Testimony
Examining the Committee on Foreign Investment CFIUS
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James A. Lewis, Center for Strategic and International Studies

I thank the Committee for this opportunity to testify. The Department of Treasury's Committee on Foreign Investment (CFIUS) is one of the most important tools for protecting national security while also creating the conditions that enable a strong economy and an advanced technological base. CFIUS is one of three activities that protect national security related technology and the defense industrial base along with export controls and federal investment in research and development. (R&D). The CFIUS Committee has done well, but the growing volume of cases, increased complexity of acquisition transactions, and China's industrial policies pose an increasing challenge to the CFIUS process.

The U.S. created the CFIUS process to regulate foreign acquisitions of American companies in response to concerns that strategic industries were being lost to foreign competitors. The goal is to maintain an open investment environment while mitigating risk to national security. CFIUS's authorities were updated in 2007 by the Foreign Investment and National Security Act (FINSA), which expanded the Committee's remit to include homeland security, created timelines for review, and gave the President the authority to reopen and reexamine already completed transactions (known as an "Evergreen" provision). FINSA is now ten years old and faces challenges created by a changing global economic environment.

The most important of these challenges comes from China. China is a strategic competitor who seeks way to circumvent CFIUS protections. China's industrial policies are the greatest challenge for CFIUS. The laws, policies, and regulations that were adequate in the past, whether for export control or for foreign investment, must be reviewed and reconsidered to manage the challenge America faces from China's managed economy. China's goal is to end its dependence on foreign technology and overtake the U.S., as it has overtaken other nations.[1] This is not a military conflict, but it has deep implications for American security and for the prospects of an international system based on the rule of law and democratic norms. The fundamental issue for the U.S. and other western nations is how to respond to a managed economy with a well-financed strategy to create domestic industries intended to displace foreign suppliers.

Although it is a member of the World Trade Organization (WTO), China does not follow WTO rules. Its public justification for this is that China is still a developing economy and should not be held strictly accountable, but this is nonsense for the world's second largest economy. Compare the treatment of U.S. companies in China to Chinese companies in the United States. When Alibaba built a data center in Seattle, it was not forced to do this as a junior partner in a joint venture, nor was it forced to provide source code, but U.S. companies in China face these requirements. There are other countries that want to challenge the global institutions created by the U.S. and it allies after 1945, chief among them Russia, but the Russian economy is in steady decline and while Russia is dangerous in many areas, it is not an economic competitor.

[1] My colleague Scott Kennedy's research initiative "Made in China 2025" explores this at greater length.

One reason that China has gotten away with this for so long is that many companies have been ambivalent about pushing back. They fear retribution from China—a reasonable concern, since China is not shy about retaliating against critics —and many do not believe the United States will take action to support them against such retribution – also a reasonable concern. China is a huge market that companies are reluctant to risk, but as the consequences of China's industrial policies become clearer, company attitudes have changed and there is growing concern about unfair competition from the Chinese state.

If China followed international practices, its decisions to invest in domestic industries would be unobjectionable. There would be potentially profound effects on the global economy, but competition is the nature of the market. But China has not hesitated to extract concessions or block foreign competition in order to advance its own firms. China's five year plans lay out the strategic economic and technological goals that China will pursue and fund. These have had mixed success in the past, but a steady, well-funded pursuit of its economic and technological goals is one of the hallmarks of Chinese policy. China is pulling ahead because it has a strategy to build a high-tech economy and is willing to spend heavily and consistently to achieve this. We do not always want to take Chinese propaganda announcing technological success at face value, but China commits to research and investment programs for decades, while our spending is often limited to fits and starts.

China's announcement of an indigenously produced commercial airliner illustrates Beijing's intent to "move up the value chain," build industries, and displace western firms. China's Soviet-supplied aircraft factories made shoddy aircraft. When China opened its market, Western firms rushed to sell aircraft. Part of the requirement for market access was coproduction, where Chinese companies worked with Western aircraft firms to make parts for Western commercial aircraft. Coproduction, over 20 years, taught Chinese companies essential production know-how, and the quality of Chinese aircraft has improved markedly. Most of this transfer did not involve IP theft. However, the Chinese government will be tempted to use subsidies, pressure domestic airlines to buy the new Chinese plane, and barriers to foreign companies to give their manufactures an edge in China and in the global market. These practices are not uncommon as Beijing seeks to promote its domestic companies.

Semiconductors are another key industry for China and a major concern for CFIUS. Since the 1960s, the United States has been the leader in semiconductor manufacturing. A strong semiconductor sector is crucial for growth in key high tech industries and will grow more important as more devices are connected to the internet. Semiconductors enable a broad a range of industries and serves a foundational role for critical civilian and military digital technologies. Persistent Chinese efforts to acquire semiconductor technology, combined with changes in the industry, could create risks for the U.S. and opportunities for potential attackers. In the last few years, there have been a number of efforts by Chinese companies with links to the government to buy western semiconductor firms, using a multi-billion-dollar acquisition fund created by the Chinese government. While the CFIUS process has been successful in blocking many of these efforts, China's policy to end its reliance on foreign semiconductors manufacturers by creating its own companies has not changed and there will be continued pressure.

Chinese policy seeks to extract technologies from western companies; use subsidies and nontariff barriers to competition to build national champions; and then create a protected domestic market for these champions to give them an advantage as they compete globally. Huawei is the best

example of a now globally dominant Chinese company built along these lines, but there are others. A senior Chinese official once remarked that if China had not blocked Google from the China market, there would be no Baidu. Various strategies are employed, using barriers to trade, security regulations, procurement mandates, acquisitions (both licit and illicit) of foreign technology, and through strategic investments in or acquisition of foreign firms. In addition, companies from the U.S. and other western nations have found themselves under pressure to make long-term concessions in technology transfer in exchange for market access.

Intellectual property (IP) theft is no longer the most important problem. It is easy to overstate the cost of commercial cyber espionage. While China's policy has been to acquire western IP from the start of the opening of its market, and while the high point of IP theft came from cyber espionage between 2000 and 2015 (more a reflection of our lax defenses than of Chinese skill), the situation has changed considerably. Most of the estimates of the cost of Chinese commercial espionage, however, are exaggerated. A country could steal "$600 billion" in IP and not gain $600 billion in value if it is unable to turn the stolen IP into commercially valuable products. It does little good to steal IP if you do not have the expertise to use it, and until recently, this was true for China's espionage in advanced technology. What has changed in the last decades is that in many cases, China has the money and the skill to use much of the IP it has acquired licitly or illicitly. In other cases, China has realized that acquiring "know-hos" is more important than acquiring IP, and has turned to the purchase of western companies as a key part of its new industrial policies.

Because of past technology transfers through joint ventures and coproduction, and in part because of heavy, sustained government investment in science and research, China has developed its own innovation capabilities. In some technology areas, China may even be the world leader. This is a good thing for the global market and competition, and it should help spur a rethinking of America's relaxed approach when it comes to technology and innovation. What is not good is the Chinese government's policy of using unfair business practices to give Chinese companies an edge in marketing their innovations.

In the worst case, stolen IP means that the victim company faces a new competitor. In China, this new competitor may have access to government subsidies or benefit from a protected domestic market built with nontariff barriers to hobble foreign competition. Subsidized Chinese companies have an immense advantage operating from a closed domestic market and selling to an open international market. Confronting China over these practices is long overdue, but the central issue is not IP theft but the unfair treatment of U.S. companies in China. The word that China fears is reciprocity—that they should be treated in the United States the way American companies are treated in China.

Concern over technology transfer has been an element of the U.S.-China relationship for decades, but China's growing wealth and sophistication poses a new kind of challenge U.S. regulation and policy. Moreover, China's strategies for acquiring technology and, perhaps, for circumventing FINSA, are relatively agile and attempt to take advantage of this policy gap. The long-term viability of China's managed economy model is an open question, but in the near term, it creates new risks for U.S. companies and for national security.

One question for this hearing is whether the existing tools to manage risk are adequate. These include export controls and foreign investment reviews. Another question is whether a defensive strategy that seeks to block Chinese acquisitions is enough. The answer is both cases is that

there is room for improvement. Improving the ability to compete and to create new products in the United States is an essential complement of maintaining U.S. national security and leadership in technology.

We can review the question of the effectiveness of existing policy tools like CFIUS by looking at some of the ideas for CFIUS reform. The incentive for this review is that China appears to have looked for ways around FINSA regulations. This needs to be addressed by expanding the scope of covered transactions, by providing the Committee with additional flexibility for review in difficult cases, by moving from a transactional focus to better identify technology and business trends that create risk, finding ways to cooperate with foreign partners, and by ensuring it has the resources and information needed to timely decisions.

Some recommendations, such as expanding CFIUS's jurisdiction to review transactions that do not result in foreign control of a company but still allow access to technology, or expanding CFIUS authority to review overseas joint ventures, are better handled by export controls. The same is true for having CFIUS create lists of critical technology. The Departments of Defense, Commerce, and State already maintain such lists for export control purposes and while in some cases these lists need to be updated to focus on new and truly crucial technologies, another list is unnecessary.

Similarly, while it may be helpful to the CFIUS committee to have access to lists that identify countries of concern and broader technology trends, these are competencies already found in the National Intelligence Council (NIC), which already has a CFIUS support group and is required by FINSA to review CFIUS applications. The NIC would require additional resources if these tasks were added to its portfolio, but one important goal for change should be to expand CFIUS's current transactional focus.

FINSA gives the NIC a statutory role in the CFIUS process, but it does not have a "vote" on the committee. This is appropriate and should not change, both because of our long-standing principle of not giving intelligence agencies a role in policy-making and because the Departments of Defense and Justice, who are member of the intelligence community (IC), already protect IC equities in the CFIUS process.

CFIUS already has an implicit policy of greater scrutiny of transactions involving Chinese State Owned Enterprises (SOEs). These transactions already face significant hurdles, but it may be worth considering more explicit policies targeting SOEs.

Adding new Cabinet agencies that do not have a national security as a primary mission to the CFIUS committee would be inadvisable. The net effect would be to complicate a process and dilute its focus on national security. Twelve years ago, the French government blocked the acquisition of the yoghurt maker Danone (known in the U.S. as Dannon) by an American company to protect a national champion. This sounds and was ridiculous. We do not want to find ourselves in a similar situation, nor would it be advisable to make the CFIUS process more complicated. This applies to the question of mandatory filing as well. One authority provided by FINSA was the ability of the President to return to any foreign acquisition and reverse it. This "evergreen" provision creates a powerful incentive for filing.

The most difficult issue in considering how to expand the scope of covered transactions is whether to expand CFIUS authorities to cover "Greenfield" investments. This is a difficult issue

because many entrepreneurs, researcher and companies welcome Chinese investment in advanced technology. American companies maintain many research facilities in China. Finding a way to better grasp the potential risks of Chines greenfield divestment would require knowing the extent to which the source of Chinese investment was actually Beijing, ensuring that export control regulations are being observed, and giving CFIUS the scope to intervene if considered necessary for national security.

The U.S. would also benefit from a more formal cooperative mechanism. Informal cooperation exists now but this could be strengthened. Japan has adopted new regulations on "inward investment" and the European Union is drafting regulation to provide guidance to its members. All of them are motivated by the same challenge (although they do not say it publicly), that challenge being China's industrial policies. There is a good opportunity now to increase formal information sharing and cooperation in these matters to ensure that if an acquisition is denied on one country that others are aware of the denial and the reasons for it.

The decision to locate CFIUS in the Treasury Department was made to show that the goal is to encourage foreign investment while mitigating any risk to national security. This decision remains sound. It would not be useful to impose a "net benefit" or "reciprocity" test on foreign investment. These considerations are best left to the market, which takes these factors into account in its pricing mechanisms. The goal in any measure to strengthen CFIUS should be keep this open investment environment.

U.S. efforts to get China to follow global norms on technology, trade, and investment is long overdue, but it will not work without a strategy on how to move ahead in technology. The United States has innate advantages, with the strongest scientific base in the world, leading technology companies, and an innovative culture that others find difficult to match. Strengthening and revitalizing the partnership among companies, universities, and government can reignite U.S. innovation, but it will require a willingness to invest seriously in growth.

Reports that the Trump administration will challenge China over unfair trade practices are good news, but this needs to be accompanied by policies to accelerate the creation of new goods and services in the U.S. Innovation has become a buzzword and everyone is for it. Innovation means creating new products and services, either by improving existing products or by taking advantage of scientific discoveries. Companies spend heavily on developing new products, but very little on developing new ideas. A lack of support for research limits American innovation and economic growth.

Everyone agrees that innovation is essential for America prosperity and security, but America lives in a post-innovation environment of its own making. The nation that is coasting on the science investments of the Cold War, and underinvestment in research slows growth in income and productivity. For developed economies, innovation is the best way to grow, by finding better ways to use existing resources to produce goods and services. There are many reasons why productivity growth in the United States is flat, but underinvestment in scientific research is one of them, and this creates a self-imposed disadvantage in military and economic competition with China.

The innovation ecosystem is complex, interconnected, and global, but it is "pay-to-play." Restoring U.S. strength in innovation requires investment, both by encouraging private sector investment and by government spending in those areas, like basic research, where private sector

spending is likely to be insufficient. China has allocated billions of dollars for investment for research in and acquisitions of advanced technologies that are key to future economic growth, including semiconductors, 5G telephony, artificial intelligence, and super computers. The United States allocates millions for the same efforts, meaning we are being outspent a thousand to one. We do not want to take media hyperbole about a war over AI or supercomputing too seriously, but we also do not want to watch as others pass us.

There are other areas where policy changed could improve American innovation and economic performance. The recommendations of the International Monetary Fund for the U.S. economy include tax reform, less regulation, increased infrastructure spending, deficit reduction, educational improvements, and improved trade agreements. These can be contentious issues, but a decision to match China in investment for science and technology should not face the same debate.

It is important not to exaggerate China's strength. It faces immense problems in government debt, life-threatening pollution, mismanagement, and corruption, but under its current leaders, it intends to displace the United States and building globally dominant high tech industries is a part of this strategy. China's leaders are practical, however, and its behavior can be changed, however, if the U.S. develops a coherent strategy in cooperation with key allies. CFIUS is not the only tool we can use in this, but it is one of the most important. I thank the Committee for the opportunity to testify and look forward to any questions.