimony. It's very helpful, and let me also start out by saying both PCAOB and the SEC were invited to testify here today and were unable to come, and that's regrettable. Hopefully they'll find time to sit down with us at some point. We've had a little trouble with the PCAOB over a couple of years in getting briefed.

My question is to the three of you. What kind of confidence can an investor have in investing in any China related asset without the kind of controls, audit trails, knowledge to ensure that proper IFRS or GAAP accounting standards have been used, et cetera? The use of VIEs and other structures to access these transactions seems to me it's a real crapshoot for any investor, directly or indirectly, to invest through a U.S. exchange in a Chinese asset.

Can each of you opine on that?

DR. GILLIS: Well, I'll start out. I believe that most of the participants in the market try to do the right thing. I think the auditors are trying to do a good job. There have been some bad apples, but I think on balance they try to do a good job. But if there's one place where you need to bring to bear the full range of regulatory processes to make certain that proper practices are followed, it would be China. And it's one place where we really are operating with one hand tied behind our back.

MR. DAS: I would entirely agree with Paul's sentiments here. I do think, in terms of the investment and professional sector, I think most institutions and regulators are trying to do the right thing here, but we do have a situation where some of it is really about buyer-beware.

The SEC, as I mentioned in my remarks, is an agency built upon robust disclosure. They don't cast a view or evaluate the quality of the company or really the veracity of the financial statements but rather whether there's full and fulsome disclosure.

So while full disclosure is critical and that's the foundation of our federal securities laws, it, as I indicated in my opening remarks, can be insufficient. I think investors in the absence of PCAOB's ability to inspect these firms really need to go the extra mile and will have to look to analysts, look to the disclosures themselves that highlight the risks associated with these listings and some of the issues that they're seeing--I mean they do have some insight because the PCAOB does have access with respect to U.S. audit firms that outsource audit work--I'm sorry--the U.S. audit firms that conduct audits of Chinese-based companies listed in the U.S. and outsource most of that work to China.

And so they have some insight, but where the Chinese accounting firm serves as the principal auditor, I think that's really where the rubber meets the road here. And so I'm entirely sensitive to your question. I think it's a question that the regulators have been grappling with for a number of years, and, as I said, the PCAOB has been negotiating an agreement with the Chinese on cross-border inspections since 2007. So, with these gaps in information, I think it remains an ongoing problem.

MR. HALESWORTH: I would respectfully disagree as much as I respect these gentlemen. I would say raise the bar here at home. We've been trying to get China to be responsive for how many decades? Has it worked? So I think it's time that we just take care of our business here at home, use the regulatory and enforcement tools that we have, because without enforcement, there's basically no regulations. And we need to do that here. Targeting China to try to be responsive to our needs I think should just be off the table.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you all for being here. Very interesting testimony.

I have a question for Mr. Das and a question for Dr. Gillis. Sorry, Mr. Halesworth. Maybe next time.

But for Mr. Das, as I understand--we've talked about this PCAOB issue for a few years. I remember, I think Commissioner Cleveland and Commissioner Wessel held a hearing where, a few years ago, where people came in and testified and said this is coming to a head. We're going to have resolution on this soon.

And as I understand it, it looks like the U.S. blinked. We require by law that U.S. government has to have access to the audit work of companies listed, any company listed on U.S. exchanges. And the Chinese refuse to allow that. Negotiations occurred and now the PCAOB has been silent, as you said.

A lot happened in between, but the bottom line is: we blinked. That's how I see it. And could you, Mr. Das, tell me if I'm right or wrong on that, and if so, why did that happen? Why did the U.S. blink? What is happening behind the scenes that made the U.S. blink?

MR. DAS: Well, I would say, first of all, yes, it is a fact that PCAOB has been trying to negotiate an agreement, and again, for almost a decade here. And while there has been some progress on that front, and I'm really referring to an agreement that was struck in 2013 on cooperation with respect to enforcement matters and investigations, really what the PCAOB has been seeking is an ability to gain access to work papers and audit firm personnel to conduct inspections like it does in many other jurisdictions.

VICE CHAIRMAN SHEA: I know, but it's not doing that.

MR. DAS: It's not doing that.

VICE CHAIRMAN SHEA: So why did we--I mean there has to be--is it because diplomatic concerns because if we terminated registration or is it because of investment banking fees that might be lost? What is the reasoning?

MR. DAS: I think that's right. I think ultimately, I'll just be very candid here, it's a function of political pressure. After Dodd-Frank was enacted, I think PCAOB was buoyed by it because, as a result of the amendments of Dodd-Frank to Sarbanes-Oxley Act, it was now able to share confidential information with foreign counterparts. That resulted in numerous agreements being executed.

It also strengthened the PCAOB's ability to compel the production of work papers. But, as I mentioned, the number of Chinese listings in a six to seven year period in the U.S. largely due to the reverse merger crisis from 2007 to 2011, but not entirely attributable to that, declined precipitously. In 2011, I know I'm on the record so I probably can't say don't quote me on this, but the number of Chinese companies listed on the major US exchanges was around 600 companies. Today, it's around 136.

VICE CHAIRMAN SHEA: Okay.

MR. DAS: Right? And the Jobs Act, which was, you know, effectively a reaction to the Dodd-Frank Act and intended to address the lack of IPOs in the U.S., reflects the decline in Chinese listings, which was emblematic of the general decline in

IPO listings in the U.S. Were the PCAOB to actually follow Peter's recommendation and actually enforce the laws on the books, in this case, the Sarbanes-Oxley Act, and bring actions to deregister these firms, these companies--the Alibabas, the Baidus, the Tencents could no longer be listed--

VICE CHAIRMAN SHEA: Right.

MR. DAS: --in the U.S.

VICE CHAIRMAN SHEA: Right.

MR. DAS: Right. Further exacerbating the current decline in IPOs.

VICE CHAIRMAN SHEA: Okay.

MR. DAS: I think the PCAOB board is very sensitive to that.

VICE CHAIRMAN SHEA: Okay. Thank you. I have 30 seconds. I'm going to try to get my question into Dr. Gillis.

You write in your testimony about variable interest entities, and we have studied that issue as well. And in shorthand, they're basically work-arounds Chinese law which prohibit foreign ownership of companies in certain sectors of the Chinese economy.

So Alibaba, the IPO was a VIE structured IPO. I was wondering how many Chinese companies are listed on U.S. exchanges using the VIE structure? And what--do you have a sense of the market capitalization? And what's your sense of the risk involved? If some judge or someone in the Chinese system says this VIE structure is illegal, then what if you're an investor in Alibaba or the other companies that are VIE structured?

DR. GILLIS: Yeah, I got the question. I haven't done a calculation lately of how many companies use it, but last time I did it, it was over half, and I think it's probably the majority now use the VIE structure, which controls companies through contracts instead of through ownership, and contracts are an inferior form of ownership compared to owning stock in these.

There have been a number of cases where shareholders have been ripped off, where the VIE has been taken by the Chinese person who owns the operations, just says I'm not going to follow the contracts, and one case made it all the way to China's Supreme Court and found the contracts were invalid, following a law very similar, a Chinese law that's very similar to the common law provision against having laws that frustrate public purpose.

And so I'm not aware of a single situation where a VIE contract has ever been successfully enforced in an adversarial action. So it creates great risk for shareholders.

Now China has been trying to fix that for a few years. They recently proposed amendments to the foreign investment rules that would have allowed most of the current VIE structures, would have made them obsolete, but in the end, when those foreign investment laws came forward, that provision wasn't there.

Chinese have pragmatically allowed the VIE structure even though it allows foreign investment in forbidden sectors, including the Internet and education companies, which are highly sensitive areas. I think they like the ambiguity because it gives them the ability to shut down these companies at will.

VICE CHAIRMAN SHEA: If I could quickly follow-up. From an U.S. investor's standpoint, I assume Alibaba in the prospectus said risk factor, we are a VIE, which is illegal under Chinese law. You're buying into a structure considered illegal under Chinese law. Is that sufficient? I mean do they do that?

DR. GILLIS: Well, there are extensive disclosures, and--

VICE CHAIRMAN SHEA: Okay.

DR. GILLIS: --they have, and the SEC has done a wonderful job of making sure that companies expand the disclosures. Typically it had gone from one page ten years ago to 15 pages today, but investors don't pay that much attention to them.

VICE CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR WESSEL: Senator Dorgan.

COMMISSIONER DORGAN: In almost all of the discussions we have in every area, there's a lack of reciprocal treatment. It's true here. It's true in almost everything we discuss with respect to China, and that exists because we are enablers for that, and at some point, our country would, I would think, want to say to China with whom we have a robust trade relationship, that that will continue provided there are some reciprocal treatment of opportunities on both sides.

But I wanted to ask the question, Mr. Halesworth. You talked in the last page of your testimony, you said that the Securities and Exchange Commission should monitor the activities of an FPI during a buyout. You said the SEC should actively solicit the largest non-management shareholders for an opinion on the fairness of the buyout offer.

There is nothing that prohibits the SEC from doing that now; right? I mean if the SEC decided tomorrow morning they're going to start doing that, they could start doing it?

MR. HALESWORTH: I don't have a solid answer on that, Senator, but I can say that the SEC and DOJ and other regulators are often overstretched under the current circumstances. So layering on another monitoring activity I think would be an anathema to most of them.

COMMISSIONER DORGAN: Well, is overstretched the right word or are they undernourished or perhaps tired, sleepy, perfectly content to observe? I mean--let me ask Mr. Gillis--

MR. HALESWORTH: If I could just address that. I think what's happened is that because we've set up a two-tier system in terms of corporate governance expectations for foreign issuers, expectations are very low for these foreign issuers. And when something goes wrong or there's misconduct, it's almost like they met expectations. The default is basically let it go, and if it's too small to care, then it doesn't need to be addressed.

I mean we have foreign issuers listed trading today in the U.S. financial markets that have been confirmed to be violating the FCPA, and nothing has been done.

COMMISSIONER DORGAN: When we've gone from 600 companies listed on a U.S. exchange to 135, is that 135 equal to the value of the 600 or--I'm just curious whether it's just consolidated and the large ones remain?

DR. GILLIS: Well, most of the companies-- there have been a large number of companies that have delisted either by going dark, which means they stopped communicating or by going private. I think there are more than 135 companies still registered with the SEC. There are 135 traded on the New York Stock Exchange, NASDAQ, and American Stock Exchange.

But the market cap, most of the market cap is in the big companies--the Alibabas and the Baidus. Most of the companies that--there were some fairly sizable companies that did go private, but mostly the ones that went dark were all tiny microcap companies.

MR. HALESWORTH: And I can just add, there are some others coming, some big IPOs coming down the pipeline, including the Uber of China, which is known as Didi

Chuxing, is said to be expecting to list in the U.S. So if they want to raise capital in the U.S., and there's still a keen interest in doing that, I think it's a good opportunity to raise the bar.

COMMISSIONER DORGAN: Just as an aside, I was well familiar with the case in which a Chinese businessman had developed a very large business, became a billionaire and had oil pipelines and various things, and was picked up one day and sent off to prison for five years, never charged. Five years later he was released and his companies had all been taken from him with new board members put in, established by the government, and he then filed a suit. He had taken a lot of papers with him when he was apprehended and filed a suit.

But it is interesting--and the suit went nowhere of course. But it's interesting that the suit was against a company that's listed on a U.S. exchange, and the suit contended that almost all of the information in that company's financial disclosures was wrong, and he demonstrated it was wrong with the written evidence that he had.

And I'm not aware of anything that resulted in that circumstance. So it's exactly what we've talked about today, the lack of transparency and the difficulty of understanding what the numbers really represent and whether they are audited numbers and numbers that people can rely on.

Anyway, thank you for the testimony from the three of you. We appreciate that.

HEARING CO-CHAIR CLEVELAND: Commissioner Slane.

COMMISSIONER SLANE: I'm trying to figure out how to solve this problem in a different way, and Mr. Halesworth, you know, my feeling is shame on us for allowing this, and I'm wondering if we gave a private right, created a private right to our American stockholders to file suit, would something like that help correct this?

MR. HALESWORTH: That's a very good question. I think that would definitely help. Having some legal standing and recourse would definitely help. I think also, just getting back to my fundamental message is that the foreign issuers should be as accountable to U.S. investors as domestic issuers are to U.S. investors, which means to me that these foreign issuers should be fully subject and accountable to the U.S. jurisdiction.

So if the public enforcement tends to lack because of this regulatory relaxation that we have toward foreign issuers, then let's give the private enforcement option a chance and do something in the case of these lowball squeeze outs, similar to what we allow domestic investors and shareholders to do in Delaware, which is to petition for appraisal rights and to seek a fair value on the buyout. So that I think would be an appropriate remedy.

HEARING CO-CHAIR CLEVELAND: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you.

The wording "a loophole;" we want to close the loophole, is what you had suggested, and I think of loopholes as being relatively small. This, though, strikes me as a gigantic discrepancy.

So I'd like to ask of all of you, should we look at the suggestion you made, Mr. Halesworth, about adding to a company’s stock ticker a code that would be an explicit warning similar to the U.S. Surgeon General's warning that we see on cigarette packets. Would such a warning be useful and have a significant warning effect?

I'd like to hear, Mr. Halesworth, how have you imagined that might work and then how it would play out. I’m also eager to hear your thoughts on this recommendation, Dr.

Gillis and Mr. Das.

MR. HALESWORTH: I think what it does is send a very strong message to the industries involved in bringing an IPO to the U.S. who are benefiting greatly from it. And that is we are going to inform. It's no longer a casual “buyer beware.” It's “buyer beware, but make them aware.”

It's very difficult to understand securities law. Tax law is almost a holiday compared to reading and understanding securities law.

COMMISSIONER TOBIN: Yes.

MR. HALESWORTH: I would say labeling might get the exchanges and the investment banks and the legal advisors on their toes if we even raise this as a possibility.

I would add that this labeling occurs in stock exchanges around the world, not necessarily for this reason, but there are different stock ticker symbols that are intended to send a message to investors.

COMMISSIONER TOBIN: Which exchanges?

MR. HALESWORTH: Other exchanges in Asia, they'll have a unique suffix for preferred shares, if you're going to have different rights owning these, et cetera. The pushback might be it's seen as discriminatory, but I think if the investor and the buyer or purchaser has no legal rights or recourse--

COMMISSIONER TOBIN: Right.

MR. HALESWORTH: --we've got to be very up-front about that. So I think it would send a message, and I think it would be a worthy message to start the conversation about maybe tightening up things.

COMMISSIONER TOBIN: Before I go to the others, I think that the naming of it, one, could begin to put pressure; two, it goes to what you said, the responsibility is on us to do something. And to me, it doesn't strike me as the least bit discriminatory because it's calling things for what they are.

Dr. Gillis and Mr. Das, what are your thoughts on that recommendation?

DR. GILLIS: Well, stock analysts tell me that they are well aware of these risks that are there, and that these risks are reflected in the value of these stocks. And that if companies like Alibaba were U.S. based and focused on U.S. market, their market cap would be significantly higher than it is now so that they think that risk has been priced in.

I think that the U.S. has long had a lighter regulatory touch on foreign companies listed in the United States than on domestic companies, and I think that's based on the theory that foreign regulators are picking up the gap.

However, in this case, we've got companies, most of these U.S. listed companies, other than the big SOEs, are not subject to any foreign regulation. They're incorporated in Cayman Islands and other tax haven jurisdictions. They're not listed in China or any other stock exchange, and the U.S. is the sole regulator, yet the U.S. is hamstrung in its ability to regulate.

COMMISSIONER TOBIN: Thank you.

MR. DAS: Yeah, I generally agree with my co-panelists here, specifically Paul's remarks, but I will say there is a continuing appetite by institutional investors, hedge funds, public pension funds, private equity firms, to invest in Chinese companies. I mean they see it's a high risk and reward proposition.

I think they appreciate those risks. I think some of that is reflected in the value that these stocks are trading on our markets. I would not necessarily support here, something akin to what you suggested as a Surgeon General's label because I think really that's the entire point behind the SEC's disclosure review process?

I mean, again, this is what they do. They make sure that all the risks are adequately and sufficiently disclosed. It's a rather rigorous process. You know I mentioned that with respect to Chinese listings and IPOs, they must disclose that they have not been inspected by the PCAOB. That's a prominent disclosure. It was in Alibaba's--

COMMISSIONER TOBIN: I see my time is up and I know--

MR. DAS: --registration statement.

COMMISSIONER TOBIN: Okay. Keep going.

MR. DAS: So, no, my only other point that I think what you are suggesting might move us away from this disclosure-based system and more to a system that's sort of judgment or merit-based, which is where the government is almost selecting--

COMMISSIONER TOBIN: I understand.

MR. DAS: --you know, which companies that investors should invest in.

COMMISSIONER TOBIN: But I see it less selection than if we can't get what we need in terms of the audit process, it could be a flag, so to speak, for potential stock purchasers.

If we do t a second round, I have more questions. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you and thanks to our witnesses.

Dr. Gillis, I have a colleague in the corporate world who loves your China Accounting Blog and--

DR. GILLIS: Well, thank him for me.

CHAIRMAN BARTHOLOMEW: --and thinks that it gives some of the best insight into what's going on in China so thank you for the service that you're providing with that, too.

So if companies are deregistered--this is kind of a naive question--but if companies are deregistered, what happens to the investors?

DR. GILLIS: Generally they're wiped out. I mean they may become investors in a private company, and they still have the rights to the shares that they have, but the ability to sell those shares basically disappears, and in reality, what has happened in companies that have gone dark and the SEC has deregistered is that the Chinese shareholders take the assets out of the company and no one ever hears from them again. They're completely wiped out.

CHAIRMAN BARTHOLOMEW: So we've been told over the course of the increased U.S.-China relationship that U.S. engagement with China on a lot of issues, but I'm going to focus on this one, will improve Chinese practices. But what it sounds like, of course, with this two-tier system is that we are heading towards a potential race to the bottom.

Do you have any estimates on how much U.S. pension fund money is invested in Chinese companies that are listed on the exchanges and extending it to some of these Caymans?

DR. GILLIS: I don't have numbers like that. I do--I talk with a lot of these pension funds, and I know, I would guess most of them have investments in China. It's the fastest growing economy in the world and they need to be part of that.

CHAIRMAN BARTHOLOMEW: Mr. Halesworth and Mr. Das.

MR. HALESWORTH: I don't have an estimate on that, but I would say, and I think you're really getting to the point here, is that we're not talking at an abstract level of only big institutions. “Mom-and-Pop” investors are getting impacted by this.

CHAIRMAN BARTHOLOMEW: Yeah, which I was also thinking about when you talk about stock analysts, who are, of course, supposed to be sophisticated in what they're doing, versus people who are doing investing, or in the case of people who have pensions, and these pension funds don't even know where that investment is going.

Another question is some of the practices of the Big Four contributed to the global financial crisis because they had a conflict of interest in their business practices. Is that a concern as the Big Four are engaging in activities in China, are setting up subsidiaries in China, that their desire for business in China is going to color the work that they're doing in terms of accounting?

DR. GILLIS: I don't see the same kind of issues present here. The issue of the fact that companies pay auditors, select and pay auditors, is a conflict of interest that has always been present. And it's exasperated there. You're reporting to management and so you're reluctant to call out management in that kind of situation--normal human behavior.

I do think that most of the Big Four firms are trying to do a good job in China, but occasionally they make mistakes.

CHAIRMAN BARTHOLOMEW: Anybody else?

MR. DAS: No, I would agree with what Paul said. I mean that conflict is also present with respect to the credit rating agencies as well.

CHAIRMAN BARTHOLOMEW: Right.

MR. DAS: Perhaps even more so. But I think generally, I think the Big Four firms are trying to do their best under very difficult circumstances, and they have to adapt to Chinese business practices, laws, and I do think that the trend that I've seen, and particularly when I was at the PCAOB, is that the Big Four is trying to exercise greater enterprise-wide oversight in the management of their affiliate firms around the world.

CHAIRMAN BARTHOLOMEW: And are there any, in terms of governance, sort of standards for audit committee members on these companies in China? Not just the Big Four. I don't mean the Big Four, but the companies that are listing.

DR. GILLIS: Well, all the companies that are listed in the United States are subject to U.S. rules, which are often defined by the exchanges, and so those apply. Chinese companies that list in China on the Chinese exchanges, there are actually very similar rules, sometimes even stricter than U.S. rules. China has a tendency to try to adopt the best practices worldwide for its own markets.

CHAIRMAN BARTHOLOMEW: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: I'd like to try and understand some basics. We have on one side of the equation, there are the auditing firms, which may or may not have access to necessary financial details.

But it also strikes me the SEC has filings, which I talked about this morning, and I'm curious as to what's disclosed. If you could sort of walk through what is disclosed on those filings, and whether, I understood from the SEC appearing here before that the standards for Chinese companies are no different than any other company filing. They're held to the same standard.

So are the filing requirements rigorous enough to get at some of the concerns about governance or financials? And if they're not rigorous enough, what would you suggest that these documents require? Understanding that they're all dependent in the end on audits, but--

DR. GILLIS: Yeah, I think the same standards do apply to U.S. listed Chinese companies apply to other companies listed. And I think the disclosures are extensive. These filings are often hundreds of pages long. The problem is not in the disclosures. It's a question of whether, not in the requirement for disclosure. The question is whether the disclosures are, in fact, accurate or whether they're, in fact, misleading or false. And that is what the role of auditors and other participants in the market is, to validate.

MR. HALESWORTH: If I can just add to that. The private issuers, though, in the U.S., they have exemptions. For example, no quarterly reporting. That's not required. Also exemption from U.S. proxy rules, which is separate from reporting. Exemption from insider trading reports, Reg FD ("Fair Disclosure"), and also limited executive compensation disclosures.

So we go back to there is a relaxation for foreign issuers. On the U.S. side, domestic issuers are required to file what are known, for the annual report, the 10-K, and then the quarterly, the 10-Q. For the foreign issuers, it's a 20-F for the annual, and then for the quarterly, it's a 6-K.

HEARING CO-CHAIR CLEVELAND: Mr. Das, do you have anything to add in terms of what could be?

MR. DAS: No, I would just echo, again, what my co-panelists commented on. I mean I think the standards with respect to public companies are generally the same as applied by the SEC. Again, with respect to private companies, there are certain exemptions that Peter just outlined here.

I mean, I will say, I think this harkens back to Peter's comments earlier that we shouldn't just focus on what's happening in China but our own regulatory system. Yes, in some cases, perhaps, our regulatory regime may be overly permissive in some areas and may be more rigid in other areas.

I mean, in fact, that was the very calculus that Alibaba undertook when it determined to list in the U.S. as opposed to Hong Kong. Hong Kong would not accept dual classes of common shares for publicly listed companies. So that played I think a major role in the decision to list in the U.S.

HEARING CO-CHAIR CLEVELAND: Buyer beware.

I'm looking at a letter that Chair White sent to Congressman McHenry in 2011 in which during the course of five weeks the SEC moved against three reverse merger entities and suspended trading, and in each instance, HELI, CHJ1, I guess, and RINO, they acted because of concern about accuracy and completeness of information contained in their public filings.

Have we seen any kind of action like that since 2011 against any companies? I mean it sort of seemed to be a spurt of activity and then--

DR. GILLIS: There was extensive regulatory activity around 2011, and that's when we had this explosion of fraud allegations against China, and the SEC set forth a task force to go after these companies, and they've been dribbling, the actions have been dribbling out over the years. I haven't noticed anything--there have been continued cases over the years against those.

The SEC, most of the cases they tend to be successful at bringing are U.S. listed companies that have some U.S. connection. They're using a U.S. corporation. Their executives may be actually based in the U.S. Because those are much easier to bring than something where everybody is in China, where it's quite difficult to bring action.

MR. HALESWORTH: I know reciprocity is something that's been in the air a lot with your Commission and in your hearings, and I would just like to point out, the SEC has done a tremendous job in cracking down on fraud by Americans who were defrauding Chinese investors. One firm in the U.S. called GeoInvesting has done some great reporting on this, showing how the SEC is very good at making sure we're protecting these Chinese or foreign investors, but where is the quid pro quo?

HEARING CO-CHAIR CLEVELAND: Uh-huh. Okay. I'll come back to this.

Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you all again, and Mr. Das, I want to make one thing clear. I respect and appreciate all of your public service and the work you did. Those of us who have toiled in the China issue know very well how difficult it is and, you know, you tried exceptionally hard, as did the entity that is PCAOB, to get a good agreement. The Chinese just didn't want one, and our overall system didn't support or demand that there be a proper result. So I just want to make that clear. Thank you for being here and thank you for your work.

MR. DAS: Thank you.

HEARING CO-CHAIR WESSEL: I want to ask two separate questions. First, and each of you have talked, I think, briefly about it. Each of the exchanges has differing standards. For example, I think financial competence as it relates to audit committees, there's a different standard on the NYSE versus NASDAQ, et cetera. Chicago, Pacific, you know whatever.

What's being done--is there any best practices within the exchanges? How could the exchanges do a better job is the first question?

Number two, the power of the SEC, should it choose to use it, is quite broad and effective. You know when you serve on a public company, one of your first trainings is what's your D&O insurance because of shareholder derivative suits, et cetera? There's accountability there.

To what extent could we ask or could the SEC demand that companies disclose the subsidies they're getting from the Chinese government, whether it's a U.S. company operating in China, because that's a material fact, you know, with all of the countervailing duty and other activities that may be engaged in by this administration? There actually may be greater exposure.

So how could we use the SEC and the activities, all the accounting issues, to get deeper at some of the systemic issues that are perplexing us? Subsidies, tech transfer, et cetera. That seems to me beyond just the normal VIE disclosure. What's the corporate, how to pierce the corporate veil that we have to also get to the actual financing issues.

So if you could respond on both of those. You know, what should the exchanges be doing, if anything, differently, and what can we get the SEC to do to address the China problem to a greater extent?

DR. GILLIS: Well, the exchanges competed quite vociferously for the U.S. listings of Chinese companies, and I think they all have some regrets over what they did during the peak period. Many of them took on companies that ended up being frauds and diminished the exchanges, and they have backed back from that. You don't see quite the activities. They all had marketing people based in China, and there were big problems associated with that.

As to expanded disclosures with respect to subsidies and other transactions: I think that's within the power of the SEC to do that. Some of these disclosures are required by existing accounting standards and are present, but the SEC could, within its power, expand those disclosures.

HEARING CO-CHAIR WESSEL: Mr. Das or Mr. Halesworth?

MR. DAS: Yes, I mean the SEC has broad and plenary oversight over the stock exchanges, and so were they to implement certain requirements or rules, the stock exchanges would have to adhere to them.

But I should note, though, what the SEC requires really reflects a floor and not a ceiling. So the stock exchanges could go much further, and to add to Paul's point, during the reverse merger crisis, if you will, the NYSE and NASDAQ were competing with each other for listings, and that really was, I think, a race to the bottom.

And I recall meetings with them rather vividly, but as, you know, after that crisis had dissipated, I think they recognized, and of course the SEC recognized, by issuing new rules for reverse merger listings, which the exchanges implemented almost immediately, that they had to step up their efforts here and really monitor the companies that they choose to accept for listings.

But still there's a lot of competitive pressure there, and I think this also addresses the point that I think Commissioner Shea had raised earlier about why these negotiations ongoing, and why doesn't the PCAOB now deregister these firms? I think a lot of it has to do with the political pressure associated with it. So--

HEARING CO-CHAIR WESSEL: Just going back to the second question before Mr. Halesworth, as it relates to the disclosure, very few companies disclose the subsidies they're getting in any granularity that you can really understand what's going on, number one, or tech transfer or performance requirements.

As a matter of law, do you believe it is a material issue for most companies because materiality I know is a function of net income? But presumably in most of these companies, it is a material issue. Would you agree or disagree?

MR. DAS: I frankly, I can't address that in isolation.

HEARING CO-CHAIR WESSEL: Okay.

MR. DAS: No. This issue of materiality is a very complex--

HEARING CO-CHAIR WESSEL: No, no. I understand it's a function of net income.

MR. DAS: Yes, exactly.

HEARING CO-CHAIR WESSEL: If, you know, if Microsoft--if GE, which did a JV on avionics, does a JV on, and it's $100 million out of a $6 billion market cap, to me that would be, as an investor, that would be a material issue. It's not like $5,000 of paper clips that go missing some day.

MR. DAS: Right, right, right.

MR. HALESWORTH: I would suggest instead of the SEC being involved in the exit process of these companies that have bought out U.S. investors, it could equally be the stock exchanges as well being involved, in particular hiring independent valuation experts to make sure that on the way out of U.S. stock markets their constituents and their investors are being treated fairly.

The other issue I would raise, and it's typical here in Washington, as I'm sure you all know, is just the stove-pipe or silo approach to government. For example, and not to pick on Alibaba.com because I think it's a very interesting company, and in most cases a good company, but, the USTR (U.S. Trade Representative) names them as a “notorious marketplace” and puts them on a blacklist, and currently it's the 16th largest stock by market capitalization in U.S. stock markets.

If there is a desire to use different levers and tools to bring pressure for better outcomes for everybody, and to raise the bar for corporate governance here, all the Chinese companies are looking at Alibaba. They're the godfather of Chinese companies.

If they see that one U.S. agency is slapping Alibaba on the wrist and calling them a bad name, but their stock continues to go up, it's a mixed message.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR CLEVELAND: I'm not sure the message is so mixed, but--

Commissioner Tobin. Oh, you didn't want--

CHAIRMAN BARTHOLOMEW: Yeah.

HEARING CO-CHAIR CLEVELAND: Sorry. Commissioner.

COMMISSIONER TOBIN: Thank you.

CHAIRMAN BARTHOLOMEW: Thanks, again. I would just mention to my colleague, of course, that Chinese government subsidies could be a risk factor because what is given can be taken away for political reasons, yeah.

So we've been talking rightly here about impact, potential impact, on investors. But when American companies are, in essence, held to a higher standard because people can look at the accounting and what they are reporting, does that serve as a competitive disadvantage for American companies? I am not advocating that we loosen our standards. I want to stipulate that. But is it yet another competitive disadvantage that Americans have?

DR. GILLIS: Well, it's a competitive disadvantage any time that you list a company anywhere and have to disclose financial information, and that is probably one reason why some of the state-owned enterprises have not chosen to list because that listing would require them, even listing in China, would require them to make public financial information that would be valuable to competitors.

CHAIRMAN BARTHOLOMEW: Anybody else?

MR. HALESWORTH: I think that's a distinct possibility, but actually I think it boomerangs on the Chinese companies because as Paul pointed out, they trade at a severe discount to most of the domestic issuers here in the U.S. because of this cloud of uncertainty. Their cost of capital is higher as a result, and their ability to basically raise funds in a consistent fashion is broken.

So the idea that these Chinese companies came here to continue to get sustainable financing, they've basically shot themselves in the foot, and we've allowed this race to the bottom. Instead, we can reverse the situation and get a better outcome by making U.S. stock markets a boot camp for shareholder rights and protection.

And I think the Chinese government would like to see that. In fact, in Paul's testimony, he points out that when these U.S. listed companies delist and go back to China, all these jurisdictional arbitrages and jurisdictional holes that they have here in the U.S. have to get cleaned up and closed, pronto, before they go back and list in China.

So I think it really shows that the Chinese government is very sensitive to shareholder rights, and we should make it work here in the U.S. for these Chinese companies.

CHAIRMAN BARTHOLOMEW: Thank you.

COMMISSIONER TOBIN: Madam Chair, I will ask, this is less related to the FDI, but I've been curious for the last three or four years, when you're a company like Boeing that is increasingly dependent on the purchases of China, and you've got their auditor, --I don't know who that is--but how do their auditors handle it? Can they get access to legitimate data and how are they integrating it into to global company's financial statements?

I figure as long as you're all here, Dr. Gillis, you can--

DR. GILLIS: I'm not familiar specifically with the audit of Boeing. I believe their auditor is Deloitte, and what I expect that they do is that their auditor in Chicago or Seattle or wherever it is they're headquartered sends instructions to their Chinese member firm to conduct certain procedures for them and to report upon those procedures, and that technically the Chinese government could interfere with that because they don't allow audit work papers to leave China.

But I think that China has had a pretty light touch on the audits of U.S. multinationals based in China. They have not really interfered in that process that I'm aware of. And so I think that that generally works pretty well.

COMMISSIONER TOBIN: And just as a board hires their auditor, is the board of say Boeing--I'm just using them as an example--are they doing the auditor hiring, or is that the Chinese who choose the auditor?

DR. GILLIS: The company could hire a different auditor in China than they have in the United States. That's quite rare. Typically you use the same firm all the way around the world because there are synergies with that. It's probably in the investor's best interests to do it so typically when a job goes up for bid, it is, it's going to be, they're going to select one auditor worldwide.

And that auditor will--then the auditor in the U.S. will decide what work needs to be done around the world.

MR. DAS: That's exactly right. I mean the Big Four audit firm will generally choose one of its affiliates, as in the case of Boeing, in China to conduct the audit of its local operations. Yes. And as Paul pointed out, in light of this restriction regarding the transfer of work papers, my understanding is that, what the U.S. audit firm of Boeing would receive, is a summary memo, right--

COMMISSIONER TOBIN: Okay.

MR. DAS: --describing the audit procedures that were conducted by its affiliate in China, and review that summary memo. If it has questions or is not satisfied with what's provided, then it may go to China and actually do some hands-on due diligence.

COMMISSIONER TOBIN: Thank you. And did I also understand correctly from your remarks, Dr. Gillis, that Sarbanes-Oxley is being followed, the guidelines of it?

DR. GILLIS: Yes. I mean the requirements of Sarbanes-Oxley apply to multinationals on their worldwide operations, and so to the extent that the auditors are reporting on internal controls, as they're required to do, they would be examining the internal controls of material operations in China.

COMMISSIONER TOBIN: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: Thank you all very much for appearing. Thank you for coming all the way from Beijing. We appreciate your testimony. It was valuable. I'm not sure what we're going to do with it or do about the problem.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: But you've certainly raised some important points so thank you for appearing.

MR. DAS: Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

[Whereupon, at 2:58 p.m., the hearing was adjourned.]