TRENDS AND IMPLICATIONS OF CHINESE INVESTMENT IN THE UNITED STATES

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED THIRTEENTH CONGRESS
FIRST SESSION

THURSDAY, MAY 9, 2013

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2013

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).

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

May 29, 2013

The Honorable Patrick J. Leahy
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable John A. Boehner
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR LEAHY AND SPEAKER BOEHNER:

We are pleased to notify you of the Commission's May 9, 2013 public hearing on "Trends and Implications of Chinese Investment in the United States." The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing.

At the hearing, the Commissioners received testimony from the following witnesses: Thilo Hanemann, Research Director, Rhodium Group; Dr. Derek Scissors, Senior Research Fellow, The Heritage Foundation; Andrew Szamosszegi, Principal, Capital Trade, Inc.; Elizabeth Drake, Partner, Stewart & Stewart; Mark Plotkin, Partner, Covington & Burling LLP; and Dean Popps, former Acting Assistant Secretary of the Army, Acquisition, Logistics and Technology. The hearing explored patterns of Chinese investment in the U.S. and the implications of that investment for U.S. policymakers.

We note that prepared statements for the hearing, the hearing transcript, and supporting documents submitted by the witnesses will soon be available 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 2013 Annual Report that will be submitted to Congress in November 2013. 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, Reed Eckhold, at (202) 624-1496 or via email at reckhold@uscc.gov.

Sincerely yours,

Hon. William A. Reinsch
Chairman

Hon. Dennis C. Shea
Vice Chairman

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TRENDS AND IMPLICATIONS OF CHINESE INVESTMENT IN THE UNITED STATES

THURSDAY, MAY 9, 2013

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in Room H-309 The U.S. Capitol, Washington, D.C. at 9:00 a.m., Commissioners Carolyn Bartholomew and Larry Wortzel (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF CAROLYN BARTHOLOMEW HEARING CO-CHAIR

HEARING CO-CHAIR BARTHOLOMEW: Good morning, everyone, and thank you for joining us. Today's hearing is on "Trends and Implications of Chinese Investment in the United States." It's the fifth hearing of the 2013 Annual Report cycle. Our next hearing is scheduled for June 6 when we'll explore China's relations with the Middle East.

Today we'll examine the patterns of Chinese investment in the U.S., the rationale for Chinese investment here, and the U.S. government's rules and procedures to screen and monitor such investments.

Historically, China has been a major recipient of foreign direct investment but not a major investor. Now, as its economy and its foreign exchange reserves continue to grow, it has the potential to become an important investor in its own right. Though starting from a very low base, the growth of Chinese outward FDI has been astronomical: from $2.5 billion in 2002 to just over 77 billion in 2012, according to official figures.

But official figures do not capture the full extent of Chinese investment. For example, they do not account for flows of FDI through Hong Kong and other offshore financial centers, which are likely transit points for Chinese money on the way to the real investment destination, and investments made by Chinese entities in the U.S. through private equity funds, venture capital firms, or other financing vehicles are very difficult to track.

In the U.S., Chinese FDI has been quite low so far, but it has substantial room to grow. The U.S. needs to be prepared to harness the benefits and address the potential problems posed by Chinese funds flowing into our economy. Though estimates vary, even the most generous assessment shows that Chinese FDI constitutes less than two percent of total inward investment coming to the United States.

For now, Chinese companies seem most interested in the U.S. energy and service sectors, particularly real estate and financial services. In energy, as in other sectors, they are pursuing technology and expertise they do not yet have. Chinese investors are, for example, acquiring companies with fracking technology, a field in which they are several generations behind.

If current trends continue, much of China's outward FDI will be made by Chinese state-owned enterprises. These SOEs receive substantial benefits from the central and provincial governments that are not available to their foreign competitors, including preferential policies and low cost of capital.

These SOEs are increasing their global presence, seeking to expand China's economic reach and power around the world. They are involved in aerospace, autos, oil, steel, and telecommunications, all industries that the Chinese government have designated as strategic. U.S. companies may face an uneven playing field when competing against Chinese SOEs in the United States and in the global market while enjoying none of the benefits afforded to SOEs by the Chinese government.

Investment by Chinese companies, the state-owned or state-controlled entities, in particular, is an issue of concern for members of Congress. In recent years, members of Congress have expressed misgivings with the security and economic implications of Chinese companies buying up American companies and resources. Cases that have garnered congressional attention in the last year include CNOOC's purchase of Nexen, a Canadian energy company with U.S.-based leases, as well as the Wanxiang Group's purchase of the Massachusetts-based battery maker A123 Systems.

In response, Congress has taken steps to gain more information on the nature and implications of China's investment. Most recently, pursuant to a recommendation in our 2011 Annual Report, Congress passed a provision in an appropriations bill that assigned the International Trade Administration, the ITA, at Commerce to report to Congress annually on Chinese investment in the U.S.

As agents of the state, SOEs should be given careful scrutiny as they come not only armed with the financial and policy support of their government, but also as implementers of the Chinese government's strategic thinking. Beyond the state-owned or state-controlled enterprises, there are companies that act under the direction of the state or with delegated authority. We need to understand the implications of their investment efforts in the United States.

Before I turn the microphone over to my colleague and co-chair of this hearing, Commissioner Wortzel, I would like to thank Congressman Frank Wolf and his staff for helping to secure today's hearing venue.

PREPARED STATEMENT OF CAROLYN BARTHOLOMEW
HEARING CO-CHAIR

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Hearing on Trends and Implications of Chinese Investment in the United States

Opening Statement of Commissioner Carolyn Bartholomew
May 9, 2013
Washington, DC

Good morning and thank you for joining us. Today's hearing on "Trends and Implications of Chinese Investment in the United States" is the fifth hearing of the 2013 Annual Report cycle. We appreciate your attendance and we encourage you to come to our other public hearings throughout the year. Our next hearing is scheduled for June 6, when we will explore China's relations with the countries of the Middle East.

Today's hearing will examine the patterns of Chinese investment in the United States, the rationale for Chinese investment here, and the U.S. government's rules and procedures to screen and monitor such investments.

Historically, China has been a major recipient of foreign direct investment (FDI) but not a major investor. Now, as its economy and its foreign exchange reserves continue to grow, it has the potential to become an important investor in its own right. Though starting from a very low base, the growth of Chinese outward FDI has been astronomical: from $2.5 billion in 2002 to just over $77 billion in 2012, according to official figures.

Official figures do not capture the full extent of Chinese investment. One reason is that they do not account for flows of FDI through Hong Kong and other offshore financial centers, which are likely transit points for Chinese money on the way to the real investment destination. Another is that investments made by Chinese entities in the United States through private equity funds, venture capital firms or other financing vehicles are difficult to track.

In the United States, Chinese FDI has been quite low so far, but it has substantial room to grow. The United States needs to be prepared to harness the benefits and address the problems posed by Chinese funds flowing into our economy. Though estimates vary, even the most generous assessment shows that Chinese FDI constitutes less than 2 percent of total inward investment coming to the United States. Chinese companies are most interested in the U.S. energy and service sectors, particularly real estate and financial services. In energy, as in other sectors, they are pursuing technology and expertise they do not yet have. For example, Chinese investors are acquiring companies with fracking technology, a field in which they are several generations behind.

If current trends continue, much of China's outward FDI will be made by Chinese state-owned enterprises (SOEs). Chinese SOEs receive substantial benefits from the central and provincial governments, which are not available to their foreign competitors, including preferential policies and low cost of capital. These SOEs are increasingly active globally, seeking to expand China's economic reach and power around the globe. They are involved in aerospace, autos, oil, steel, telecommunications and other industries that the Chinese government has designated as strategic. U.S. companies face an uneven playing field when competing against Chinese SOEs in the United States and in the global market while enjoying none of the benefits afforded to SOEs by the Chinese government.

Investment by Chinese companies, the state-owned or -controlled entities in particular, is an issue of concern for some Members of Congress. In recent years Members have expressed misgivings with the security and economic implications of Chinese companies buying up American companies and resources. Cases that garnered Congressional attention in the last year included CNOOC's purchase of Nexen, a Canadian energy company with U.S.-based leases, as well as the Wanxiang Group's purchase of the

Massachusetts-based battery maker A123 Systems. In response, Congress has taken steps to gain more information on the nature and implications of China's investment. Most recently, pursuant to a recommendation in the Commission's 2011 Annual Report, Congress passed an appropriations bill that assigned the International Trade Administration (ITA) at the Commerce Department to report to Congress annually on Chinese investment in the United States.

As agents of the state, SOEs should be given careful scrutiny as they come not only armed with the financial and policy support of their government, but also guided by the Chinese government's strategic thinking. Beyond the state-owned or state-controlled enterprises, there are companies that act under the direction of the state or with delegated authority. We need to understand the implications of their efforts.

Before I turn the microphone over to my colleague Commissioner Wortzel, I would like to thank Congressman Frank Wolf and his staff for helping to secure today's hearing venue.

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OPENING STATEMENT OF LARRY WORTZEL
HEARING CO-CHAIR

HEARING CO-CHAIR WORTZEL: Thank you, Commissioner Bartholomew, and welcome to our panelists and guests.

The dominance of state-owned companies in China's foreign direct investment means that the PRC government's technology acquisition, economic and foreign policy goals may be the guiding principles behind any given investments rather than commercial considerations.

Although Chinese investments may benefit the U.S. economy or U.S. companies and the U.S.-China bilateral relationship, these investments may be with other strategic goals in mind and could pose risks to U.S. economic and national security interests. Yet separating mutually beneficial investments from those that may ultimately hurt U.S. security and interests is no easy task.

Now, the United States has several policy mechanisms at its disposal to examine and mitigate any potential security risks from Chinese investments. The Committee on Foreign Investment in the United States, or CFIUS, is a specialized interagency process that reviews mergers or acquisitions of U.S. assets by foreign entities for national security threats. CFIUS reviews of foreign investments assess national security concerns, but they do not assess the economic benefits of any given transaction. CFIUS also does not apply to greenfield investments, which involves the creation of an entirely new company. The vast majority of Chinese investment in the United States either has been approved by CFIUS or has not required any review.

Another policy mechanism designed to protect classified national security information is the National Industrial Security Program. This is a program administered by the U.S. Defense Security Service on behalf of the Department of Defense and 25 other government agencies. This program outlines measures that prevent the unauthorized disclosure of classified information, including protective measures designed to mitigate any threat posed by companies determined to be under foreign ownership, control or influence.

There may be gaps, however, in the ability to identify and mitigate foreign ownership, control and influence. For example, a foreign entity could be the primary investor in a U.S. private equity fund with ownership in a company in this National Industry Security Program without this potential influence ever being disclosed.

Before we go further, I'd like to thank the Department of Defense and the Defense Security Service and the Department of Treasury, which manages CFIUS, for briefing the Commissioners on issues related to the national security aspects of Chinese investments in preparation for this hearing.

I would like to remind the members of the audience that all the written statements submitted for the record will be available on our website, www.uscc.gov, and a transcript of today's hearing will be published on our website later.

The testimony at this hearing and other hearings will help inform our Annual Report to Congress which we expect to publish in November.

Now, this first panel is going to give us an overview of sectoral and geographical patterns of Chinese foreign direct investment in the United States and analyze the drivers, the motivations, and incentives for Chinese investors.

We'll hear from Mr. Thilo Hanemann, Research Director of Rhodium Group, first. Mr. Hanemann leads the Rhodium's cross-border investment work. He's published numerous studies on cross-border investment, including one on the benefits of Chinese FDI in the United States. He was educated at the Free University of Berlin, Nanjing University and Columbia University in New York.

Also testifying in this panel is Derek Scissors. He's a Senior Research Fellow at the Asian Studies Center in the Heritage Foundation.

Dr. Scissors focuses his studies on the economies of China and India and analyzes and comments on broader economic trends in Asia.

He's testified before Congress a number of times. He has a master's degree in economics from the University of Chicago and a doctorate in International Political Economy from Stanford University.

The third panelist is Andrew Szamosszegi. Mr. Szamosszegi is a principal at Capital Trade, Inc., where he specializes in international economics and trade policy. He's consulted for U.S. and international clients on a wide range of economic and policy topics. His experience covers industrial, high technology, and agricultural products.

Mr. Szamosszegi earned his A.B. from Harvard University, studied at the University of Nagoya in Japan, and received his M.A. in Pacific International Affairs from the University of California, San Diego.

We try to limit the oral statements to seven minutes, and then each of the Commissioners generally get five minutes for questions and answers. So if we'll do it in that order, I think Mr. Hanemann, you start.

PREPARED STATEMENT OF LARRY WORTZEL
HEARING CO-CHAIR

U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

Hearing on Trends and Implications of Chinese Investment in the United States

Opening Statement of Commissioner Larry Wortzel
May 9, 2013
Washington, DC

Thank you, Commissioner Bartholomew, and welcome to our panelists and guests.

The dominance of state-owned companies in China's foreign direct investment means that the PRC government's technology acquisition, economic and foreign policy goals may be the guiding principles behind any given investments rather than commercial considerations. Chinese investments may benefit the U.S. economy or U.S. companies and the U.S.-China bilateral relationship; however, these investments may be made with other strategic goals in mind and could pose risks to U.S. economic and national security interests. Separating mutually beneficial investments from those that may ultimately hurt U.S. security and interests is no easy task.

The United States has several policy mechanisms at its disposal to examine and mitigate any potential security risks from Chinese investments. The Committee on Foreign Investment in the United States (CFIUS) is a specialized interagency process that reviews mergers or acquisitions of U.S. assets by foreign entities for national security threats. CFIUS reviews of foreign investments assess national security concerns, but they do not assess the economic benefits of any given transaction. CFIUS also does not apply to greenfield investments, which involve the creation of an entirely new company. The vast majority of Chinese investment in the United States either has been approved by CFIUS or has not required any review.

Another policy mechanism designed to protect classified national security information is the National Industrial Security Program (NISP): a program administered by the U.S. Defense Security Service (DSS) on behalf of the U.S. Department of Defense and 25 other government agencies. This program outlines measures that prevent the unauthorized disclosure of classified information, including protective measures designed to mitigate the threat posed by companies determined to be under foreign ownership, control or influence (FOCI). There may be gaps, however, in the ability to identify and mitigate FOCI. For example, a foreign entity could be the primary investor in a U.S. private equity fund with ownership in a company in the NISP without this potential influence ever being disclosed.

Today's hearing is designed to explore some of these very important issues. We have a number of highly qualified expert panelists today to help us assess these issues and think about possible solutions. Before we proceed, I would like to thank the U.S. Department of Defense, the DSS, and the Department of Treasury, which manages CFIUS, for briefing the Commissioners on issues related to the national security aspects of Chinese investment in preparation for this hearing.

I would like to remind the members of our audience that all of the written statements submitted for the record are available on our website, www.uscc.gov. A transcript of today's hearing also will be published on our website at a later date. And the testimony at this and other hearings will help to inform our Annual Report to Congress, which will be published in mid-November.

OPENING STATEMENT OF THILO HANEMANN
RESEARCH DIRECTOR, RHODIUM GROUP

MR. HANEMANN: Thank you. Co-chairs, Commissioners, good morning, and thank you for the opportunity to testify today.

My name is Thilo Hanemann. I am research director at the Rhodium Group, which is an economic consultancy based in New York. My research focuses mostly on global cross-border investment trends, and in that capacity I've been following Chinese outbound investment for many years now. My colleagues and I, we've published several reports on Chinese investment in the United States, which were based on a proprietary database that we have developed in-house that tracks Chinese FDI projects, so greenfield investments and acquisitions in the U.S. from 2000 onwards, and I think some of the data points from that work are highly relevant to the questions you are trying to address in today's hearing.

I have submitted an extensive written testimony, and I just wanted to focus on five key points from that written testimony in my initial statement, and I think your staff should have distributed a little chart book to you, which I'm going to use for my initial comments.

So the first important finding from the work that we've been doing is that we think the recent increase in Chinese FDI is a lot bigger than reflected in the official FDI statistics that we have from the BEA and others.

We count that between 2000 and 2012, Chinese firms have done about 630 FDI transactions in the United States, worth about 23 billion U.S. dollars. It's about double the latest figure that we have from the BEA.

The major reason for that difference is, as you can see in the chart on page two of my chart book that this increase mostly happened over the past three years. So there's a little bit of a time lag in those official statistics, but I think, hopefully, by summer 2013, we'll get an update from the BEA on those figures, and we expect them to be a lot higher than the figures we have from 2011.

However, even if you take into account the higher figures, Chinese FDI is still a very small portion of the overall FDI coming into the U.S. By using the BEA's preliminary figures for 2012 and our figures, China accounts for less than four percent of annual flows and less than one percent of total stock of inward FDI in the U.S. So it's still comparably minor.

Second, on slide three, I've plotted the industry distribution of Chinese investment in the U.S., and you can see that the increase happened because of a broadening of the investment interests by Chinese companies in the U.S. Before the mid-2000s, those entities invested mostly in trade facilitating operations, so smaller scale trade offices or rep offices in the U.S., which were aimed at facilitating exports. Over the past five years, that base has been broadened quite significantly, and the four most important trends are:

The first trend is in energy. We estimate that there's been about $5.5 billion invested in unconventional oil and gas extraction in the U.S.

The second trend is in advanced manufacturing. You can see on the chart that industrial machinery is a big area, as well as auto parts or aviation—all assets that help Chinese companies to move up the value chain in manufacturing.

The third trend is in modern services. So service sector investment targets not just trade facilitation, but also higher-value-added stuff like software and IT. There's also an increase of investment in entertainment and hospitality.

And then the last trend we see, especially over the past two to three years, is an increase in investments that help Chinese individuals and entities to preserve value at a fairly stable rate of return. Real estate is one of those industries mentioned before, and utilities are another area where Chinese entities have invested a lot of money.

With regard to the geographic distribution of Chinese investment in the U.S., we find that Chinese investors pretty much follow the path of other foreign investors before them with the big coastal economies attracting the majority of deals and investment dollars. California or New York are leading the list, but we also see states that have industrial clusters that are attractive to Chinese investors, like Texas in oil and gas or Illinois or Michigan in auto parts.

Overall, we find that Chinese companies are operating in at least 43 of the 50 U.S. states, so we are seeing a pretty broad-based increase across all different states.

Finally, as mentioned in the initial statements by the chairs, you were interested in a breakdown of Chinese investment by ownership structures of the investing company, and I've tried to calculate that on slide number five in your book. Three things are important.

First, if you look at the number of deals that have been done in the U.S., the overwhelming majority is done by privately owned companies, about 73 percent, from 2000 to 2012.

Second, if you look at the value of investment, total U.S. dollar value, the picture is reversed. State-controlled or state-owned enterprises account for more than 60 percent of the total dollars that are coming into the U.S. economy because those SOEs and sovereign entities are operating in capital-intensive industries like oil and gas extraction.

Finally, one trend that I would like to mention is that over the past one-and-a-half years especially, we see a marked increase in private investment flows from Chinese companies. Over the past 15 months, we have Chinese private companies investing about $4.7 billion in the U.S., which is as much as the combined 11 years before, so that's a pretty interesting trend that's important to consider. Private firms now account for about 50 percent of total inflows if you just look at the past one-and-a-half years.

Finally, as you will be looking at the economic and national security impacts of Chinese FDI into the U.S., I would like to mention one more figure that I think we provide uniquely. We also track employment at the subsidiaries of Chinese companies in the U.S., and we find that at the end of 2012, Chinese companies employed about 30,000 people in the United States.

Now compared to the total workforce of the U.S. and the total jobs provided by foreign enterprises that's not a lot, but it's a big increase compared to just 10,000 five years ago. And we also find that if you look at acquisitions separately, there have been no systematic job losses after a Chinese company acquired a U.S. company.

Now, the track record is probably not long enough to make a final judgment, but we don't see any evidence for a systematic asset stripping or acquiring of U.S. technology and moving jobs back. We actually see quite the opposite: Chinese companies tend to hire more local staff after they acquired a U.S. company that is in high-tech industries.

I think I'm at the end of my statement, and I'll be happy to answer any follow-up questions.

PREPARED STATEMENT OF THILO HANEMANN RESEARCH DIRECTOR, RHODIUM GROUP

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

Thilo Hanemann
Research Director, Rhodium Group LLC

Hearing on “Trends and Implications of Chinese Investment in the United States”
May 09, 2013

Patterns of Chinese Investment in the United States

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

I am research director at Rhodium Group (RHG), a New York-based economic research firm supporting the investment management, strategic planning and policy needs of firms in the private and public sectors. My own research focuses on global cross-border investment flows and the implications of the rise of China, India and other emerging markets as global investors.

I have been closely following Chinese overseas investment for more than five years and have published several studies on the topic. I also manage a proprietary database tracking Chinese investments in the U.S., and I would like to offer some numbers from this dataset to help the Commission better understand the extent of Chinese firms’ operations and investments in the United States and answer some of the questions laid out for this hearing.

This written statement summarizes some of these numbers. Charts representing the data graphically can be found in the Appendix.

1. Data on Chinese Investment in the U.S.

Analyzing Chinese investment in the U.S. is challenging due to lack of reliable and timely data sources. Neither the U.S. Bureau of Economic Analysis (BEA) nor Chinese statistical agencies offer a detailed breakdown of bilateral international investment positions. A rough picture of China’s investments in the U.S. can be drawn using the BEA’s international transactions data and the U.S. Treasury’s International Capital System (TIC). The latest available data points are summarized in Figure 1 in the Appendix.[1]

BEA’s latest available statistics on direct investment - which is traditionally defined as long-term ownership of 10% or more voting shares - put China’s FDI stock in the U.S. at $3.8 billion at year-end

[1] These charts are the best available snapshots; they are by no means complete, as no reliable statistics xist due to difficulties capturing financial flows.

2011. Another data set from the BEA that is compiled after the ultimate beneficiary owner (UBO) principle puts the stock of Chinese investment at $9.5 billion at year-end 2011 - an indication that the extensive use of offshore financial centers and tax havens makes it difficult for statistical agencies to accurately track Chinese FDI. However, this is the latest available official data point, and it dates back 1.5 years. In addition to a significant time lag, official sources also do not provide detailed data on the distribution of those investments and important variables like ownership or employment, often for confidentiality reasons.

Seeking more accurate and timely data, researchers have developed alternative databases to capture Chinese capital outflows by collecting information from regulatory filings, media reports and commercial M&A databases. One such database is Rhodium Group's China Investment Monitor (CIM), which covers acquisitions and greenfield projects by Chinese-owned firms in the United States with a value of $1 million and higher. It only includes investments that qualify as direct investment, using the 10% ownership threshold. The CIM is not directly comparable to data sets compiled using the traditional balance of payments approach to collecting FDI data, as it neglects reverse flows and does not fully capture intra-company loans and other follow-up flows. However, the bottom-up approach overcomes many of the weaknesses of the traditional approach - such as the incomplete accounting for flows through offshore financial centers - and allows for a detailed, real-time assessment of Chinese investment flows and ownership in the United Sates. [2]

2. Annual Flows of Chinese FDI to the U.S.

The RHG China Investment Monitor (CIM) records 633 Chinese deals in the United States between 2000 and 2012, amounting to $23.1 billion. These 633 deals consist of 445 greenfield projects – factories, offices and other facilities built from scratch – and 188 acquisitions of existing companies and assets. Acquisitions account for 85% of total investment value ($19.6 billion) and greenfield projects for the remaining 15% ($3.5 billion).

The annual patterns (presented in Figure 2 in the Appendix) illustrate the recent growth spurt in inflows. Before 2008, Chinese FDI flows into the United States typically stood below $1 billion annually, with the singular exception of Lenovo's $1.75 billion acquisition of IBM's personal computer division in 2005. Since 2008, Chinese investment has gained momentum, growing to just under $2 billion in 2009 and $5.5 billion in 2010. In 2011 Chinese investment came in slightly lower at $4.7 billion, but reached a new record high of $6.7 billion in 2012. With announced deals worth more than $10 billion by the end of the first quarter, 2013 will likely be another record year for Chinese direct investment in the United States.[3]

Our numbers on Chinese FDI transactions are higher than the latest available official data but still just a

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[2] For a detailed review of existing data sets and their advantages and weaknesses, see Rosen and Hanemann (2011) or Hanemann and Rosen (2012).

[3] Chinese FDI in the United States: Q1 2013 Update", Rhodium Group, http://rhg.com/notes/chinese-fdi-in-the-unitedstates-q1-2013-update

small percentage of total FDI in the United States. A few large-scale transactions and alarming headlines have led to the impression that China is “buying up” America.[4] This is not the case. Using official BEA figures for total FDI inflows (since our data does not cover FDI from other countries into the United States), China’s $6.7 billion accounted for less than 4% of total U.S. FDI inflows of $175 billion in 2012.[5] China also remains a small share (less than 1%) of total inward FDI stock in the United States of $3 trillion by the end of 2012.[6]

At the same time, it is important to note that China was one of the few bright spots in a deteriorating global FDI environment in 2012. Foreign direct investment into the United States dropped markedly during the 2008/2009 financial crisis and has never recovered to previous levels. In 2012, FDI inflows to the United States were down 25% compared to previous year, partially because European firms were investing less. The rapid increase of FDI from China goes against the global trend, highlighting China’s potential to become a significant source of FDI for the U.S. in the future.

3. U.S. Industries Favored by Chinese Investors

The recent increase of Chinese FDI in the United States is driven by a mix of changing policy conditions and commercial motives. On the policy side, Beijing’s official line flipped from opposed to highly supportive of FDI in overseas markets. This reversal was rooted in the interests of several bureaucracies, including awareness of the importance of global operations for firm competitiveness (MOFCOM and SASAC), fading concerns about maximizing foreign exchange reserves (MOF and PBOC), and increasing awareness of the strategic vulnerability entailed in a U.S. debt-heavy portfolio of external assets (NDRC, PBOC and others). While the ODFI approval process is still burdensome for many firms, it has been significantly relaxed in recent years.

While policy liberalization was an important prerequisite for growing Chinese outward FDI, the most important drivers of outward investment are changes in China’s domestic economy that are pushing Chinese firms to invest overseas. The distribution of Chinese investment by industry (as presented in Table 1 in the Appendix) underscores those changes. Before the mid-2000s, Chinese FDI into the U.S. mostly consisted of smaller-scale operations to facilitate trade in electronics and other consumer goods. Since then, a much broader set of motives drew Chinese firms to invest in the U.S. In 18 industries, we find more than $200 million in Chinese deals, of which about half are in industrial and half in service sectors.

The biggest recipient of Chinese FDI is the U.S. oil and gas industry. The unconventional energy boom has made the United States a prime frontier for global oil and gas investments, and is attracting Chinese firms eager to expand their overseas production bases and involvement in cutting-edge extraction techniques. The 2005 CNOOC-Unocal deal failure chilled Chinese enthusiasm about natural resource

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[4] See Time, “Will Asia “buy up” America?” August 30, 2011, available at: http://business.time.com/2011/08/30/will-asia-buy-upamerica/.

[5] According to preliminary figures from the BEA, the U.S. registered $175 billion of inward direct investment flows in 2012.

[6] The BEA records an inward FDI stock of $3.07 trillion as of the end of 2012.

projects in the United States, but the boom in unconventional oil and gas extraction has revived interest in North American acquisitions, resulting in several larger-scale oil and gas plays since 2010 adding up to more than $5 billion.[7]

American technology and advanced manufacturing are also attracting Chinese investment, fueled by structural adjustment at home. Increasing competition, rising factor input costs (especially labor), environmental compliance and remediation costs, and local impediments to consolidation to achieve economies of scale have spelled the end of the old Chinese business model focused on domestic markets and exports. These operating realities are compelling Chinese firms to look at U.S. assets to increase their competiveness at home and preserve access to U.S. customers abroad. The growing number of investments in industrial machinery, electrical equipment and components, automotive, alternative energy, medical devices and communications equipment illustrates the strong desire to invest in technology, brands, human talent and other competitive assets.

A related trend is increasing investment in modern service operations such as research and development, customer service and retail. Those investments complement the acquisition of advanced manufacturing assets and allow Chinese firms to tap into the U.S. talent base and move closer to their U.S. customers.[8] In the last two years we also saw increasing interest in acquiring core service sector assets, as Chinese firms gear up to profit from a domestic service sector boom.[9] The most targeted sectors are software and IT, hospitality and financial services.

Finally, direct investment stakes are increasingly becoming part of the asset management strategies of Chinese individuals, firms and institutional investors. Traditionally, those investors have a mandated "home bias" and hold most of their assets in China. However, given the risks of an undiversified portfolio and the current uncertainties about the outlook for growth in China, those investors are increasingly looking to diversify their portfolio internationally. Safe haven economies with a sound legal system and property rights protection like the United States are naturally attractive for such flows. The drop in prices following the financial crisis has made U.S. residential and commercial real estate an attractive target for these investors.[10] Other industries that traditionally offer stable long-term returns such as utilities have also attracted significant Chinese interest.

4. Geographic Location of Chinese FDI in the U.S.

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[7] For example, CNOOC's acquisition of stakes in Chesapeake Energy projects in 2010 and 2011 worth $1.7 billion and Sinopec's acquisition of Devon Energy in early 2012 valued at $2.5 billion.

[8] Some prominent examples include Huawei and Yingli Solar establishing high-tech R&D centers in California in 2011 and Lenovo establishing a fulfillment center in North Carolina in 2008.

[9] For example Wanda's acquisition of movie theater chain AMC in 2012.

[10] Both official statistics and our database underreport Chinese investment in U.S. real estate. However, recent examples of large-scale real estate grabs in the United States by Chinese firms include Shenzhen New World Group's dual acquisitions of Sheraton and Marriott hotels in Los Angeles in 2010 and 2011, and HNA Group's purchase of a New York City office building in 2011.

Unlike official FDI statistics, our dataset also provides a detailed breakdown of Chinese investment by state. Those data points (presented in Figure 3 in the Appendix) show that the recent increase in volume and scope of investment has brought Chinese firms to at least 43 of the 50 states. Mapping out Chinese investment flows by state reveals that Chinese money largely follows in the paths of other foreign investors, with traditionally strong economies on the east and west coasts being the top recipients of Chinese investment.

California is by far the number one destination for Chinese investment by number of deals, with more than 170 transactions between 2000 and 2012, or roughly one-quarter of all Chinese direct investments in the United States. The other top recipient states by number of deals are New York, Texas, Illinois, and North Carolina. In terms of total investment value, New York, Texas, Illinois and Virginia are leading the pack, followed by California. States with industry clusters that are attractive for Chinese investors have also received significant capital inflows, for example Michigan, Illinois and Ohio (automotive) or Texas (oil and gas).

5. Profile of Chinese Investors in the U.S.

Finally, our micro dataset allows for an in-depth analysis of Chinese investors in the United States by ownership and other variables. The first important finding here is that the pool of Chinese firms operating in the U.S. reflects the diversity of ownership in corporate China, ranging from sovereign investment entities (such as China Investment Corporation) to central state-owned enterprises (e.g., Sinopec) to firms with hybrid ownership structures (e.g., Lenovo), and wholly privately-owned firms (e.g., Wanxiang). Table 2 in the Appendix presents an overview of firms of different ownership types and their share in total Chinese investment in the U.S. from 2000-2012.

China's sovereign investment entities are making significant portfolio investments in the United States but have traditionally kept a low profile when it comes to direct investment. China's primary sovereign wealth fund, the China Investment Corporation (CIC), is an active investor in the United States, but has only made one investment in the U.S. that meets the direct investment threshold.[11] However, there are several investments by Chinese companies in which CIC has a significant ownership stake, for example the big state-owned banks. Several other high-profile government-controlled entities such as the State Administration of Foreign Exchange (SAFE) and the National Social Security Fund (NSSF) have portfolio investment positions in the United States, but have not yet ventured into FDI stakes.

State-owned enterprises account for only 27% of transactions from 2000-2012 but for 63% of total investment value in the same period. This reflects the fact that those SOEs are dominating capital intensive industries in China, and they are the ones closing the larger-scale deals in the U.S. too, for example in the extractive industry. Within the group of state-owned firms, central SOEs account for the majority of deals (73%) and investment value (75%) while firms owned by provincial and municipal governments play a smaller role (26% of deals and 25% of deal value).

[11] This refers to CIC's 2010 $1.58 billion investment of Virginia's AES Corporation. Details of the deal can be found at: http://investor.aes.com/phoenix.zhtml?c=76149&p=irol-newsArticle&ID=1402516.

Private firms - which we define as those having 80% or greater nongovernment ownership - account for the vast majority of transactions in the United States: 461 of 633 recorded investments between 2000 and 2012, or 73%. In terms of total investment value, private firms accounted for only 37% of total flows from 2000-2012 as they tended to invest in smaller and less capital-intensive projects than SOEs. However, private firms have lately been catching up with SOEs and are becoming an increasingly important driver of capital flows. They are now interested in medium and large-scale deals, not just the smaller transactions seen in the past, and they are increasingly capable of managing those investments. In the fifteen months from January 2012 to March 2013, private firms have spent as much money on FDI transactions in the U.S as in the eleven years before combined. In the same period, they accounted for 80% of transactions and close to 50% of total transaction value (as displayed in Figure 4 in the Appendix).

6. Employment Impacts of Chinese Investment in the United States

Our dataset also tracks the number of Americans employed by the subsidiaries of Chinese firms in the US. Chinese firms were negligible employers before 2008, with the exception of Lenovo's acquisition of IBM's personal computer division in 2005. Since 2009 the number or jobs provided has increased substantially on the back of greater annual investment flows and an increase in large-scale acquisitions. We find that the number of jobs provided by majority Chinese-owned subsidiaries has grown from fewer than 2,000 in 2000 to around 10,000 in 2007 and more than 30,000 at the end of 2012 (Figure 5 in the Appendix).

Our figures only refer to U.S. subsidiaries with a Chinese majority ownership, so they do not include employment provided by firms in which Chinese investors hold a minority interest. The latter account for more than 40% of the total value of investments in our database from 2000-2012, including shale gas assets by Devon Energy or Chesapeake Energy. If we added jobs at firms with Chinese minority equity stakes, our figure would be higher by several thousands. Nor do we include indirect job creation related to the construction of facilities or at suppliers, which can be sizable; Tianjin Pipe Corporation's (TPCO) new steel plant in Texas, for instance, is estimated to employ 1,000-2,000 construction workers.

The most prominent greenfield investors are Wanxiang, which entered the U.S. market in 1994 and grew into a diversified business employing 6,000 Americans; Haier, which established its first production facility in South Carolina in the late 1990s and today employs about 350 people; Huawei, which employs around 1,500 people at its R&D centers in California, Texas and New Jersey and other U.S. facilities; and Sany, which runs a manufacturing facility employing more than 130 people in Georgia. Big manufacturing projects currently under construction include TPCO's steel pipe plant in Texas and a copper tube manufacturing facility by Golden Dragon in Alabama.

The impacts that mergers and acquisitions have on jobs are less clear. M&A deals can be positive for local employment if the investor saves the target from bankruptcy or hires additional staff after the acquisition. But the impacts could also be negative if the post-merger integration or restructuring results in the downsizing of local employment, or if the investor chooses to extract valuable assets and shut down local operations completely. Reviewing the M&A transactions in our data set that gave Chinese investors majority control of a U.S. company, we find that the jobs impact is overwhelmingly positive.

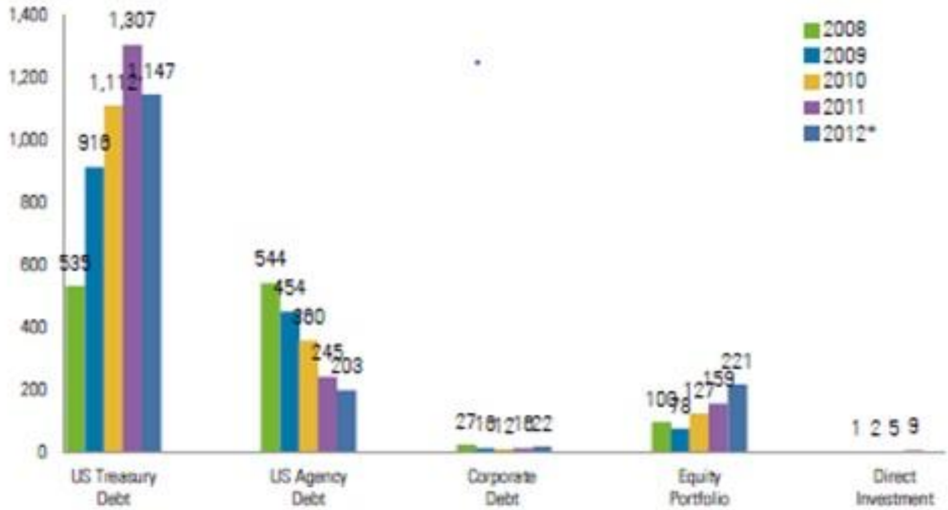
We see no evidence of systematic "asset stripping" behavior and find that most Chinese parent firms have maintained or added staff after acquiring companies in the United States.[12]

[12] For more details, see Rhodium Group, The Employment Impacts of Chinese Investment in the United States,
http://rhg.com/articles/the-employment-impacts-of-chinese-investment-in-the-united-states

Data Appendix

Figure 1: China's Investment Position in the United States, 2011/2012

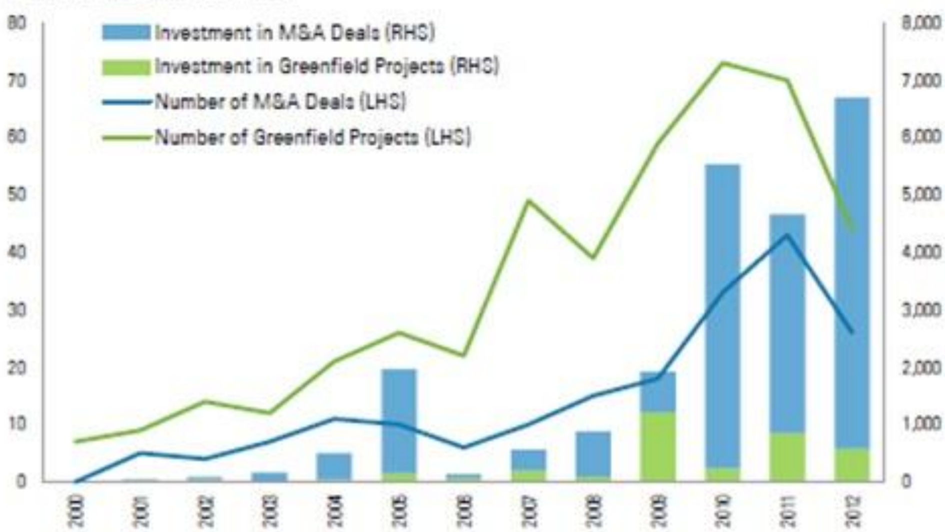
Billions of U.S. dollars, direct holdings only



Sources: FDI figures based on ultimate beneficiary owner data from the Bureau of Economic Analysis; other figures from the U.S. Treasury International Capital System (TIC). *2012 data are preliminary estimates.

Figure 2: Chinese Direct Investment in the United States, 2000-2012*

Number of deals and USD million



Source: Rhodium Group. *Numbers are preliminary and subject to adjustment. A detailed explanation of sources and methodology can be found at: http://rhg.com/interactive/china-investment-monitor

Table I: China's FDI in the U.S. by Industry, 2000-2012*

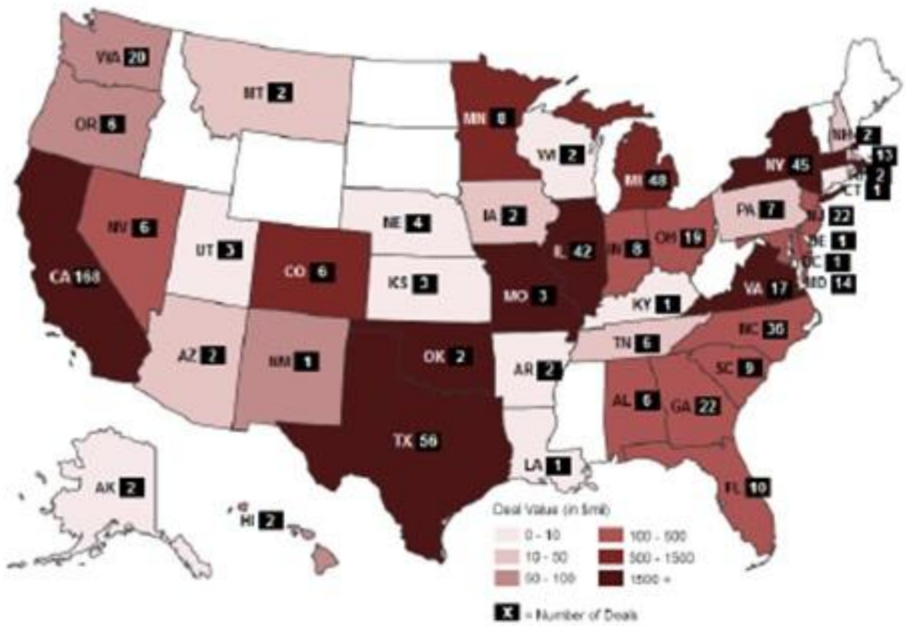
USD million and number of deals

			Value (USD mn)			Number of Projects		
			Greenfield	M&A	Total	Greenfield	M&A	Total
1	Coal, Oil and Gas	Primary	6	5,250	5,255	4	11	15
2	Farming, Logging and Husbandry	Primary	15	64	79	1	7	8
3	Paper, Rubber and other Materials	Primary	111	0	111	15	0	15
4	Aerospace Equipment and Components	Secondary	106	460	566	4	5	9
5	Automotive Equipment and Components	Secondary	422	739	1,160	45	22	67
6	Chemicals	Secondary	5	4	9	5	1	6
7	Consumer Products and Services	Secondary	189	2,050	2,239	56	18	74
8	Electronics and Electronic Parts	Secondary	55	88	143	33	9	42
9	Food Processing and Distribution	Secondary	8	33	41	6	2	8
10	Healthcare and Medical Devices	Secondary	13	279	293	7	4	11
11	Industrial Machinery and Tools	Secondary	197	1,711	1,908	39	13	52
12	IT Equipment	Secondary	221	190	411	36	6	42
13	Metals and Minerals	Secondary	1,256	70	1,327	14	4	18
14	Other Transportation Equipment	Secondary	51	5	55	9	1	10
15	Pharmaceuticals and Biotechnology	Secondary	65	192	257	20	6	26
16	Renewable Energy	Secondary	483	204	688	44	13	57
17	Semiconductors	Secondary	1	212	213	1	5	6
18	Business Services	Tertiary	43	318	361	20	15	35
19	Construction Services	Tertiary	6	0	6	4	0	4
20	Entertainment, Media and Publishing	Tertiary	9	2,814	2,823	4	5	9
21	Financial Services and Insurance	Tertiary	58	344	402	10	3	13
22	Hospitality and Tourism	Tertiary	13	345	358	1	5	6
23	Real Estate	Tertiary	0	992	992	0	10	10
24	Software and IT Services	Tertiary	176	612	788	45	21	66
25	Transportation Services	Tertiary	31	0	31	21	0	21
26	Utilities	Tertiary	1	2,813	2,814	1	2	3
	Total		3,540	19,590	23,130	445	188	633

Source: Rhodium Group. *Numbers are preliminary and subject to adjustment. A detailed explanation of sources and methodology can be found at: http://rhg.com/interactive/china-investment-monitor

Figure 3: Geographic Distribution of Chinese Direct Investment in the United States, 2000-2012*

Accumulated deal value from 2000-2012, USD million



Source: Rhodium Group. *Numbers are preliminary and subject to adjustment. A detailed explanation of sources and methodology can be found at: http://rhg.com/interactive/china-investment-monitor

Table 2: China's FDI in the U.S. by Ownership of Investing Company, 2000-2012*

USD million and number of deals

Number of Deals

	Greenfield	% share	M&A	% share	All Deals	% share
Government Controlled	131	29%	45	24%	176	28%
Central SOEs	*84*	*19%*	*23*	*12%*	*107*	*17%*
Provincial & Municipal SOEs	*29*	*7%*	*16*	*9%*	*45*	*7%*
CIC & Central Huijin	*10*	*2%*	*2*	*1%*	*12*	*2%*
Other	*8*	*2%*	*4*	*2%*	*12*	*2%*
Private and Public*	314	71%	143	76%	457	72%
	445		**188**		**633**	

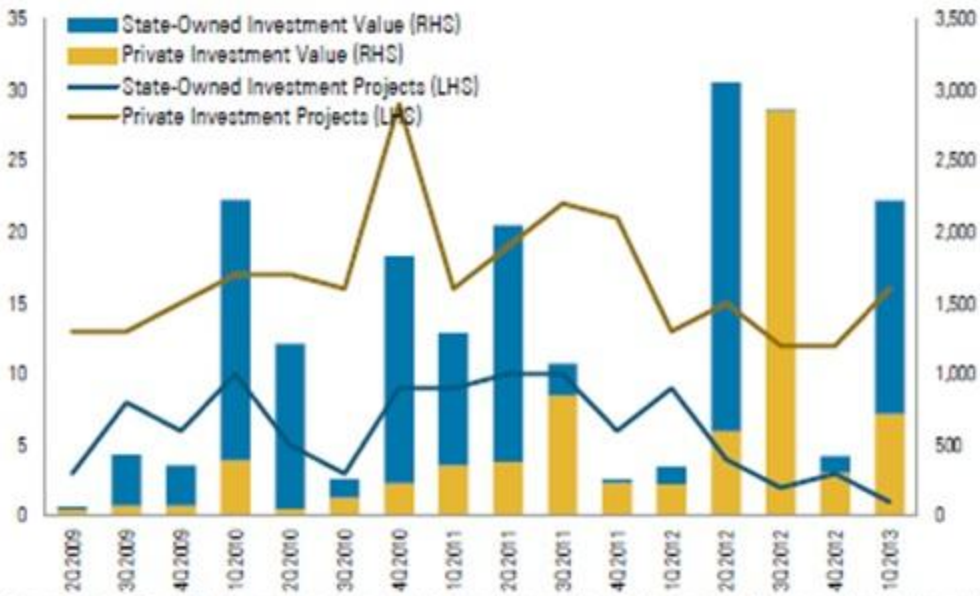
Value of Deals

	Greenfield	% share	M&A	% share	All Deals	% share
Government Controlled	2,227	63%	12,399	63%	14,626	63%
Central SOEs	*877*	*25%*	*6,667*	*34%*	*7,544*	*33%*
Provincial & Municipal SOEs	*1,188*	*34%*	*2,154*	*11%*	*3,342*	*14%*
CIC & Central Huijin	*49*	*1%*	*1,721*	*9%*	*1,770*	*8%*
Other	*113*	*3%*	*1,857*	*9%*	*1,970*	*9%*
Private and Public*	1,313	37%	7,191	37%	8,504	37%
	3,540		**19,590**		**23,130**	

Source: Rhodium Group. *Numbers are preliminary and subject to adjustment. A detailed explanation of sources and methodology can be found at: http://rhg.com/interactive/china-investment-monitor; **May include minority stakes by government-owned investors below a combined 20% of voting shares

Figure 4: Chinese Direct Investment in the US by Ownership, Q2 2009 – QI 2013*

Quarterly figures, USD million



Source: Rhodium Group. *Numbers are preliminary and subject to adjustment. A detailed explanation of sources and methodology can be found at: http://rhg.com/interactive/china-investment-monitor

Figure 5: Chinese FDI and Employment at Majority Chinese-Owned US Firms, 2000-2012*

Value in USD millions (RHS); number of investment deals (LHS)

Source: Rhodium Group. *Numbers are preliminary and subject to adjustment. A detailed explanation of sources and methodology can be found at: http://rhg.com/interactive/china-investment-monitor

OPENING STATEMENT OF DR. DEREK SCISSORS
SENIOR RESEARCH FELLOW, THE HERITAGE FOUNDATION

DR. SCISSORS: I'm glad to be in front of the Commission again. Thank you, everyone, for inviting me.

Overview--I'll start with a case. IDG Accel, which is a joint venture, just bought Memsic in Boston for about $90 million. Memsic is a microelectronic manufacturer, and the role of the Chinese state in this is not obvious, and experts like me should be employed to evaluate it, and the importance of the technology is not obvious, and experts not like me at all--real experts--should be employed to evaluate that.

The U.S. should be doing that, and that's an example of an acquisition here that we should be looking at. I really hope CFIUS is involved even if they say, hey, we looked at it, the technology is fine, and we're done.

Having said that--that's an actual point of data, and there is a fair amount of data. Rhodium has some. We have a different set of data. Other people have data. The decision should be based on data, not stories, not hearsay, not "doesn't this sound like advanced technology; we should restrict it." That's not the way to do an evaluation. "China is taking over the world" is not correct or the way to make an argument either.

So I do think there are reasons for the U.S.--this is an overview statement-- to evaluate Chinese investment, to study it, but that's what we should be basing our decisions on, those studies and evaluations. We have a pile of data we should look at, and we should not be telling stories and making assertions.

Yet you're going to get different numbers from different people and, for example, different numbers from us than Rhodium. The advantage we have over Rhodium--and I'll get to their advantage later unless, of course, I forget it.

[Laughter.]

DR. SCISSORS: The advantage we have over Rhodium is a global context. I started studying Chinese outward investment in 1999. There really wasn't much going on. It became interesting when Lenovo bought IBM's personal computer unit so the data set we have starts in 2005, and the advantage we have over the Chinese official data is they have 40, 50, sometimes 60 percent of China's investment going to Hong Kong, which is absurd. It just goes through Hong Kong with the other countries so you get a bad regional distribution. They call their top sector Business and Leasing Services. Nobody knows what that means, including MOFCOM, Ministry of Commerce. So official data isn't useful.

On our tally, China is--you get the slow climb on annual investments so it's about $80 billion in 2012. It could dip in 2013 depending on when they count the CNOOC Nexen investment. If it doesn't, it will dip in 2014, but then it will go back up. So we have a secular slow climb.

They have problems. We have a troubled transactions list that amounts to over $200 billion now. So Chinese investment could be considerably higher. They're going to continue to have problems. They make mistakes in their investments, and as more companies get involved in investing, it's not just a couple of huge state giants, they'll make more mistakes.

They get the host countries upset with them. There was a huge surge of Chinese investment into Brazil in 2011. The Brazilians said okay, okay, just slow down, and they weren't angry. It’s not that they didn’t want Chinese investment, they just felt a bit overwhelmed. So there are these reasons for the growth to be slow, but there should be continued growth.

The top country, the U.S., has now pulled even on our count with Australia, kind of neck and neck for the top country. The way we organize North America is the biggest recipient. Some people will talk about the EU versus the U.S. I don't think that's the appropriate comparison. The EU should be compared to North America if you're going to group the EU.

As I think everybody here knows, commodities lead. Energy first, led by oil, though not just oil; then metals led by iron. There's an obvious aim to secure supply. I'm going to talk about that a little bit at the end when we talk about strategy.

And then till now--and this echoes a point that Thilo has just made--if you look over the history of 2005 to 2012, state-owned enterprises account for, on our tally, 92 percent of Chinese investment--by volume, not by transaction--, but the number drops to about 75 percent in 2012. So we don’t have a trend as it’s just one year, but we have evidence that Chinese private investment volume has increased and could continue to increase.

So you've got to be careful, which the previous testimony said very well. There’s been a surge in Chinese investment in the last year-and-a-half and it’s very important, but the question is: will it last? It’s not yet clear. It's only a year-and-a-half, but we have seen a change from the previous pattern. When this started, it was 100 percent state-owned. That’s who invested overseas.

And I'm going to do the U.S. side of this very quickly because I don't want to get people confused. We have a different data set. We count portfolio investment that isn't in bonds, meaning not the huge Treasury bond investment. The reason is because it's policy relevant. Therefore, on our side, finance leads, not energy, because there have been a bunch of Chinese financial investments.

So we reached the same point as Rhodium. Our number--which is high for Chinese investment, because we count those portfolio investments outside of bonds--is $50 billion from 2005 to 2012. Cumulative U.S. GDP over this period is $114 trillion. It's less than one-twentieth of one percent, so who cares? It's not an important economic factor.

Yes, it could be understated. Their indirect acquisitions, SAFE is always trying to hide what it's doing--SAFE, the State Administration for Foreign Exchange--trying to hide what it's doing everywhere, but no matter what you do, it's trivial. If Chinese investment total in the U.S. doubles in the next four years to 100 billion, it will still be trivial. It's not an important economic factor in the United States. That's not why we're talking about it.

Now, I want to talk about strategy. The yellow light is already on.

There is an obvious Chinese strategy. They want to secure valuable resources whether it's physical resources or technology. It's not mysterious. They're not trying to hide it. They may be trying to hide individual transactions--SAFE certainly does--but they're not trying to hide a strategy.

And it's not a particularly good strategy. They bought a bunch of financials in 2007. For all of us who were in the stock market in financials in 2007, I think we know how that turned out. They're recently trying to tap into U.S. energy, which makes a lot of sense. They would like U.S. technological innovation in shale, but why? Because they're never going to innovate in shale at home since they have monopolies, and so the small companies that have innovated in shale in the U.S. don't exist in China, can't really exist in China in that particular field, so they have to get the technology from somewhere else.

You might say, well, this is smart, but it's only smart because they've set themselves up foolishly at home, and I don't know how great I think that strategy is. They are trying to acquire U.S. technology. They've been cagey about it on more than one occasion. The Chinese strategy is something to watch for.

I'm going to quickly talk about the U.S. response. The fact that they're trying to acquire U.S. technology does not mean that everything they're trying to acquire is advanced technology that we have to restrict. And I think A123 is a very clear example of that. Nobody wanted it, but somehow it's really important and advanced. You need to make a pretty strong case when no one wants the technology and the company is failing.

Is Memsic, which is where I started, is that not advanced technology? I don't know. We need to do an evaluation. The Pentagon, CFIUS, depending on what's involved, should be doing these evaluations, and when there is illegal Chinese activity, there should be some sort of response. So I'm not advocating that the U.S. do nothing. I am advocating that we do this on the basis of facts, and we otherwise keep our market open. Those are our principles. That's what we want the Chinese to do. That's what we want the world to do.

Thank you.

PREPARED STATEMENT OF DR. DEREK SCISSORS
SENIOR RESEARCH FELLOW, THE HERITAGE FOUNDATION

Testimony for the U.S.–China Economic and Security Review Commission
May 9, 2013

Chinese Investment in the U.S.: Facts and Motives
Derek Scissors, Senior Research Fellow in Asia Economics, The Heritage Foundation

Now and for some time to come, the bulk of Chinese investment in the United States will take the form of Treasury bond holdings. Excluding bonds, Chinese investment in the U.S. is a $50 billion issue that could have been a $75 billion issue already and will be a $100 billion issue within a few years. When flowing out of an economy still largely centrally directed, this spending naturally raises questions about whether the investment strategy or strategies involved could harm American interests.

The answer is yes, but not to the extent and apparently not in the way some critics fear. There is plainly a strategic dimension to Chinese outward investment, and it has harmful elements. State-owned enterprises are instructed to acquire assets perceived as valuable by Beijing. They are heavily subsidized, posing questions about whether the clear benefits of investment in the U.S. are offset by anti-competitive influences. But these features are not hidden, much less insidious. Nor is Chinese strategy especially wise or effective.

Unfortunately, this answer is incomplete. Indirect purchases by PRC entities do occur, as do clandestine attempts at technology acquisition. The U.S. should ask for voluntary disclosure of investments routed through third parties and sharpen disclosure requirements if the response is unsatisfactory. Dual-use technology should be protected by an enhanced Committee on Foreign Investment in the United States. To be genuinely productive, any steps the U.S. takes should themselves be transparent.

What American policymakers should avoid is discouraging Chinese investment on the basis of exaggerated hearsay. The facts on the ground indicate what are now well-known policy challenges and immediately useful steps to increase transparency. They do not come close to justifying protectionist actions.

The Heritage Tracker

The Heritage Foundation's China Global Investment Tracker is the first public dataset in the field, including the limited offerings from the PRC government. It covers outward investment excluding bonds. The Tracker is global and extends back to 2005, the start of large-scale Chinese investment in the U.S. and the world. It utilizes corporate data and is updated semiannually.

The Tracker presently contains over 400 investment transactions of $100 million or more dated between

January 1, 2005, and December 31, 2012. The total value of these transactions approaches $390 billion. The Tracker also contains an auxiliary dataset of over $200 billion worth of investments which have lost more than $100 million in value. Finally, it contains supplementary data on Chinese construction and engineering contracts worth well over $200 billion. (This list is incomplete and contains very few U.S. transactions to date.)[1]

The trend for Chinese outward, non-bond investment is to increase, if unsteadily. (See Appendix 1.) Investment in 2012 was close to $80 billion. Outbound investment will likely breach $100 billion annually by 2015 or 2016.

Official Chinese sector categories are topped in investment volume by "business and leasing services" and seem designed to draw attention away from an obvious bias to commodities. On the Heritage tally, energy is the top investment target. (See Appendix 2.) Within energy, oil leads but it is no longer dominant due to surging investment in integrated oil and gas projects. Metals is next; energy and metals together account for over 70 percent of Chinese outward investment since 2005. The heyday for finance was before the global crisis. Agriculture, real estate, and technology are other areas of high interest, while transportation is an area of high expertise.

Official Chinese data purport that Hong Kong receives at least 40 percent of annual investment and sometimes a good deal more. In fact, this money moves through Hong Kong on its way elsewhere. According to the Heritage tracker, the U.S. has pulled essentially even with Australia in the total amount of non-bond investment received since 2005. In 2012 alone, Canada led, via a $15 billion energy acquisition. Unsurprisingly, the European Union as a whole receives more than any individual country, though it is often the case that acquisitions are of European-headquartered companies and the bulk of the actual assets is located elsewhere.

Chinese firms have moved overseas in packs. Australia was the first destination, followed by sub-Saharan Africa, South America and, beginning in 2012, North America. It may be that the end of 2013 and start of 2014 will see another shift, perhaps to the oil-producing states in West Asia or assets physically located in Europe.

U.S. Facts

The Tracker includes 58 Chinese investments of $100 million or more in the U.S. since 2005, totaling about $50 billion. This is 13 percent of China's global total. In 2012 alone, the U.S. was second to Canada in attracting investors, drawing a record $14.7 billion on the Heritage tally. This was nonetheless only the equivalent of less than 0.1 percent of 2012 GDP. Looking forward, Chinese investment in the U.S. could outpace investment growth globally, but there will undoubtedly be fits and starts. Cumulative

[1] For a global overview, see Derek Scissors, "China's Global Investment Rises: The U.S. Should Focus on Competition," Heritage Foundation *Backgrounder* No. 2757, January 9, 2013, http://www.heritage.org/research/reports/2013/01/chinas-global-investment-rises-the-us-should-focus-on-competition. For an interactive tool, see "China Global Investment Tracker Interactive Map," http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map.

investment should reach $100 billion within five years, still a relatively small amount.

The leading sector for investment in the U.S. has been finance, at a bit over $20 billion. This constitutes over half of Chinese non-bond investment in finance worldwide. Multiple large acquisitions occurred before the financial crisis and therefore lost considerable value. More active recently is energy and power, at $11.4 billion. This is just 6 percent of Chinese energy investment worldwide, indicating the American market has considerable potential in this regard.

Surprisingly, transport is the third-largest recipient in the U.S. at close to $6.5 billion, which constitutes almost 40 percent of China's global investment in transport (construction contracts are the more popular form of overseas transport business). But this is driven by a single transaction: the acquisition of AIG's aircraft leasing unit in December 2012.

Real estate and agriculture qualify as promising. Due partly to political and economic conditions in the PRC, there has been a surge in real estate purchases in the U.S. during the past two years and more are coming. Most are small-scale, but large-scale spending has also begun to appear. Agriculture is a missed opportunity: U.S. farmland should be more highly prized. In technology, despite the restrictions, the PRC's $2.5 billion investment in the U.S. is almost 30 percent of its global total. (The total does not include technology equipment contracts, where the U.S. is not involved.) Finally, the U.S. accounts for only 1 percent of Chinese metals investment.

With the leading role played by finance, the state of New York has drawn over two-fifths of Chinese investment in the U.S. If New York were a separate country, as some allege, it would be the fifth-largest recipient of Chinese investment. Next is Texas at 12 percent; no other state stands out. Only 17 states have drawn a Chinese investment of $100 million or more to date. This will change—more states are actively seeking investment and they will be successful. The American political debate over China policy will shift as a result.

The leading Chinese investor also follows directly from the emphasis on finance. China Investment Corporation (CIC), the smaller of the two sovereign wealth funds, is the undisputed king. CIC was created in part to diversify Chinese investments in the U.S. away from bonds, and aside from Hong Kong, the U.S. is its most important market. By itself, CIC accounts for over two-fifths of Chinese investment in the U.S. It was far less active in 2012, though, and may be seeking to reduce the U.S. weight in its holdings.

The larger wealth fund, the State Administration for Foreign Exchange (SAFE), is the next-largest investor at a bit under 10 percent of non-bond investment. SAFE is also the principal vehicle for purchases of American bonds. It is extremely secretive, and it would not be at all surprising if SAFE vehicles held more in American assets than can be documented. A small group of companies is in the $2 billion–$3 billion total investment range through end-2012. Oil major Sinopec is perhaps most notable among these, since it also is involved in large construction contracts here. As yet, very few Chinese companies have made the U.S. their top investment destination. If the environment remains stable, this will change.

The Heritage Tracker identifies parent companies, not subsidiaries. In terms of the volume of investment in the U.S., state entities predominate. From 2005 to 2012, they accounted for 86 percent of total investment, private entities 14 percent. However, in 2012 alone, the private share was almost double that, possibly indicating a new trend.

Why and Why Not

Outward investment by any firm seeks something relatively lacking at home: additional demand (new market), physical assets, technology, labor force qualities, or simple financial return. The value of these is judged against the risk imposed by the political and regulatory environment.

Energy and metals—physical assets—have drawn by far the most Chinese investment globally. Farmland is similar but has not yet been made widely available. Finance and real estate are the next largest in size and aimed primarily at simple financial return. In transport, Chinese firms are looking to exploit their expertise by finding demand beyond the home market. Acquisitions of technology have been largely stymied. Across sectors, Chinese firms have long sought particular skills in foreign labor forces and now may seek cheap labor as the home labor market tightens.

On paper, the U.S. has everything an investor could want. It is by far the world's largest market. The U.S. has abundant land and energy assets, coal as well as shale. It is the world leader in technology and, arguably, skilled labor. The American real estate market has been more lucrative than China's for the past three years (Chinese investment in the U.S. has only an eight-year history). And American demand for transportation infrastructure is potentially quite high. The U.S. government does not need to do anything to make the country more attractive; the fundamentals are more than enough.

However, Chinese firms have not yet sought on a large scale to serve the American market through investment here. The U.S. does not permit most Chinese technology investment, with the medical sector an exception. This also reduces the scope for utilizing skilled labor. Energy assets were initially blocked, then perceived as blocked, and even now there is uncertainty over the acceptability of majority ownership in shale and any investment in coal. Banking drew heavy investment before the crisis; now real estate is drawing heavy investment. In practice, the main drivers of Chinese investment in the U.S. have been limited to perceived financial returns in banking and then real estate, supplemented by rising interest in American shale extraction.

One way to quantify the gap between the potential of the U.S. market for Chinese investment and its realization is Heritage's data on troubled transactions. The Heritage tally for the value of troubled Chinese investments in the U.S. between 2005 and 2012 is 15 transactions for about $30 billion, the most famous being CNOOC's attempted $18 billion acquisition of Unocal. (A $5 billion equipment contract was also blocked.) Had all of these been successful, total Chinese non-bond investment in the U.S. would have already reached at least $80 billion and probably more, since the Unocal failure was followed by an almost two-year lull in spending.

There are multiple reasons for the partial or complete transaction failures: (1) the inexperience of many Chinese firms; (2) American barriers; and (3) the role of the Chinese state. The first will fade over time.

As more PRC firms become more knowledgeable about the U.S. market, they will be able to cater more to American consumers. Other PRC companies will learn which opportunities in land and transport are genuine. Parts of the American labor force will become more appealing. Sustained Chinese investment in the U.S. began only in 2007 and was carried by financials until 2010; there is still a great deal of space for learning.

The second explanation for the unrealized market potential is U.S. government policy. In addition to CNOOC-Unocal, there are six cases of U.S. government actions that hampered or prohibited over $4 billion in investments. There are also potential projects that, in light of these failures, never moved forward. The latter point is critical both from a simple reading of the data and the clear consensus of Chinese executives: By far the most important U.S. government action to discourage investment is policy uncertainty.

For example, how exactly should other investors read the treatment of Huawei? American policymakers might think telecom has been clearly differentiated from any other sector, but the Chinese side does not. And there are matters that no American policymaker can possibly believe are transparent. Where does CFIUS's role end and Congress's begin? More narrowly, why did the $440 million acquisition of Nexteer's auto parts business sail through in 2010 but a $170 million minority investment in Steel Development's low-technology rebar production see sharp criticism a year later?

In general, what is available for investment and what is not? This is the most basic question for any investor, and the U.S. has failed to answer clearly with respect to many Chinese enterprises.

Strategic Behavior by Chinese Entities

The third factor influencing Chinese investment choices in the U.S. is the Chinese state. There is almost surely a plan behind Chinese investment, both globally and in the U.S. State-owned enterprises dominate outward investment volume, making it feasible to have a coordinated strategy beyond simply seeking demand or higher financial return. More specifically, Beijing has repeatedly indicated that ownership of overseas commodities is a valuable means of ensuring the continuous imports the PRC's economy so badly needs. It is therefore no surprise that commodities investment by state firms dominates spending.

For the U.S., investment from 2007 to 2009 was almost entirely by a very small number of state financials. This certainly looks coordinated. The interest of the state oil majors in U.S. shale matches perfectly the interest of their government in diversifying energy sources and finding techniques to extract shale at home. More broadly, China's national interest in and corporate attempts to acquire technology to move up the value chain in production are no secret.

This is an important aspect of China's global investment strategy: it is not mysterious. Beijing perceives economic needs and strongly encourages state enterprises to meet them. The desire for resources and technology is well-known, as is the desire for national champions who can expand overseas. The foundations for Chinese outward investment are neither subtle nor, except for advanced dual-use technology, dangerous. They are also not especially sound. Metals investment feeds industries the central government constantly cites as suffering from sustained overcapacity. The PRC can catch up by buying foreign technology; by definition, it can never lead.

More specific sets of policies are equally unimpressive. The 12th Five-Year Plan discovered new strategic industries, adding them to the pile of old industries that should be fading but are still treated as strategic due to lack of political will. As a matter of economic development, the central government has shown little aptitude for identifying sectors to support, much less to abandon. In terms of outward investment, the loose guidance means most Chinese investments can be labeled strategic in policy terms, and the label thus has almost no real significance.

The challenge for the U.S. is not that Chinese industrial policies are especially effective; it is merely that the policies exist. Designated and aspiring national champions are handed the internal market and further subsidized in order to win global market share. They cannot go bankrupt and so no competition with them can be entirely fair. How to respond to the basic fact of state subsidization is a vital, well-established issue for the U.S. in dealing with the PRC; the additional matter of a grand investment strategy employing the subsidies is far from vital.

A second genuinely important issue concerns a second absence of transparency, this time on the Chinese side. SAFE in particular is a remarkably opaque organization and very likely has substantial indirect investments it is attempting to keep hidden.

The slim evidence of indirect acquisitions—an opaque Australia-based investor buying Japanese equities, a conspicuously timed surge in Cayman Islands purchases of U.S. Treasuries—indicates SAFE is probably interested in diversification and secrecy rather than dual-use technology. Indirect transactions by SAFE and others in the U.S. have focused on real estate and, to a lesser extent, autos. But SAFE's secretiveness plus several unwise choices by Chinese companies mean there are transactions whose nature was or is intended to be opaque, fueling suspicion.

The U.S. government can partly address this problem. Specific disclosure requirements can be formulated for financing vehicles, whether domiciled in the U.S. or elsewhere, receiving large sums from government arms or state firms. An example is SAFE's $2.5 billion contribution to one of TPG's funds in 2008. Stringent requirements, of course, will tend to reduce the capital inflow from SAFE and perhaps other entities. It would be better to have information voluntarily provided by the Chinese side and to take regulatory action only if such reasonable cooperation is not forthcoming.

Beyond additional disclosure, the Committee on Foreign Investment in the United States (CFIUS) must have clear authority to monitor indirect investments by any foreign entity, through foreign or domestic financial vehicles. A slow, unclear process will reduce investment, so the CFIUS mandate must also include strict operational guidelines. An intrusive CFIUS would be an unintended protectionist barrier, and also risk undermining the American goal of greater investment access to foreign markets.[2]

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[2] The proper role for CFIUS is an important issue deserving of separate discussion. See, for example, Derek Scissors, "A Better Committee on Foreign Investment in the United States," Heritage Foundation *Issue Brief* No. 3844, January 28, 2013, http://www.heritage.org/research/reports/2013/01/enhancing-

Conclusion: Tweak Rather Than Twist

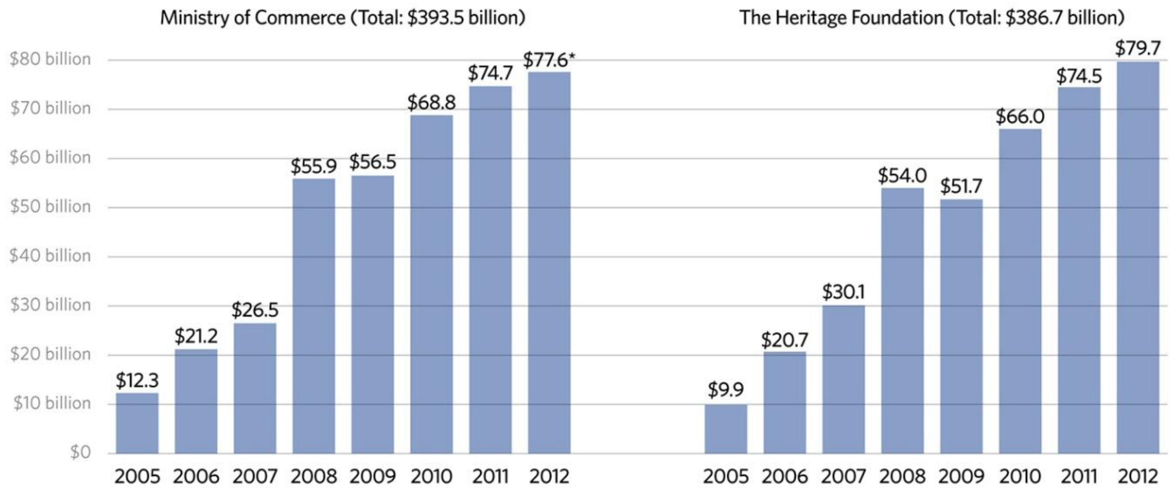
The U.S. does not desperately need policy steps to lure Chinese investment and avoid missing out on hundreds of billions of dollars in spending this decade. Nor does it need to embrace mercantilism to halt insidious Chinese technology acquisition for which there is precious little evidence. Chinese entities should be more transparent, preferably of their own accord but, if required, through regulation and quick, well-defined CFIUS action. This will ensure protection of sensitive technology, and the attractiveness of the American market will do the rest.

the-committee-on-foreign-investment-in-the-united-states-cfius.

Appendix 1

CHART 1

Chinese Outward Investment Since 2005: Two Views



* Estimate based on extrapolating official figures for January through November.

Sources: The Heritage Foundation, China Global Investment Tracker dataset, updated January 2013, https://thf_media.s3.amazonaws.com/2013/xls/China-Global-Investment-Tracker2013.xls; Ministry of Commerce of the People's Republic of China, National Bureau of Statistics of the People's Republic of China, State Administration of Foreign Exchange, *2011 Statistical Bulletin of China's Outward Foreign Direct Investment*, China Statistics Press, August 2012; and Xinhua, "China's non-financial ODI grows at slower pace," December 18, 2012, http://english.peopledaily.com.cn/90778/8061743.html (accessed January 2, 2013).

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Appendix 2

TABLE 1

Sector Breakdown, 2005–2012

CHINESE BUSINESS ACTIVITY, IN BILLIONS OF DOLLARS

Sector	Investment	Engineering contracts	Troubled
Energy and power	$186.1	$97.2	$75.4
Metals	90.2	8.6	57.7
Finance	37.3	—	29.2
Real estate and construction	21.7	27.6	7.2
Transport	16.6	72.9	15.0
Agriculture	11.8	6.8	9.5
Technology	8.7	4.9	13.3
Chemicals	6.2	2.1	0
Other	8.2	0	0.3
Total	**$386.7**	**$219.9**	**$207.5**

Source: The Heritage Foundation, China Global Investment Tracker dataset, updated January 2013, https://thf_media.s3.amazonaws.com/2013/xls/China-Global-Investment-Tracker2013.xls.

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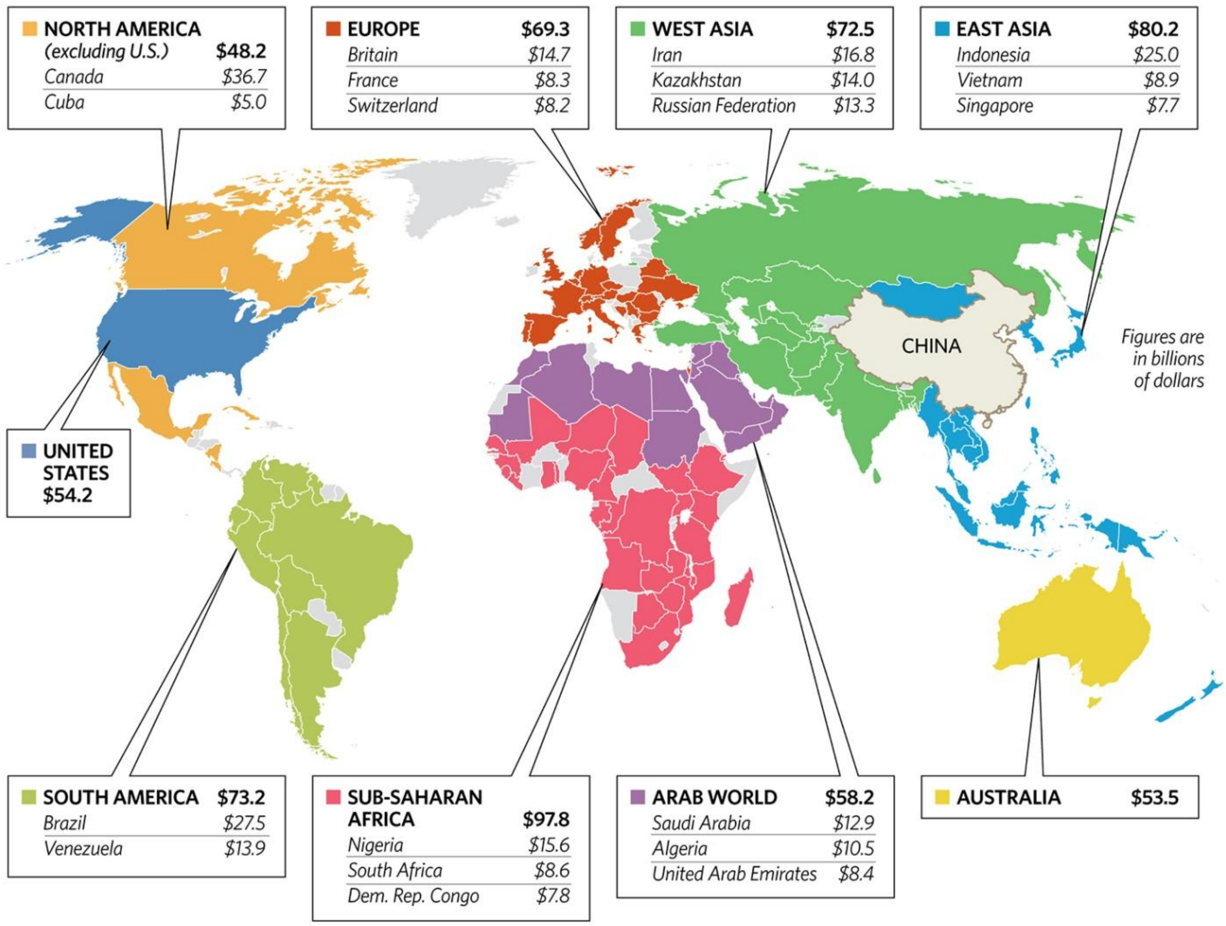
Appendix 3

MAP 1

China's Worldwide Reach

North America drew the most Chinese investment in 2012 while sub-Saharan Africa had heavy engineering and construction activity by PRC firms.



Source: The Heritage Foundation, China Global Investment Tracker dataset, updated January 2013, https://thf_media.s3.amazonaws.com/2013/xls/China-Global-Investment-Tracker2013.xls.

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OPENING STATEMENT OF ANDREW SZAMOSSZEGI PRINCIPAL, CAPITAL TRADE, INC.

MR. SZAMOSSZEGI: Good morning. Thanks for having me. It's an honor to be here before you and next to Derek and Thilo. As you know, I wrote a report for the Commission on foreign direct investment, and I really relied heavily on their work, so I'm going to try to avoid touching on their excellent testimony and focus more on the motivations underlying Chinese investments and on the roles played by the U.S. and Chinese governments.

I'll use my time to address several points covered in my written testimony. First, the Chinese government has by varying degrees controlled the pace, direction, and composition of China's outward direct investment. For about 30 years following the formation of the People's Republic, China had no ODI. Once the government began to permit ODI, it acted as a gatekeeper. The gate was opened wider with the announcement of the "go out" policy in 2001, but Beijing did not turn around and walk away.

At first, it encouraged outward investment in resource-rich countries and developing markets. Now, investments are also targeted at advanced country markets such as the United States for a variety of purposes. In general, there's a sense in China's government that ODI should also serve national aims and not just corporate ones.

Second, there have been significant big picture developments that have facilitated the increase in China's ODI to the United States. Why are Chinese firms investing here? Well, they have to and they can. From January 1986 to March 2013, the United States registered a cumulative trade deficit of $3.06 trillion with China. China primarily recycled these dollars in U.S. government securities, but this is not sustainable or wise. Investing through ODI and sovereign wealth funds was inevitable.

Chinese firms can invest in the United States also because they are much more capable investors than they were ten years ago. Chinese enterprises are now more sophisticated, they make use of top deal-making talent, and they have greater buying power. The absolute level of corporate profits at state-owned and private enterprises is significantly higher than it was a decade ago, and the yuan now buys more dollars.

Asset prices in the United States and Europe are no longer out of reach for profitable Chinese companies, whether state-owned or private. This was especially true during the past recession when Chinese firms purchased all or portions of U.S. companies experiencing financial distress.

Third, China's investments are motivated by both market forces and government policy and guidance. By and large, the companies that invest in the United States seek to make a good return on their investments. The United States is a large and wealthy market that provides significant opportunities for Chinese firms to leverage their firm-specific advantages and brands.

For non-state investors, their access to capital into the United States is probably better than it is in China. Indeed, many Chinese firms that are acquiring U.S. companies via reverse mergers are doing so not because they want to do business in the United States but because they want to finance their operations in China.

But China's investments are also guided by the government. Beijing provides general guidelines to investors through its investment policy documents and catalog. China's five-year plans also identify specific industries of interest to the government. The plans do not specifically mandate foreign investments in specific industries, but many Chinese investments in the United States reflect the industries mentioned in the plan.

These include investments by CNOOC and Sinopec in shale gas plays, Sinopec's investment in Syntroleum, various investments in U.S. lithium battery producers, recent investments in Complete Genomics, and investments in the U.S. aerospace and automotive sectors.

Chinese companies also invest in the United States to acquire U.S. distribution networks and brand names and to solidify or gain market access. Investments in the AMC movie chain and in natural gas fueling stations are prominent examples of Chinese investments in distribution networks.

Another motivation for Chinese investments is the desire to avoid U.S. trade remedies, such as antidumping and countervailing duty orders. There are currently about 121 orders that apply duties on a wide range of Chinese imports. Investing and producing in the United States is one way to avoid such duties, though even this strategy is not foolproof.

The investments of some Chinese companies are also motivated by their desire to compete for contracts subject to Buy America provisions.

So how significant is Chinese investment in the United States? By the broadest official measure of U.S. data, which includes investments by Chinese-owned entities and tax havens, China's inward investment position in the United States was $9.5 billion by year-end 2011. On the same basis, Japan's investments in the United States at that time totaled $293 billion, and the total foreign direct investment position was $2.5 trillion.

So I think we all agree that Chinese investment right now in economic terms is fairly minor. China's direct investment footprint in the United States is relatively small, but I have no doubt that the official data undercount investments because of the lag that Thilo mentioned, but also just because they don't capture all the investments through the tax havens even though they get some of them.

All sources show Chinese investments in the United States to be growing rapidly, and that is likely to continue unless there's a dramatic unforeseen reversal in China's current policies towards FDI or a dramatic change in economic performance. This means more workers at, more tax revenues from, and more visibility for Chinese-owned companies, and as the Chinese footprint grows, its investments will be driven not only by fresh capital flows, but also by the extent to which Chinese companies reinvest earnings in the United States.

I'd like to spend the next minute or so on the U.S. policy response to FDI. If I had to summarize, I'd say it's been schizophrenic, yet measured. We have CFIUS screening. We have governors, congressmen and mayors traveling to China to try to get inward flows to increase.

So what is U.S. policy? I'd say there's an obvious tension here, but I think it's a healthy one. We can continue to attract Chinese capital, but while weeding out potentially threatening investments, as Derek said, by actually seeing which technologies are important and then making sure those do not fall into the wrong hands.

Thank you.

PREPARED STATEMENT OF ANDREW SZAMOSSZEGI
PRINCIPAL, CAPITAL TRADE, INC.

Hearing on "Trends and Implications of Chinese Investments in the United States"

Thursday, May 9, 2013
Testimony before the U.S.-China Economic and Security Review Commission
Andrew Szamosszegi, Principal, Capital Trade, Inc.

Good morning. I'd like to thank to the Commission for having me here today to discuss the rationale for China's investment in the United States. It is an honor to appear not only before you, but also on a panel with Derek and Thilo. My focus this morning is on the motives underlying Chinese investments in the United States and on the role played by the Chinese and U.S. governments.

The Role of the Chinese Government

Chinese investments in the United States are motivated by both market forces and government policies and guidance. Despite China's indisputable liberalization in the areas of trade and investment during the past 34 years, Chinese enterprises continue to take their cues from government. The Chinese government has by varying degrees controlled the pace, direction, and composition of China's outward direct investment ("ODI").

This is largely a legacy of China's hard core communist past. Although Chinese multinational enterprises existed prior to 1949, China's ODI took a thirty-year hiatus following the formation of the Peoples Republic. Since then, the government has gone from the cautious liberalization of the late 1970s and early 1980s to limited promotion of the 1990s to the official embrace of ODI with the "Go Out" policy enunciated in 2001. China's past avoidance of ODI placed the government in the role of gatekeeper once Beijing decided to allow outward investments, and it did not open the door and walk away.

As a gatekeeper, the Chinese government has had a pronounced impact on where China invests and in what sectors. When China first announced its "Go Out" policy, it was a major exporter with growing shares in advanced country markets, such as the United States. But rather than focus on those markets, China initially directed the bulk of its investments toward resource-rich countries, many of which were in Africa or members of OPEC. Indeed, Jiang Zemin's announcement of the "Go Out" policy identified Africa, Central Asia, the Middle East, Eastern Europe, and South America as favored destinations for Chinese investments.

The proclivity for resource-oriented investments is also evident in China's preference for investing in resource-rich advanced economies. According to OECD partner data, more than three quarters of China's FDI stocks in OECD countries were located in Australia and Canada, as opposed to the larger economies in Europe or the United States.

In general, there is a sense in China's government that ODI should also serve national aims, not just corporate ones. The Chinese government influences investments through a variety of policy documents, including the Overseas Investment Industrial Guidance Policy, which sets forth the broad parameters for investors; the Overseas Investment Industrial Guidance Catalogue, which provides specific details on the sectors where investments are encouraged; and the Five-Year Plans, which provide overall guidance on favored sectors. For example, China's latest five-year plan calls for developing strategic emerging sectors, such as electric cars and biology-based industries, and clean energy technologies, such as the development and utilization of coal-bed gas and shale gas. These sectors feature prominently in China's U.S. investments.

Main Drivers of China's Investments in the United States

So, why are Chinese enterprises investing in the United States now? I'd like to start with the big picture: they have no choice. The United States has been a large net importer of goods and services over the past 35 years, and for the past 13 years, our largest deficits have been with China. This means that the United States must import capital and that China has trillions of dollars that it must recycle into U.S. assets. The Chinese government traditionally invested these dollars in U.S. government debt but several years ago decided to diversify its asset base into other U.S. investments. It created two large sovereign wealth funds to take make portfolio investments but these funds are passive investors, invest globally, and in any case cannot reasonably be expected to invest all of China's excess dollars. The only other alternative was to allow Chinese enterprises to significantly increase ODI to the U.S. market.

Sticking with the big picture, Chinese enterprises invest in the U.S. market because they can. Firms must have sufficient financial resources to invest abroad, especially when the host country is an advanced economy where asset prices are high. Twenty years ago, profits at Chinese firms were much smaller and the Yuan was weaker. Under those conditions, the number of Chinese firms that could have invested in the United States was fairly limited. Today, the Yuan is stronger relative to the dollar, the absolute level of profits in China is much higher, and Chinese investors are more sophisticated. They also have access to top M&A legal talent in Hong Kong. Thus Chinese enterprises today are much more capable of investing in the United States than was the case even a decade ago.

My final "big picture" reason for Chinese investments in the United States is that the financial crisis and subsequent recession created many bargains for Chinese investors. For example, Morgan Stanley was selling at a 40 percent discount when one of China's sovereign wealth funds obtained a nearly 10-percent stake in December 2007. CIC and other private investors have also made many investments in U.S. real estate, either directly through property purchases or indirectly through property funds. But bargain hunting also took place in the manufacturing sector in industries such as solar, auto parts, and advanced batteries.

Aside from the big picture explanations, there are a number of industry and firm-specific reasons why certain Chinese firms are investing in particular U.S. industries. These include:

- maintaining or increasing U.S. market share in the face of trade remedies, such as antidumping and countervailing duties;

- acquiring technology and other strategic assets (such as distribution networks and brands);
- participating in U.S. sectors deemed important to the Chinese government; and
- making money.

Chinese firms from certain industries have invested in order to insulate their U.S. exports from trade remedies. Chinese producers are currently subject to 121 antidumping and countervailing duty orders. Chinese firms in some industries have sought to avoid the consequences of trade remedies by shipping to the United States illegally through third markets or by establishing export platforms outside of China. Other Chinese firms from the steel, aluminum, and solar panel industries have attempted to invest in the United States to avoid existing trade remedy orders or preempt an investigation.

Firms in industries favored by Chinese government policies have also sought to expand in the U.S. market through FDI. Two recent examples are Anshan, a major state-owned steel producer, and Suntech, a private manufacturer of solar panels. Anshan's efforts were unsuccessful and it never invested, while Suntech established a facility in Arizona.

It is worth dwelling on Suntech's investment because it provides a vivid illustration of how the intersection of Chinese government policies and market forces can lead to foreign investments and market distortions that are harmful to U.S. industries.

China's five-year plans have been promoting the expansion of renewable energy industries in China since the mid-1990s. The 11^{th} Five-Year Plan and other contemporaneous measures explicitly encouraged production of renewable energy and continued industry incentives. The government funded national R&D efforts aimed at solar and other renewable technologies and provided financial incentives. As described by Keith Bradsher in one of his excellent New York Times articles on China's solar industry, "Chinese governments at the national, provincial and even local level have been competing with one another to offer solar companies ever more generous subsidies, including free land, and cash for research and development. State-owned banks are flooding the industry with loans at considerably lower interest rates than available in Europe or the United States."

Even more important than government funding in my view is the signal that such official imprimatur sent to private investors. Major Chinese producers were able to leverage government support into hundreds of millions of dollars' worth of private capital. This in turn fueled a reckless expansion in China that caused solar panel prices to drop precipitously worldwide, leading to plant shutdowns and insolvencies in the United States, Europe, and even China. Though Suntech closed its Arizona facility, local governments in China and China's policy banks have been keeping the major producers in China afloat with subsidized access to capital, prolonging depressed prices in the United States and Europe.

The recent experience with the Chinese solar industry is very instructive and something that we should be mindful of going forward. As distortive as China's subsidies and targeting have been in the past, the solar industry has shown what can happen when you throw vast sums of private capital into the mix. The effects can be dramatic and have devastating consequences to firms in emerging industries that are being targeted by Beijing in China's 12th Five-year Plan.

Another reason why Chinese firms invest in the United States is because the amount of red tape is less of a problem in the United States than it is in China. Unless there are national security concerns, or investments in sensitive U.S. sectors by state-owned enterprises or their subsidiaries, investing in the United States is not very difficult. Also, if you are a privately owned firm, you probably have a more level playing field for accessing capital in the United States than you do in China, where state-owned banks continue to give favorable treatment to state-owned firms.

Gaining access to U.S. capital markets seems to be the primary motive of enterprises that have purchased listed U.S. shell companies through reverse mergers. From 2007 to 2011, more Chinese firms entered U.S. capital markets through reverse mergers than through IPOs by a ratio of three to one. In the typical reverse merger, a Chinese enterprise purchases a listed firm that has few if any assets. This technique is typically used by private firms that have difficulty accessing capital in China or by provincial SOEs trying to support restructuring efforts in China.

There have been a series of de-listings and huge drops in the share prices of more than two dozen Chinese firms that initially listed in the United States via reverse mergers. As a result of numerous instances of poor financial reporting and outright fraud involving Chinese reverse mergers, the SEC approved new rules in November 2011 and the Public Company Accounting Oversight Board has tried to negotiate with China's Ministry of Finance (MOF) to allow more oversight of Chinese accounting firms. Many investors have been burned, but there is also research showing that Chinese reverse mergers have performed better than reverse mergers in which the purchasing entity was a U.S. firm.

The point I want to make is that although the initial purchase of U.S. assets by Chinese firms may seem like Chinese FDI in the United States, the flow of money is more likely to be from the United States to China.

Aside from making money, the main motivations for investing in the United States are technology acquisition and market access. Technology acquisition is a major goal of Chinese government policies. These days the focus is on cyber espionage, but Chinese policies toward inward and outward FDI are also geared to promote the flow of technology from advanced countries to China. Technology related investments frequently involve firms with state ties; some notable examples include government-owned Anshan Iron and Steel and Huawei, which has long been suspected of having ties to the Chinese military. Chinese firms have also made a number of investments in which the goal was obtaining energy-related technology, advanced battery technology in particular. Examples include:

- Yingtong Energy's Altair Nanotechnologies, a producer of lithium titanate batteries;
- Wanxiang's purchase of A123, a U.S. producer of lithium ion batteries for automotive and utility applications;

- A private equity purchase of lithium battery maker Boston Power, a deal that triggered financial incentives provided by the Chinese government;
- Sinopec's purchase of Syntroleum, which operated a gas-to-liquid demonstration facility and supplied military bases with fuels;
- Sinopec's purchase of a stake in certain Devon Energy shale gas fields; and
- CNOOC International Limited's purchase of an ownership stake in Chesapeake Energy's shale oil plays in Wyoming, Colorado, and Texas.

I think that the hand of the government is plainly visible in all these investments, with the possible exception of Wanxiang's investment in A123. In some cases, the investing companies stated unequivocally that the investment was made to acquire technology and know-how. In others, production was moved to China.

U.S. Government Policies and Chinese Investors

At first blush, U.S. policy toward Chinese investment seems schizophrenic. On the one hand, there is the Committee on Foreign Investments in the United States (CFIUS), which examines the national security aspects of potential investments and has had a hand in derailing investments by CNOOC (Unocal) and Huawei (3-Com and 3Leaf Systems). Various members of Congress have criticized specific Chinese investments and expressed their concerns about investments by Chinese state-owned enterprises quite forcefully.

On the other hand, SelectUSA of the Department of Commerce is courting Chinese investments and working with states to attract Chinese FDI. Other politicians are trumpeting their roles in bringing Chinese investments to their states.

Oddly enough, this hodgepodge makes perfect sense. The federal government is responsible for national security and has put in place a system to review transactions with potential security implications. China presents new challenges because investments by SOEs can blur the line between national and economic security. Congress has responded by strengthening CFIUS through the Foreign Investment and National Security Act of 2007.

State governments are more concerned with attracting investments to support jobs and economic growth and do not care much if the investor is a state-owned enterprise. For Congressmen with limited constituencies in manufacturing industries, attracting Chinese investments has little downside.

So, there is obviously a tension here, but it is a healthy one that can weed out potentially threatening investments.

The response of the Security and Exchange Commission and the Public Company Accounting Oversight

Board to the problems caused by reverse mergers involving fraudulent accounting by Chinese firms is also noteworthy. Some may say that it is unfair to single out Chinese reverse mergers when all reverse mergers are risky. Here again, the policy response has been a healthy one; from what I have seen in my work, the concerns expressed about the credibility of audited financial statements are well founded. Washington has not prohibited reverse mergers, but instead taken steps to ensure that the Chinese companies which enter the U.S. capital markets via reverse mergers are legitimate.

Chinese investments in the United States are subject to the same set of rules and regulations as investments from other foreign countries in the areas of foreign corrupt practices, export administration, sanctions, and antitrust. If Chinese firms run afoul of these rules, they should expect to pay the price, as ZTE has done due to its business with Iran. The one area where Chinese firms are subject to additional scrutiny is in the networking sector, where cyber-security and other concerns with Huawei and ZTE have led to greater scrutiny of those firms and legislation that requires federal agencies to get approval from cyber-espionage investigators before buying IT systems from Chinese companies.

Closing Thoughts

Historically, foreign direct investments in the United States have emanated from advanced, market-oriented economies or oil exporters recycling petrol dollars, neither of which posed much of a national security threat. China is different and U.S. policies have had to adjust. By and large, these measured responses have created an environment that allows investments from China to continue, while reducing the potential for adverse security and economic outcomes.

PANEL I QUESTION & ANSWER

COMMISSIONER FIEDLER: Let me, the numbers that you all present are all over the lot, and I'll take your comment about data and facts. I want to understand a couple of things.

So how do we identify in the United States offshore Chinese investment into the United States via offshore entities? How do we track it? Is it possible for you to track it, and is it possible for the U.S. government to track it?

DR. SCISSORS: I mean I can start to answer this. Rhodium has done a great job--I'm putting words in their mouth--badgering Commerce better than I have. I've been badgering Commerce for a longer time. We don't track these things properly. And that just doesn't apply to China. You know, the Cayman Islands hold a trillion dollars of U.S. securities. Oh, really.

COMMISSIONER FIEDLER: Yes.

DR. SCISSORS: I mean that's our detailed report, that the Cayman Islands hold a trillion dollars' worth of U.S. securities? So this is not a China issue. This is the U.S. government, and with some good reasons, does not want to be intrusive and force disclosure for company after company that will discourage investment. So you have a balancing act.

Yet we have an incomplete count. Sometimes you can find the stuff, and sometimes you can't. That's why I said SAFE is doing things we don't know about. How much? You don't know what you don't know.

MR. HANEMANN: Let me add to that. I think for portfolio investment flows, so stakes that end up at one or two percent in a company, it's almost impossible to track them down accurately. For higher stakes that exceed certain thresholds--

COMMISSIONER FIEDLER: Five percent--

MR. HANEMANN: Five percent, ten percent.

COMMISSIONER FIEDLER: --in a publicly traded company, you have to disclose who the ownership is.

MR. HANEMANN: Right.

COMMISSIONER FIEDLER: So disclosure of ownership is not onerous if it meets our legal thresholds, but it is onerous--in other words, people don't want us to know who they are, or we don't want to know who they are?

DR. SCISSORS: Well, disclosure of ownership is not sufficient because if the ownership is an offshore vehicle, all you're doing is disclosing that five percent is held by an offshore vehicle.

COMMISSIONER FIEDLER: No. My point was that, as a matter of fact, there's 260 megabytes or gigabytes of information sitting at the Center of Public Integrity at the moment on BVI companies that may, in fact, enlighten us to this phenomenon, which is alleged largely Chinese-Hong Kong-Taiwan based. What I'm saying is that why do we want someone's investment if they don't tell us who they are?

When I walk across the border I need to give my iris, I need to give my fingerprints, I need to give them a passport, because people are dangerous, but money is not. And it's too onerous to ask who you are before you invest in the United States, no matter whether you're from China or from France?

MR. HANEMANN: I think it's just the sheer volume of portfolio investment transactions. It would be very onerous to track all those down.

COMMISSIONER FIEDLER: If I start a pastry shop in downtown D.C., I need to tell them who I am. I need to incorporate, and I need to disclose, and I need to do it annually.

Let me get to an issue that is slightly more dangerous in my view--capital flight. There's a couple hundred billion dollar discrepancy in understanding the source of last year's flows from China outward. I want to say $275 billion. Now, there may be some benign excuses for that or reasons for that, but it's not $9 billion, it's $200 and something billion. U.S. investment banks--it's capital flight in some measure--have wealth management entities that are vehicles. The United States remains the safest place in the world to invest money.

There has got to be some measure of capital flight from China to the United States via wealth management vehicles. Have we any sense of what Goldman, J.P. Morgan, and others who operate in China are sending into the United States for Chinese citizens via capital flight?

DR. SCISSORS: We have a sense. I think the way you look at this is in our balance of payment statistics, and you can see patterns. They're not very clear, but there are patterns in other investment and errors and omissions in the Chinese balance of payments statistics showing up in deposits in U.S. banks. It is not the capital flight.

What you have--I'll take my own opinion on what happened in China because I have lots of evidence for it. You had a situation where a lot of people in reaction to the Bo Xilai crackdown, meaning leading Communist Party cadres who have all the money and have a way to get it out, thought they needed to send some money overseas and maybe some people in their family as well.

That money, a lot of that money is now returning, and we're getting false export invoicing. This is normal for China, and it doesn't necessarily signal that there are long-term investments in the U.S. It's very similar to their short-term bond holdings. I need a place to dump a lot of money and America is a good place to do that. New Zealand, for example, would be a little too noticeable.

Now I want to take the money back. So I'm not arguing that this isn't worth studying. I'm just saying that the large portion of the transaction is this kind of short-term flow in and out of China, dumped in U.S. financials, taken back out of U.S. financials.

MR. HANEMANN: There's a couple of data points by the Treasury Department that lets you track those flows from China, but only if they come from China directly--the Treasury's International Capital System.

COMMISSIONER FIEDLER: But we don't know where it's going really in the United States. You're alleging that it's bank deposits, liquid bank deposits?

DR. SCISSORS: When you see a correlation between the two data movements.

COMMISSIONER FIEDLER: Yes.

MR. SZAMOSSZEGI: Now, just quickly, I'd like to say with the tax haven, and I know the red light is on, with the tax haven--

HEARING CO-CHAIR WORTZEL: No, no, you go ahead. I know you wanted to respond.

MR. SZAMOSSZEGI: Thank you. With the tax haven investments, the Commerce Department, maybe it's different with foreign direct investment than it is with portfolio, but with foreign direct investment, the Commerce Department publishes a statistic on FDI by country of the ultimate beneficial owner. So in the documents that the investors are supposed to fill out, they're supposed to report the final owner in the chain of ownership that isn't majority owned by someone else, and that's the ultimate beneficial owner.

So that will track you back to China, and that number is about twice as high as the headline FDI number that's given for China in the official data.

COMMISSIONER FIEDLER: Okay, I have a second round when you're ready.

HEARING CO-CHAIR WORTZEL: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all for being here. Several of you I've known in the past. Thilo, it's good to meet you. I know Rhodium quite well and have several hours of questions but will restrict it to five minutes.

As you probably know, the U.S. is now engaged not only in the Trans-Pacific Partnership discussions, but also there's continuing interest in whether we should have a Bilateral Investment Treaty with China.

In a recent discussion with some of our top administration officials about this, I was talking to them about the impact of the SOE chapter in TPP and the BIT negotiations and how we look at Chinese investment. Clearly, China is not part of TPP, but everyone is looking over their shoulder at how those disciplines may affect it.

After going through a number of transactions with them, one of the U.S. officials said how do you know all this, which was probably one of the most frightening things that I've had to encounter in a discussion with our negotiators. I then actually referred each of them, and you may have gotten subsequent contacts, to the three of you, who have done great work on this, and Rhodium, Heritage and, Andrew, for your report.

It goes back to your earlier question: the data discrepancy, which I have a lot more fears than you do, Derek, about what is happening with this investment. I don't believe it's just commodities and some technologies, but it is part of a broader plan. As you know, every investment, I believe it is, over 50 million has to get through at least one, if not three, governmental hurdles in China to be able to have the right to invest in the U.S. So it's not private--it may be private investment, but it's government-approved and government-directed.

What do the three of you need from our government, what recommendations do you think we can offer to Congress and the administration that would--I don't want to put you guys out of business, but hopefully our government can do something comparable so that maybe rather than reporting half of what you report, they can report something closer?

MR. HANEMANN: I'd just maybe start with two things that I can imagine. The first one certainly is giving the BEA enough funds to do their work. I think they had a lot more data sets than they do have now. They had to discontinue some of the work that they've been doing because they didn't have enough funding.

COMMISSIONER WESSEL: So do you view it as a resource, not as an intent, issue?

MR. HANEMANN: It's partly a resource issue; right. Because I think, I mean we can compile a more accurate, timelier data than the BEA.

COMMISSIONER WESSEL: What's your budget versus BEA's?

[Laughter.]

MR. HANEMANN: Well, I don't think it's too much to ask for it.

[Laughter.]

MR. HANEMANN: So that's the first strategy that I think is a no-brainer. The second one, as you mentioned, there could be some tweaks in the regulatory requirements when it comes to transparency, especially through transparency rules for state-owned enterprises through multilateral or regional trade and investment treaties or some national regulations on certain transactions that have to be reported.

COMMISSIONER WESSEL: In the BIT discussions, while the BIT will provide protection to investments, it doesn't require disclosure of investments. Should we be looking at that as a part of this as well, that if we want to understand what the full regime of investments are, whether it's beneficial investments vis-a-vis BVI or anyone else, should that be something that's added to it with China because of the lack of transparency?

MR. HANEMANN: I would say if there is a certain threshold that's met in terms of ownership stake, then it would probably make sense. I don't think it will be very helpful if you would have to report every single portfolio transaction that you make, so there needs to be a certain threshold. So, yes, if that continues to be a problem, it could be one thing to do.

COMMISSIONER WESSEL: Mr. Scissors.

DR. SCISSORS: Yes, I mean this is a hard question because I would really, for the case that we're talking about here, want to revamp our entire approach because I think our approach is based on traditional methods, we're dealing with OECD countries, we're monitoring the flows, we're providing policy information. Most Chinese investment in the U.S., I don't care about. It's fine and I don't want more information about it. We got to decide what we care about, and if we care about anything related to the following sectors, that's where the BEA's focus should be on, and we should treat it differently.

We keep acting as if China is undifferentiated from these other countries that are investing in the U.S., and China says why are you treating us different from Britain in the Ralls case? I mean are you kidding me? So there needs to be some honesty in the approach. The approach is that BEA does something for global investment patterns, which is usually okay. What we're worried about in the Chinese case is not the volume of one percent, but Chinese cadres buying real estate to put their kids in so they don't get arrested.

We're worried about specific sets of transactions. That's where we need extra resources. That's where we need extra investigations. So just put aside what the BEA is doing now and set up something that's independent that actually responds to our concerns about China.

MR. SZAMOSSZEGI: Regarding foreign direct investment, Thilo mentioned the large volume of data collected at BEA. My understanding is that BEA can share these data with other agencies without revealing the identities of the companies. I think in countervailing duty and antidumping cases at the Department of Commerce and the International Trade Commission, people like me get to see company-specific data. We're under administrative protective order; I can't talk about what I've seen with others who are not on the APO. I'm fine with that, and I think the system works.

I see no reason why the U.S. government couldn't do something similar internally that would allow the identity of the foreign investors be known when BEA provides data for other government agencies to analyze.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR WORTZEL: I got five questions, but I'm going to ask two.

First, how can we penetrate the haze created by the use of offshore tax havens and financial centers? Are there specific legislative means any of you can suggest that would help do that?

Second, Mr. Hanemann, this is for you although I invite any of you to comment: what is private investment or a private company in China? I mean your written testimony gives a threshold of 80 percent private ownership which implies 20 percent is government ownership. And everything we have here in the U.S. says ten percent of ownership implies control. And in China, if it's government ownership, that's a one-party sort of authoritarian state, that means government direction. So how do we think about private--is there private investment when you think about that?

DR. SCISSORS: Why don't you try to answer that first?

[Laughter.]

MR. HANEMANN: I'm happy to. So the trouble we had with the zero percent ownership threshold is that if you would apply that, almost any company in China would be government owned -- and a lot of companies in the U.S. as well, because they have probably a one percent ownership of some sovereign Chinese entity or Chinese bank that invested in them. So as long as the company is listed on the Shanghai Stock Exchange, for example, it is very likely they will have some sort of portfolio investment by a Chinese bank, a Chinese investment bank, a pension fund, whatever, which is ultimately government controlled.

So we had to determine a reasonable threshold, which after discussion with corporate governance experts we decided to be 20 percent, and which we fully disclose in our data. Now, I can tell you that 20 percent threshold is probably reached in very few cases only. Most of the companies that we count as private have combined government ownership of maybe five or six percent with two or three Chinese banks holding one or two percent shares.

We do not consider that to be government controlled, which I think is reasonable, but, of course, the one point that you mentioned is important: in a country without rule of law, does it really matter? So we do the breakdown for analytical purposes because we think it's helpful. In the end, it's a little bit of an arbitrary threshold, but we think it's the one that makes most sense.

HEARING CO-CHAIR WORTZEL: And penetrating this problem of offshore investment?

MR. HANEMANN: Well, I'm not an expert on global offshore financial centers, but I think I would agree with Derek who said it's a global problem. It's not just a Chinese problem, and, historically, I think one more point that's important is that Chinese companies do not choose to go through those locations because they wanted to hide something. It's a historical legacy that they had to go through Hong Kong to make those investments in the past because there was the financial infrastructure that was needed, such as the lawyers, the investment banks, et cetera, to do these transactions. So it's not a dodgy strategy. It's just a grown historic legacy.

DR. SCISSORS: I want to separate the macro econ and the security tech stuff. There are large flows from Caymans and BVI, and that's an important macroeconomic event. Thilo just said it, and I said it before, and that's not China, that's global capital. What we care about on the Chinese side is what they're buying, not money that's routing through the Caymans to buy U.S. land. I think the Chinese should probably buy more U.S. land as long as it is not near naval bases. So what we care about is the acquisition side, and we can monitor that more closely. If somebody is buying sensitive technology, we should be investigating that, whether it says China on the company or it says Hong Kong or offshore source.

The global capital issue is a big issue. I'm not saying we should ignore it, but I don't think we have to grapple with all that to get to the China technology issue, which is also a tough issue but is narrower and is more feasible for the U.S. to deal with. That sort of disclosure can be required without us imposing our regulation on the entire global capital market.

HEARING CO-CHAIR WORTZEL: Thank you.

MR. SZAMOSSZEGI: I'd say two things. One is that the tax haven issue, the Bureau of Economic Analysis, I don't believe they present other data, industry specific data, on an ultimate beneficial owner basis. So I think that would be very helpful if you could get them to do that.

Second, I would concur that investing through tax havens isn't done in order to hide anything. I mean CNOOC, whether it's investing out of China or whether it's investing out of Bermuda, it's still a CNOOC investment.

HEARING CO-CHAIR WORTZEL: Thank you very much.

Commissioner Tobin.

COMMISSIONER TOBIN: Thank you, particularly Mr. Szamosszegi, for the guidance. Thank you, gentlemen.

My three questions are for Mr. Hanemann, and two of them are pretty straightforward facts. You mentioned employment at the end of 2012 was 30,000 U.S. employees. Do you have data on the comparable in China for our companies, how many Chinese have we employed?

MR. HANEMANN: There is certainly data on that, but not off the top of my head. I'm sorry.

COMMISSIONER TOBIN: Okay, could you provide that then?

MR. HANEMANN: Sure, I'll be happy to follow up on that.

COMMISSIONER TOBIN: And if I'm a member of the House or Senate, and I want to take a look at beyond the top ten investments, can I do that? I know you said you had a proprietary database, is that something that they could look up?

MR. HANEMANN: Well, yes, we provide data map online so people can use that and browse through.

COMMISSIONER TOBIN: So if I wanted to dig deeper under any of these states, I could see?

MR. HANEMANN: You could see the distribution by industry ownership and so on. You can't see the individual deals, however, but we'd be happy to follow up with any congressional staff.

COMMISSIONER TOBIN: So you can't see the deals. You can't see the individual names of the companies nor what they do?

MR. HANEMANN: No, you cannot. You can only see aggregates in terms of industry, ownership, and the likes. You cannot see the individual deals.

COMMISSIONER TOBIN: I know what a proprietary database is and there could be other aspects that are proprietary. Is that because it's proprietary that you don't make it available?

MR. HANEMANN: Yes, but we'd be happy to work with congressional staff and provide those breakdowns. We do collaborate with academics and public policy research, and so we'd be happy to follow up on that. But we just don't provide it to the public because it's very labor intensive so we spent a lot of time and energy and research assistant hours on developing that database.

DR. SCISSORS: Well, it's possible someone in China could copy it.

COMMISSIONER TOBIN: Yes, I will pursue that then. And the last question is on your charts, you're showing the tertiary areas, and you mentioned, all of you, that there are state interests and there are national goals. What is the national goal for this kind of new push in entertainment and hospitality and tourism? Please give me as much as you know on that.

MR. HANEMANN: Well, I think I would disagree with the statement that Chinese investment follows a grand strategy by the Chinese government. I think there certainly are sectors in which that is true. Energy, iron ore, some sectors are perceived as strategic, but I think the overwhelming majority is really driven by commercial reasons.

And I think the recent push that we see in, for example, entertainment hospitality has two reasons: first of all, there are a lot more Chinese tourists coming to the U.S. There are a lot of Chinese companies that try to capitalize on that trend so they're buying hotels in Los Angeles and providing congee for breakfast, and making Chinese guests more comfortable so they can have revenue from that trend.

And then a second aspect is that a lot of the Chinese acquisitions happen for competitive reasons and firms aim at taking the expertise back to the Chinese market. What many people expect to happen in China is an above-trend growth of the service sector in China over the coming years because they're changing their heavy investment driven growth model, and so those companies are getting ready for domestic growth in other sectors. Take the AMC acquisition, for example: movie theaters in the U.S. are considered a sunset industry, right? Nobody is going to theaters anymore. Everybody has Netflix, watching movies online. In China, that industry is still growing at double digit levels. So those companies are interested in gaining the expertise for the domestic home market in order to be competitive and make profit there.

DR. SCISSORS: I'd just add one thing. Everybody here knows because you follow China that Chinese have trouble with global brands. U.S. doesn't have trouble with global brands. So there's going to be a lot of investment trying to transport U.S. brands back to China. It's a ready-made market creation, and obviously that's not a national strategy. That's a commercial interest, self-interest of Chinese firms, they also grab U.S. brands and use them to headline their China business.

COMMISSIONER TOBIN: A shortcut again.

DR. SCISSORS: Yes.

MR. SZAMOSSZEGI: I agree with Thilo and Derek generally. I would say, though, that a government that is always interested in increasing exports and increasing the balance of payments or improving the balance of payments is interested in things that will generate exports. A movie theater is something like that because it will generate income exports to China if the company is profitable.

COMMISSIONER TOBIN: Thank you.

HEARING CO-CHAIR WORTZEL: Commissioner Bartholomew.

HEARING CO-CHAIR BARTHOLOMEW: Thank you, gentlemen. Thanks to those of you who are returning, and it's always interesting, Derek, in particular, to hear from you, but thank you all.

Just a comment before my questions, and sometimes I think that this investment in the entertainment industry, particularly if you look at movies and other sort of cultural production, it's perhaps not quite as benign as we think that it might be. I'm waiting to see if there are any forthcoming movies about Tibet and whether the AMC theaters will be allowed to show them.

I think that's not necessarily the driving factor, but the long arm of Chinese censorship is something that I find that I keep my eye on.

I'm interested, Mr. Hanemann, I was looking at your map here of Figure 3 about the geographic distribution, and there is none in North or South Dakota and none in Wyoming. I'm interested in North Dakota because you would think that with all of the oil and gas stuff that's going on up there, that there would be some sort of investment.

MR. HANEMANN: Right.

HEARING CO-CHAIR BARTHOLOMEW: But we had a hearing last week, two weeks ago in Ames, Iowa, talking about agricultural investment, and South Dakota, and there's agriculture out there. So I'm wondering if you have any sense of why there are those states, in particular, that have no investment?

MR. HANEMANN: Well, one important thing, I should say, is the way we log or register investment is that we take the headquarters of the operations. So if you look at some of the shale gas investment that will mostly be accounted for in the Texas figure because it's just impossible to break a $2 billion investment down by state.

Take Lenovo, for example, that is registered in New York, but, of course, they have operations across the country. Breaking it down by assets would take it to another level, and that's just too onerous. So there might be actual money in Iowa or in Dakota.

HEARING CO-CHAIR BARTHOLOMEW: Okay.

MR. HANEMANN: But we count it in Texas.

HEARING CO-CHAIR BARTHOLOMEW: Thanks for that explanation.

MR. SZAMOSSZEGI: There is in Wyoming a shale gas investment by CNOOC, I believe. But for the reason Thilo mentioned, it's hard to count precisely where the money for that investment goes initially.

HEARING CO-CHAIR BARTHOLOMEW: Okay, thanks. Again, Mr. Hanemann, I've been hearing some anecdotal evidence--I'm interested in Chinese hiring of American workers in these companies. First, of course, in other places we know that they have a tendency to bring in Chinese labor in the companies that they're working in, and I wondered if any of you are seeing any evidence of that?

But the anecdotal evidence I'm hearing is that in some places, it might be that it's not full-time workers that are being hired in order to try to get around some of the obligations that would come with full-time workers, and so there's some questions. For example, BYD has announced that it's going to be hiring, I think, a thousand people in southern California. There are some questions out there. I don't know if they're based in fact, but are you guys hearing anything about this in terms of hiring patterns?

DR. SCISSORS: I can talk about Chinese corporate practices in this respect. The Chinese are deathly afraid of American workers, mostly because they don't understand labor regulations and why should they? I think we may have a few too many labor regulations. From the Chinese standpoint, it's like this giant massive scary thing.

So there is natural avoidance of a lot of U.S. regulation because they don't understand them and they're scared of them, and that's going to promote a bias towards hiring non-unionized part-time. What is the benefit I owe you? I can't figure all this out. Whom am I supposed to contribute to? They don't contribute if they have a legal option not to. Especially with the smaller firms that are making smaller investments, the costs of compliance with U.S. regulation are very high.

And we have arguments about this, about small business operating within this country, American small business. So I think that's understandable. It does have impacts on their hiring. 30,000 people--I don't know how much it matters.

The other thing is that Chinese companies are very well aware of what kind of governments they're dealing with. There are countries where you bring in your own workers, and you say do you want the investment or not? And there are other countries where you follow the law or you're going to get kicked out, and they know that very well.

So they tend to try to game the system, if they can, because they don't understand what's going on, but they're not going to mass import Chinese workers in the U.S. because they know that's not going to fly.

HEARING CO-CHAIR BARTHOLOMEW: This will cross over with some of the discussion in the next panel that we're having too, but as I look at this I see the draw for state and local governments in this country. There was the example, Mr. Szamosszegi, about Alabama providing money to pay some of the duties in order to get Chinese investment there. How much will the Chinese be either directly or indirectly pushing to reduce some of the regulations that we have to protect workers in this country as they try bringing jobs in?

Any thoughts, Derek? I know you think we probably have too much regulation, but--

DR. SCISSORS: Well, all firms lobby for a better business environment. It's one of the reasons why we don't like politics to be involved in business because it creates this rent-seeking behavior, and so the Chinese are going to do that.

But I think at the level of 30,000 firms, this is one of the things to think about, they're just not important economically here yet. I'm with the people who say if there's an investment, and there's anti-competitive behavior by the Chinese firms because there's anti-competitive behavior in the home market, and they get to 25 percent market share, we have to make sure our antitrust laws are applicable, I get that. But they are nowhere near this point yet.

So, my answer to you is it's very hard to answer this question because they're operating on such a micro scale that whatever we find, positive or negative, the other side is going to say, they hired 17 workers and this is what they do with them? Who cares? We're just not at a scale yet to give a proper answer to that question.

Would you expect Chinese workers to seek the best possible business environment, including Chinese firms, including political tools? Yes, but they're not important enough yet to have any distortions on the U.S. market.

HEARING CO-CHAIR BARTHOLOMEW: Just one, Derek, you and I, we've gone back and forth on a lot of things over the years. You talk about how they're just not important, well in the grand scale they might not be important, but in the communities in which they're working there is definite importance for the people who are being employed.

DR. SCISSORS: Yes, absolutely.

HEARING CO-CHAIR BARTHOLOMEW: And the people who are working and for the American companies that have to compete with them.

MR. HANEMANN: I just wanted to add one aspect of the story, if I may. I think Chinese firms are very well aware of the spotlight that they're in on this issue. So I think they are very cautious to avoid attention drawn by a scandal or a big case in which there are labor rights violations. One thing the Chinese government does well is damage control, and if you look at the track record of Chinese investments, compared to early Japanese investments, for example, I think they have a pretty good track record so far when it comes to labor rights and the like.

So if there was a Chinese company coming to the U.S., one of the first things that they would be looking at is compliance with local regulations and laws because they know that if they don't, that would have a very negative impact on their own brand and on the reputation of Chinese companies in the U.S.

HEARING CO-CHAIR BARTHOLOMEW: Okay, thank you. I'll have a second round, Larry, if we have time.

HEARING CO-CHAIR WORTZEL: Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you all for being here. My first question is for Dr. Scissors. Always appreciate your verbal testimony. You're very interesting, but I'm going to accuse you of being an economist in your written testimony.

[Laughter.]

VICE CHAIRMAN SHEA: I'm reading this January 8 Heritage Foundation background, and you say--help me understand this--"Even so, greater Chinese investment has multiple implications for American policy." I got that.

"The U.S. can easily absorb much more, and Beijing insists that it wants to invest more, continuously complaining about market access while the funds pour in." This is about reciprocity. "Reciprocity should not be taken too far. The American and Chinese economies are very different, and it would make no sense for the two countries to adopt identical policies."

I'm not sure what that means, and I'm not sure if I agree with it. Then you go on, "But reciprocity does bear on the priority that the U.S. should attach to Beijing's demand. American access to the Chinese market is a longstanding issue. If the PRC still cannot make discernible improvements in its anti-competitive behavior, such as regulatory protections for state firms, the U.S. has no obligation to respond to recently expressed Chinese unhappiness."

I'm not sure what that means. Could you explain that for me?

DR. SCISSORS: This is a debate that I've had with Thilo's boss on multiple occasions. Reciprocity is a good principle. It's a good principle in the WTO. It matters. It shouldn't be ignored. We have it in the WTO for a reason. You know, I'm happier opening my market to you when your market is open to me.

So I like the idea of reciprocity. The qualification I attach to it is we aren't looking in a mirror: if I move right, you should move right, and so on. The U.S. and China's economies are totally different. We don't want access to the same industries in China that they give to us. If we draw up a list of ten industries and say you have full access to these industries, and it's the same industries in both cases, that's not the ideal situation.

So you can't get carried away with reciprocity. That's the qualification. What I'm saying is a message to the Chinese, which is stop whining. Don't complain about our market access when yours is so poor.

VICE CHAIRMAN SHEA: So you would be okay--

DR. SCISSORS: Reciprocity matters politically in the U.S., and you should be aware of this.

VICE CHAIRMAN SHEA: Okay, so there are prohibited industries for foreign investment within China.

DR. SCISSORS: Strongly discouraged.

VICE CHAIRMAN SHEA: No, there's prohibited and then there's restricted.

DR. SCISSORS: Right.

VICE CHAIRMAN SHEA: And then there is encouraged. And some of these prohibited industries I would assume Western firms would want to participate in.

DR. SCISSORS: Yes.

VICE CHAIRMAN SHEA: Some of these restricted industries I assume a lot of Western firms would like to participate in. This has been going on for ten, 11 years, we've been complaining about this. What I read from your comment is reciprocity does not mean you can't access our market if we can't access yours. Reciprocity means just sort of ignore their complaints about investment in the U.S.

DR. SCISSORS: Reciprocity means that the fact that the Chinese have a list of restricted sectors should matter to U.S. policymaking. If we were dealing with a really good partner, and they were complaining about transparency and don't understand your regulations, we would have an obligation, and it would be smart for us to respond to that partner.

As it is, because of the way the Chinese handle their own industry, the U.S. should make decisions purely on its own interests as it's good for us and not listen to them because they don't listen to us. That's essentially what that statement means.

VICE CHAIRMAN SHEA: You wouldn't use reciprocity as a lever to open up Chinese industries access?

DR. SCISSORS: I would make the decision that I think is best for the U.S. without regard to Chinese complaints and without regard to negative Chinese behavior on the other side. If it's good for the U.S. to have Chinese investment in the U.S. real estate market, I would do that regardless of whether we can freely invest in Chinese real estate market.

And if the Chinese say go ahead and buy our sensitive technology because it's not useful to you, I wouldn't say, well, then you can buy our sensitive technology. That's the over-interpretation of reciprocity.

VICE CHAIRMAN SHEA: Okay, let me ask you about cyber. The Mandiant report says that the PLA, the Chinese army, is engaged in a massive espionage effort at Western firms and these Western firms seem to populate for the seven strategic emerging industries outlined in the 12th Five-Year Plan. I assume they're also cyber hacking into firms in the remaining three strategic emerging industries, as well as other industries.

MR. SZAMOSSZEGI: D.C. consultancies as well.

VICE CHAIRMAN SHEA: Okay, sure. Should access to the U.S. market be used as a lever to stop this cyber attacking? Should we allow Chinese state-owned enterprises to invest in U.S. industries that have been targeted by the Chinese army for hacking?

DR. SCISSORS: I think that's a perfectly reasonable question. I have floated a paper that has been read by a couple of committee chairs, saying that I think that Iran-style sanctions regime is an entirely reasonable response to Chinese cyber. I don't want to take a firm stand because you really need to do data work on this.

The people saying trillions of dollars, greatest transfer of wealth in history, that's a really hard number to quantify. But if the U.S. does the work and decides this has really harmed our economy, then absolutely. It's absolutely reasonable for us to use economic tools to respond to that. So I don't have any problem with it in principle.

VICE CHAIRMAN SHEA: Okay.

DR. SCISSORS: I don't think that we should keep our market open to all comers for all reasons. I just want the same thing here with technology. I want facts to justify this, not assertions at the level of many trillions, and if there is clearly Chinese cyber intrusion, maybe the cyber intrusion is not as big as we think, and we should take minor economic steps in response. So the idea that you're proposing I have no problem with.

VICE CHAIRMAN SHEA: I'm not proposing. I'm asking you the question.

DR. SCISSORS: There are many things that we could use to justify U.S. market closure. We could talk about their human rights behavior. We can talk about many things. I want to be skeptical of all those things because there are going to be ulterior motives, firms who don't want to compete and so on, but if we feel like the Chinese are engaging in anticompetitive behavior through cyber or in a certain industry, it's entirely reasonable for us to say, well, why should we cooperate with you in this industry?

VICE CHAIRMAN SHEA: Okay.

DR. SCISSORS: I don't have a problem with that.

VICE CHAIRMAN SHEA: Do any of the other panelists want to add to that? Or you don't want to wade into that one?

MR. SZAMOSSZEGI: It's really well put.

[Laughter.]

MR. SZAMOSSZEGI: Derek and you both.

VICE CHAIRMAN SHEA: Okay. Thank you.

MR. SZAMOSSZEGI: I believe Derek should stand in front of us on this issue.

HEARING CO-CHAIR WORTZEL: Commissioner Slane.

COMMISSIONER WESSEL: Derek, you got the votes.

[Laughter.]

COMMISSIONER SLANE: Some years ago, Beijing issued the edict to their state-owned enterprises to go abroad. I was expecting to see a lot of major investments in the United States by major state-owned enterprises in aluminum, rubber, steel and chemicals. It hasn't happened. Can you tell me why it hasn't happened? And do you expect it to happen?

DR. SCISSORS: I'll just give a little bit of the history because I was involved doing consulting work at the time. When Lenovo bought IBM's personal computer unit, the bonanza was on. I mean there were so many inquiries about what, you sold us a technology company, and personal computers isn't really technology, but that's the way they thought.

COMMISSIONER SLANE: It is in my house.

DR. SCISSORS: —The CNOOC-Unocal deal then they flipped entirely the other way. And there is this kind of schizophrenia, which Mr. Szamosszegi used very nicely, by U.S. policy. They flipped the whole other way and thought the U.S. market is totally closed. We can't buy anything. They're just recovering from that. Really, I'm not saying that's a reasonable response to CNOOC-Unocal. I'm saying that that's actually what happened.

CIC was the only really active investor for years after CNOOC-Unocal because all the major SOEs were saying the Americans won't let us buy anything. So I understand your response. And that's the way they headed for a little bit, and CNOOC-Unocal threw them off.

I think what you were expecting to happen, barring U.S. restrictions, is going to happen gradually, cautiously, because of the lessons they think they've learned over time, but that's why it hasn't happened until now.

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR WORTZEL: Commissioner Talent.

COMMISSIONER TALENT: Thank you, Mr. Chairman. I join in Commissioner Tobin's and Bartholomew's concern about their investments in the entertainment center, but I won't repeat questions in that regard.

Let me switch a little bit because we've had some discussion about how we define a privately-owned Chinese company, and I guess I have a threshold question on that, and it's really whether it makes all that much difference? Given the nature of the Chinese system, a firm may be private in the sense that the government allows it to make decisions most of the time based on commercial sort of concerns.

But wouldn't the leaders of that company be perfectly well aware of what the government's overall objectives are? And moreover, if somebody from the government were to call up somebody from the company and suggest that they make a particular investment for a particular reason, wouldn't they be under intense pressure to do it?

Is it really all that wise to make the kind of distinction and try and parse whether 20, 25, or 15 percent counts as state-owned given the nature of the system, the absence of the rule of law, and the general pervasive presence of the regime in the life of the economy?

MR. HANEMANN: Yes, I think that goes into the same direction as the comment I made before, that what we should really be concerned about is corporate governance structures and the rule of law. That's what we should really be lobbying for with regard to ownership structures.

Having said that, I think it makes a difference in terms of evaluating certain aspects of Chinese investment whether it's a private or state-owned company. If you, for example, look at the efficiency of a company, if you look at the technology spillovers, and the sort of investment decision-making within the firm, I think it makes a tremendous difference whether it's a state-owned central SOE or private enterprise like Wanxiang, for example.

COMMISSIONER TALENT: So if we're trying to analyze patterns of investment to see what the government is trying to do, it makes more sense to look at state-owned enterprises because they would be more likely to work through those than through the private?

MR. HANEMANN: Yes, that's one aspect of it.

MR. SZAMOSSZEGI: I would say that ownership matters. I think the ownership leverage is important. There's a parallel management structure within SOEs, a disciplinary committee, which has important people in the company and government on it, and so the Chinese government is able to influence SOE behavior more directly than the behavior of private companies.

On the other hand, when private companies see that the government favors investment in an industry, they will not only invest in that industry, but they'll be able to attract additional private capital into that industry. They will then take that money, build up capacity, invest in the U.S., and it would be the same as if the government had said we own you, we want you to invest abroad, and we want you to invest in this U.S. industry.

DR. SCISSORS: I have a very specific answer. If we're talking about tying into the U.S. telecom network, I don't care. There is no rule of law that a private Chinese telecom company is subject to demands from the Party and will follow those demands or it will die.

If we're talking about buying a steel firm, it does matter. The story with investment by steel firms, if anyone opposes it, would be what if this SOE uses all the benefits that are granted to it in its home market where it's a near-monopoly or geographic-monopoly and engages in this large-scale anti-competitive behavior in the U.S. and drives U.S. firms out of business?

Private Chinese firms don't have any of those advantages. In fact, they have lots of disadvantages. So on a security side, I don't see a difference because, as several have said, there is no rule of law and there is no right of refusal for private firms. But on the econ side, it does make a difference. SOEs are more dangerous in terms of anti-competitive behavior than private firms.

COMMISSIONER TALENT: Thank you. Thank you, Mr. Chairman.

HEARING CO-CHAIR WORTZEL: Commissioner Cleveland.

COMMISSIONER CLEVELAND: I am probably the only person sitting up here at this point that would say that I welcome Chinese investment, and I agree with you, Derek, when you, several of you, actually expressed corporate governance and rule of law matters. I think we ought to differentiate when it comes to companies that have been victims of cyber attack, but fundamentally I welcome Chinese investment just like I welcome Dutch investment. I think it's essential for our economy to grow.

So with that frame of reference, I'm not sure whose data we're looking at, but we have lots of charts that the staff has included, and I think it's a mix of Rhodium and your work, Derek. With the top five states that have attracted FDI being Michigan, Illinois, New York, California, and Texas, I'm wondering what they're doing right to attract investment? Particularly Michigan which I found an outlier. Granted it's not a lot, but what are they doing differently than Kentucky, for example, which has one investment that I noted. So what are they doing right?

MR. HANEMANN: I think it's a result of the real economy, frankly, what the state has to offer. So if you look at Michigan and Illinois, there's a lot of auto firms that are in troubled situations, have been in troubled situations over the past couple of years, and at the same time, there's a fast-growing Chinese auto market, and so some of those firms brought in a strategic investor from China.

So I think in large part, it is really the assets that the state has to offer. If you talk about agriculture or farmland on the other hand, it's an area that the Chinese have only recently started to look in, and it's politically a very sensitive issue.

And then the second reason certainly is policy and politics, and that you have certain incentives on the state and local level that Chinese investors might tap into. You have a lot of governors and mayors who are actively promoting investment, setting up trade offices, investment offices in China, going on delegation, and I think those interpersonal relationships certainly help to attract Chinese investment, too.

COMMISSIONER CLEVELAND: So when we're critical of these investments, what we're really doing is criticizing the governors, mayors and local officials who are eager and have open arms to these kinds of investments? Do you think that the governors and mayors and local officials are just naive?

DR. SCISSORS: Because I don't have a problem with the economic side of these investments, I agree with you on that respect. In the case of several of the Michigan and Illinois auto parts companies, they were bought because they are cheap, there are countries around the world that were like, oh, no, you can't buy our assets when they're cheap. I say, well, the other alternative because we have bankruptcy here is they die.

COMMISSIONER CLEVELAND: Right.

DR. SCISSORS: Which would you rather have? And so the local officials are doing the right thing. My restriction is if a governor was saying I know this is advanced technology that has military uses, but I'm going to sell it anyway, then I'm going to criticize the governor.

When the governor is saying I'm making a decision about what's best for my state economy, or a representative is saying I made a decision what's best for my district, I think that's what we want. They're usually making good decisions. I think going to seek Chinese investment that isn't in technology-sensitive industries is a good decision, and it's absolutely fine, and we should encourage it.

COMMISSIONER CLEVELAND: I don't think all of the investments in New York were presented in the material, but 12 of the 22 investments were by CIC. They're buying shares in organizations like Blackstone. Do you think it makes a difference if CIC invests in something like Blackstone versus buying a failing plant in northern California?

DR. SCISSORS: CIC doesn't like to manage things so they usually get someone else that they use as a tool to manage it, whether it's Blackstone or some other organization. No, I don't think so. I think what we don't like about that indirect situation is when they don't tell us. If CIC says, hey, we're contributing to a Blackstone fund, great, that's fine. When SAFE is involved in a fund and they don't tell us, that's the real problem.

So whether they go through Blackstone or do directly, as long as it's disclosed, I think those are equal things. The indirect part is just the question of disclosure, and CIC has been very careful. I wish they would continue to itemize their investment results, which they've done a couple times, and then they stopped, but SAFE is not at all careful. SAFE has built in anything we tell you means we have to kill you kind of attitude so that's the real difference, not the direct versus indirect.

COMMISSIONER CLEVELAND: And if you had to define a framework or the stress test that reflected what you just said earlier, if the governor is essentially selling out a defense industry regardless of security concerns, what would be on that short list of things that we should consider or provide as a framework to governors when they're thinking about reaching out and traveling to China and seeking investment?

MR. SZAMOSSZEGI: I think that's an excellent question, but I think it goes back--

DR. SCISSORS: It's a tough question.

MR. SZAMOSSZEGI: --to what Derek was talking about before: we need to have expert input from people who understand the technologies and their capabilities. That's not us.

DR. SCISSORS: Right.

COMMISSIONER CLEVELAND: What's the standard? I'm not suggesting that you are the experts on the technology. Is there a technology standard? Is there a defense standard? What would you say should be included on a list of recommendations for governors and mayors and--

DR. SCISSORS: The standards are going to evolve, and we're not even experts on how the standards are going to evolve. I think the recommendation list for governors and mayors is we have CFIUS, if you're not sure, don't go be promising stuff; right? I mean, well, it's farmland. Okay. Well, it's biotechnology. Do you see the difference between these two things?

So I think a common sense approach should be fine. There will probably be a couple of exceptions, and then those governors are going to have to get corrected, and then if that's done, others will learn.

I agree with Andrew. To really get precise guidance before Governor Brown goes to China and wants $68 billion worth of investments, you need somebody to really think about this, and it's not us.

HEARING CO-CHAIR WORTZEL: Commissioner Reinsch.

CHAIRMAN REINSCH: Thank you. I want to follow up what Robin was doing because she started down the road that I was going to go down anyway so this is mostly for Derek, but if the rest want to chime in, that would be good.

I'd say, first, I think in a sense we've gotten a little bit off the track in the last exchange. I don't think national security is the job of governors. It's the job of the president and the federal government. The governor of California doesn't get to decide what's in the national security interest of the United States; the president does.

So I think it's a federal question which brings us back to CFIUS. I certainly agree, with all due respect, you guys are not the ones to make the national security judgment.

On the other hand, let me just ask one question about that, and then I want to get back to the framework. In thinking about national security, I think we can all construct a set of stuff that we don't want anybody to have, including the Chinese. Would natural resources and energy resources be in that category, in your judgment?

DR. SCISSORS: It certainly wouldn't be in that category, in my judgment. I can imagine technology used for energy resources that could have dual uses.

CHAIRMAN REINSCH: Yes, but I mean the resource itself.

DR. SCISSORS: But no, I would not.

CHAIRMAN REINSCH: Oil, the iron ore, the gold, whatever it is.

DR. SCISSORS: This gets back to Commissioner Shea's argument, if we're going to decide that they're harming us in such fashion, then you might say as a retaliation, we're not going to allow you to do "x." I want the harm to be well-defined.

CHAIRMAN REINSCH: Different question.

DR. SCISSORS: In general, no, I would absolutely not deny them natural resources. I think it helps the world economy and it helps the U.S. to be able to have resource trade with China.

CHAIRMAN REINSCH: Okay, getting back to the framework then which you've indicated is CFIUS. And this is really a question for the next panel, I think, but you're not on the next panel so we'll take advantage of your presence now. Do you think they're doing an adequate job of making that judgment?

DR. SCISSORS: I think they're doing an adequate job of making the judgment with the qualifier you've already mentioned, that as somebody said, you don't understand microelectronics, I would say you're right, I don't. I think the CFIUS process should be better than it is. I don't think the individual judgments made in cases are the problem. I think the time it takes, the cluelessness of companies on how to deal with CFIUS, our SAFE-like desire for CFIUS to be this opaque entity, I don't think it's necessary to the extent that we have it. But I think the judgments on individual cases, I don't have reason to question those from my limited knowledge. I just think the process itself is what needs improvement.

CHAIRMAN REINSCH: I would think the government, embodied in CFIUS in this case, would certainly have access to the kind of expertise that you think is necessary. Whether they use it, I don't know, but there certainly are people in the government that can answer those questions in detail, I would think.

DR. SCISSORS: So, again, I think the outcomes of the cases are not necessarily what bother me. I don't want Huawei to be able to supply large amounts of equipment to Sprint. Nonetheless, the way that went down with these phone calls, and I'm not telling you who I'm representing, is absurd. It's exactly what we accuse the Chinese of doing--correctly--in blocking our investments so you don't know what the environment is. The outcome, the judgment was correct. That doesn't mean the process is not flawed.

CHAIRMAN REINSCH: Just think of it as reciprocity.

DR. SCISSORS: Yes.

[Laughter.]

DR. SCISSORS: I'm getting tag-teamed here.

CHAIRMAN REINSCH: Thank you.

HEARING CO-CHAIR WORTZEL: We have some time for some more questions. So Commissioner Wessel is top of the list.

COMMISSIONER WESSEL: Thank you, Mr. Chairman. I want to go to the nature of the Chinese investment, and I believe it was you, Derek, it may have been you, Andrew, though, who raised the question of the Japanese investment. Having been deeply involved in that in the '80s, we had similar trade tensions with Japan, not necessarily the same security issues, but trade tensions. Japan started investing here. Although they did it, as I understand it, in a very different way. They were just-in-time manufacturers so not only did they bring their companies over, they then brought their supply chains over.

China is not doing that. China appears to be bringing companies over as distribution outlets for their products. Let's take the Sinopec recent transaction in Wyoming, which was $2 billion plus. The Wall Street Journal announced that they were going to supply all of the materials used in that project from China despite having adequate oil country tubular goods and all the other products here.

If you look at Suntech--I believe it is in Arizona--a thousand people they're hiring simply to put together the solar panels. All of the material for those solar panels is coming from China.

McKinsey and others are all talking about this localization model that needs to drive business in the future. You need to be close to your customers. GM, when it moved its facilities or invests in China, they were told they had to source, as I understand it, 100 percent of their product used in that facility within five years from Chinese suppliers and had to get them up to ISO-9000 or higher certification.

China is not doing that. When you look at Siemens or other FDI, it's operating under a different model than Chinese FDI in terms of the supply chains localization and many other things. Many of the auto investments are designed not only to serve the market here, but just as much to game the technology, to bring it home to produce in China, things that many other national companies don't do.

Should we be looking at Chinese investments in a different way because they're pursuing a different model?

MR. HANEMANN: Let me attempt to answer that. I think the difference between Chinese and Japanese companies is just a degree of globalization that we live in. If you are asking about sourcing and say that Chinese companies source most of their inputs from China, I would expect that it's the same with most U.S. companies that still assemble in the U.S. And at the same time, the good news is--

COMMISSIONER WESSEL: Sorry, U.S. companies that assemble here.

MR. HANEMANN: Right, a lot of them, the parts that make sense to produce in China, they have outsourced it already. So I think that's a fact of globalization and of commercial decision-making. The good news is that in the past, Chinese companies had this mandated home bias, I would say, that they drew in all productive capacity into their home markets because they were not allowed to rationalize their value chains across the globe, but that's exactly what's happening right now.

So we see, for example, R&D operations going to California or to places where it makes most sense in terms of IPR protection, in terms of human talent. And we actually see that happening with respect to Chinese companies.

In the auto parts sector, you have Wanxiang and you have Nexteer that's now Chinese owned. They produce a lot of goods in the U.S. for the U.S. markets. You have steel companies for which it does not make sense to produce at home under current commercial incentives and they are moving their production overseas. TPCO in Texas for example is building a one billion dollar plant for steel tubes.

COMMISSIONER WESSEL: But Nexteer, having had some discussions with them, it appears that the exports they had hoped to have from the U.S. to China, they're not getting. So the purchase of that company didn't open up new opportunities for U.S. producers and U.S. workers but rather the technology. They're serving the U.S. market from Nexteer here, but the exports that could have happened are, in fact, being produced indigenously in China.

MR. HANEMANN: Well, from what I understand of the situation is that the Chinese investor saved Nexteer from going bankrupt and saved a lot of jobs, and, in fact, they are expanding their greenfield operations locally. They just announced another 400 jobs I think that they're hiring at their local facilities so I think that's a success story.

DR. SCISSORS: I have a very cynical response, which is China is a mercantilist economic country. There are many examples of this, and I'm not going to try to debate this. Until 2007, 2008, there were pretty clear instructions to Chinese companies when they went overseas, like how are you creating jobs back in China? If you're buying resources, fine. Go hire iron miners because it's bringing the steel back. You're going to create jobs overseas? Why are you doing that?

That is changing. It's not changing because China has seen the light. It's changing because the labor market is not as challenging as it is for the Chinese. So you're going to get an evolution of Chinese practices where they'll probably be willing to move production and to behave differently, and so you know that sounds good.

But they're going to be mercantilists in a different way. Why can't Nexteer send parts back to China? Because their production firms in China like they want the share because it's a consolidation of the auto industry that's supposed to happen someday, and they don't want to lose their share because they're more vulnerable to political pressure under consolidation.

So we're going to get a shift in the mercantilism, but they're still going to be a mercantilist country. In our judgment, it's going to be, and I agree with Thilo, despite that cynicism, better for Nexteer. Is it as good as it could have been if it had been a Dutch investor? No, because China is not the Netherlands, but it's still a plus for the U.S.

HEARING CO-CHAIR WORTZEL: Commissioner Shea.

MR. SZAMOSSZEGI: If I can--I'm very sorry--I'm slow to the draw here. One direct measure of what you're talking about is imports to value added, which I calculated in the report for the Commission. Granted, the information was a little bit dated--it may be different now--but China did have a higher import to value-added ratio in 2011, I believe, than most other countries.

But on the other hand, Korea imported much more relative to its value-added in the United States. That's probably changed now with auto production here, but that tells me that though China is different from the average, it's still within the bounds of what's normal.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR WORTZEL: We're down to about six minutes. I got two Commissioners so let's cut the time to three minutes.

VICE CHAIRMAN SHEA: Derek, I'm back to these Heritage Foundation issue briefs, one of which is from January 28. You propose reform of CFIUS, and this is very not like an economist. You're very specific here. But you say the CFIUS mandate should be extended to all types of transactions involving foreign entities. My reaction to that, just reading that, seemed like it was very impractical to have CFIUS apply to all types of transactions, including equipment purchases and orange sales and chickens.

DR. SCISSORS: Well, presumably the orange sales would go through pretty quickly. And my answer to that-- everybody thinks that's impractical-- but that's what we're doing with some countries led by China now anyway. It's just that we're pretending that we're not doing it under CFIUS. It's just happening somehow.

So we block Chinese transactions other than acquisitions in various ways. We just don't do it in a transparent and timely fashion. The general point is CFIUS is supposed to be checking for technology transfers. 98 percent of the transactions, they're going to be done in one second. So, yes, it will increase CFIUS' explicit burden. The U.S. government is already doing this. I just want to rationalize and formalize the process.

VICE CHAIRMAN SHEA: Be more transparent about it.

DR. SCISSORS: Yes.

VICE CHAIRMAN SHEA: Okay. Just real quick, you say the U.S. should formulate a more precise definition of national security for use by CFIUS, thus offering a solution to a major global issue. Do you have a definition to propose?

DR. SCISSORS: I refuse to put this definition on the record given how you've used my comments on the record against me at this point.

[Laughter.]

DR. SCISSORS: What I mean by that, and I understand Commissioner Wortzel's response, is for CFIUS. It's not for all of our policies, and the reason is, in the second panel, and without prejudice to who's going to say what, you're going to get people throwing around it's bad for national security, and national security means--you know-- I think that high unemployment is bad for national security. Well, I can see that argument actually. That's not what CFIUS should be using.

CFIUS, in my view, should have a very narrow definition of national security. And that makes it easier to operationalize their actions so they don't have to worry about-- oh, they're producing oranges. Some day this could be bad for America's health. That should be handled by other regulatory agencies.

So I'm really trying to argue in there for an operational definition for CFIUS--it's not supposed to apply elsewhere--that is narrow, and that will enable them to take on a larger range of transactions without slowing down too much.

VICE CHAIRMAN SHEA: Okay, thank you very much.

COMMISSIONER FIEDLER: I wanted to follow up on Bill's question and your answer actually. You said that you didn't care if the Chinese bought all sorts of energy resources in the United States. If we were to posit that the United States for the first time in its history has a near-term chance of being energy independent, which has vast national security implications, and the Chinese purchase of those assets would diminish our ability to be energy independent, would you have the same answer?

DR. SCISSORS: And my answer, and this is going to go back to the fundamentals of foreign investment, I don't care where we get our energy except in a crisis. So in a crisis when foreigners think they own your assets, and that's true in every country, they don't really own your assets. I don't think nominal Chinese ownership of our energy assets matters to our real energy independence.

COMMISSIONER FIEDLER: Well, in 1974, we had gas lines in the United States because we needed oil from the Middle East. If we have that oil in the United States, we say eliminate the prospect of gas lines in a crisis when oil is unavailable to us without having to go into the Strategic Reserve in order to pump people's gas, which gets to reciprocity. For the Chinese, I actually understand and maybe support their notion that they’ve got an energy security problem. They’ve got sea lanes problems. They’ve got access problems. They’ve got all kinds of things.

So I understand fully why they want to be energy self-sufficient, if not independent or more secure, but we are on the edge of being totally secure, yet, we're willing to give that up to the Chinese or anyone else. I'm not even pointing the finger at the Chinese. Even though the Dutch don't have nuclear weapons; okay?

DR. SCISSORS: That you know of.

[Laughter.]

COMMISSIONER FIEDLER: I don't necessarily want the Dutch to control those assets and make those decisions when the time is right.

DR. SCISSORS: I can answer, but I don't have to.

HEARING CO-CHAIR WORTZEL: No, you don't. Actually we're just about on time. I genuinely appreciate your time and the work and the thought that went into this and your responses here. I have one leftover question--everything else has been addressed-- that I'll get to you. Thank you very much for your willingness to appear.

We're going to take a 15-minute break.

HEARING CO-CHAIR BARTHOLOMEW: We'll start at 11.

[Whereupon, a short recess was taken.]

PANEL II INTRODUCTION BY COMMISIONER CAROLYN BARTHOLOMEW HEARING CO-CHAIR

HEARING CO-CHAIR BARTHOLOMEW: In this panel, we'll examine the national and economic security implications of Chinese investment in the United States.

First up is Elizabeth Drake, a partner at Stewart and Stewart. She has experienced a broad array of international trade law matters, including antidumping and countervailing duty proceedings, Section 301 petitions, China-specific safeguards, and others.

Prior to joining Stewart and Stewart, she served for six years as an international policy analyst at the AFL-CIO. She has served on the Labor Advisory Committee on Trade Policy and Negotiations to the U.S. Trade Representative and on the Planning Committee for the Court of International Trade 16th Judicial Conference.

She's the author and coauthor of a variety of publications on a range of international trade issues, including climate change, Chinese exchange rate policies, WTO rules on balance of payment measures, Buy America laws, and trade and labor rights.

Next, we'll hear from Mark Plotkin, a partner at Covington and Burling. Mr. Plotkin chairs the firm's National Security and Defense Industry Group. He represents clients before CFIUS in obtaining Exon-Florio approval for foreign investments in the U.S., and before the Defense Security Service of the U.S. Department of Defense in connection with foreign ownership control or influence, FOCI, reviews.

MR. PLOTKIN: That's right.

HEARING CO-CHAIR BARTHOLOMEW: Mr. Plotkin is co-editor of Regulation of Foreign Banks and Affiliates in the United States and the author of several dozen articles on the subjects of U.S. national security, privacy and data security, and financial services regulation.

And finally, we will hear from Mr. Dean Popps, former Acting Assistant Secretary of the Army Acquisition, Logistics and Technology and former Army acquisition executive. Mr. Popps served two administrations as the Acting Assistant Secretary of the Army for Acquisition, Logistics and Technology, ALT, and the Army Acquisition Executive, AAE. He served in the Department of the Army as a political appointee from 2004 to 2010, officially retired from government in April 2010, after his successor was confirmed. Currently serves as Of Counsel to the law firm of Fluet Huber + Hoang in Alexandria, and is a senior advisor to clients in the defense industry. He is co-chairman of the Strategic Materials Advisory Council and a member of the Board of Directors of both the Eutelsat America Corporation and Global Integrated Security.

Thank you all for being willing to appear before us today. I think some of you know we're quite interactive in our questions so we look forward to hearing your testimony.

Ms. Drake, we'll start with you.

OPENING STATEMENT OF ELIZABETH J. DRAKE
PARTNER, STEWART & STEWART

MS. DRAKE: Thank you very much. My name is Elizabeth Drake, and I'm a partner at the Law Offices of Stewart and Stewart. I thank the Commission for the opportunity to appear before you today.

While there are many potential benefits as well as challenges posed by Chinese investment, I would like to focus on areas in which Chinese investment may undermine U.S. competitiveness and economic opportunities. I understand that my co-panelists are more likely to address the national security issues that are also of interest to the Commission.

Chinese investment may harm U.S. producers in three different ways: first, through price competition in the U.S. market; second, through trade distortions that may result from Chinese investors' supply chain policies; and third, through competition for resources and technology.

First, with regard to price competition, the threat stems largely from the massive government support many Chinese investors enjoy. As part of its "going out" strategy, the government of China has developed specific investment funds to promote outward investment in natural resources and in fields with technological promise.

In addition, China's Export-Import Bank and the China Development Bank have poured billions of dollars into supporting overseas investments with credits that are reportedly at highly concessional rates.

Furthermore, SOEs that benefit from direct Chinese government funding and are subject to Chinese government policy direction make up the vast majority of Chinese outbound investment. These firms do not face the same market disciplines or incentives as private firms.

Our current competition laws, unfortunately, assume that market actors operate on a commercial basis. They are, therefore, inadequate to remedy anti-competitive behavior by firms whose decisions are influenced by government support and government policies rather than market considerations.

Similarly, existing anti-subsidy disciplines only protect U.S. firms and workers from injury due to competition with goods that are subsidized by foreign governments. These rules do not apply to competition with investors that are subsidized by foreign governments.

Second, with regard to the trade distortions that may arise from Chinese investment, Chinese investment is sometimes motivated by the desire to overcome market access barriers that apply to Chinese exports. These barriers may include antidumping or countervailing duties. Unfortunately, our existing trade remedy laws offer relief from such circumvention efforts only in very limited circumstances.

In addition, trade distortions may result from Chinese firms' discriminatory purchasing practices. There are numerous examples of such discrimination, particularly by SOEs in China. While China has agreed at the

WTO that its SOEs will not discriminate and will make purchasing decisions on a commercial basis, these commitments have never been tested. In addition, they only apply to the SOEs' operations in China, not to their overseas investment.

Third, Chinese firms often invest to gain access to critical technologies and natural resources, which can deprive U.S. firms of equal access to these critical inputs. Yet, the current CFIUS process, as far as I understand it, only screens for such concerns as they relate to national security, not economic security.

In addition, while the Department of Justice reviews mergers and acquisitions for competition concerns, they focus on market dominance writ broadly rather than on access to critical resources and technologies.

So what should policymakers do to address these challenges? One option is to negotiate binding disciplines with China regarding its outbound investment. Such disciplines can build upon the concept of competitive neutrality that the OECD has articulated for state-owned enterprises.

These principles are now being discussed in the TPP negotiations, as well as the model Bilateral Investment Treaty that the U.S. is developing and applying.

Enforcing the disciplines that already exist on China's subsidies and SOEs is also an important step in the right direction. But even in the absence of such enforcement or such new disciplines, the U.S. can act unilaterally to minimize the threat posed by Chinese investment.

First, the U.S. should create a screening process that reviews all investments that are subsidized by or owned or controlled by foreign governments. Such investment should be reviewed from the standpoint of competitive neutrality and be reviewed for their economic as well as national security implications.

As a condition of investment approval, the U.S. should require such investors to disclose material information on levels of government support and control and require such investors to operate in a manner that is consistent with competitive neutrality principles, meaning that prices, sourcing decisions and other business decisions are made on a commercial basis and free from foreign government influence.

This is not a novel concept. Canada and Australia, for example, look at economic implications of foreign investment, and there have been examples where Australia has required that a firm's directors or officers be independent from a foreign government as a condition of investment approval.

In addition, the Department of Justice should review proposed mergers and acquisitions involving such firms with heightened scrutiny. There must also be a means for U.S. workers and firms to seek redress when they are harmed by unfair competition with foreign investors. Predatory pricing rules, for example, may need to be revised to permit alternative means of establishing predatory behavior where the firms do not operate on a commercial basis.

Competition laws should also treat discrimination against goods or suppliers based on their origin when such discrimination arises from the firm's foreign government support or control as an anticompetitive practice. Ultimately, the law should give a private right of action to U.S. firms and workers that have been harmed by subsidized and state-owned investment in the United States.

If harm is shown, the injured party should be entitled to compensation for lost revenues, lost wages and other damages. Allegations of such behavior should also trigger an investigation by the screening mechanism proposed above to determine whether any of the conditions of investment approval have been breached.

In addition, as noted above, domestic trade remedy laws may need to be strengthened to ensure they cannot be circumvented through foreign investment, particularly state-backed foreign investment.

Finally, policymakers should ensure that the other policy tools we already have at our disposal are being used to the furthest extent possible to minimize the risks that government backed investment from China and other countries may pose.

This includes strengthening the CFIUS process, ensuring firms do not gain an unfair advantage in government procurement decisions due to foreign government support or control, and clarifying that state support and control are material items that the SEC should require firms to disclose to the public.

Thank you for the opportunity to testify before you today.

PREPARED STATEMENT OF ELIZABETH J. DRAKE
PARTNER, STEWART & STEWART

Trends and Implications of Chinese Investment in the United States:
Issues for Policymakers

Testimony before the U.S. – China Economic and Security Review Commission
Elizabeth J. Drake[1]
Partner, Law Offices of Stewart and Stewart
May 9, 2013

I. Introduction

China's global outbound foreign direct investment ("FDI") reached another record level in 2012, exceeding $77 billion.[2] The United States continues to be the top destination for China's outbound FDI, receiving at least $17 billion in Chinese investment in 2012 according to one estimate.[3] While still a relatively small portion of total inbound FDI in the United States, China's investment activities deserve attention from policymakers for a number of reasons.

As a preliminary matter, investment from China will become an increasingly important part of the country's inbound flows: by 2020, China's global outbound investment stock is poised to reach $2 trillion, more than six times what it was in 2010.[4] Policymakers should thus be approaching Chinese investment not merely on the basis of investments that have already been made, but also on the basis of what is likely to occur in the near future.

Moreover, the Government of China has an explicit policy to encourage and support outbound FDI, and provides significant government support to such investment through state funding and financing from state-owned banks. Domestic firms and workers who enjoy no such support can thus be put at a severe competitive disadvantage if Chinese firms with such aggressive government backing become their closest competitors.

In addition, China's outbound FDI is unique in the extent to which it is dominated by state-invested and state-owned firms (collectively, "SOEs"). In 2012, for example, it is estimated that private firms accounted for only 9.5% of China's outbound FDI to the world.[5] These SOEs continue to be heavily influenced and supported by the state, and they may have a variety of non-commercial motives for their investments. These motivations may raise concerns not only about national security, but also about economic security.

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[1] This testimony reflects the individual views of the author, and not necessarily the views of the Law Offices of Stewart and Stewart or any of its clients.
[2] "The expanding scale and scope of China's outward direct investment," The Economist (Jan. 19, 2013).
[3] Heritage Foundation, "China Global Investment Tracker," available on-line at: http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map.
[4] Shuping Liao and Yongsheng Zhang, "Strategies for Managing China's State-Owned Foreign Direct Investment," EABER Working Paper Series Paper No. 76 (Aug. 20, 2012) at 6-7.
[5] "The expanding scale and scope of China's outward direct investment," The Economist (Jan. 19, 2013).

While there are potential benefits as well as challenges posed by Chinese investment in the United States, this testimony focuses on three areas in which Chinese investment may undermine U.S. competitiveness and economic opportunities. The three areas are: 1) price competition with Chinese-invested firms in the U.S. market; 2) trade distortions that may result from Chinese investors' supply chain policies; and 3) competition for resources and technology.

This testimony recommends policies to address the challenges posed by increased Chinese investment in each of these three areas. While some of these recommendations could be implemented by adapting current policy instruments, the challenges posed by Chinese investment would be best addressed by a comprehensive U.S. policy response. To the extent that existing policy tools are inadequate, policymakers should consider creating new remedies to ensure that Chinese investment does not distort the competitive playing field for workers and firms in the United States.

I. Price Competition with Chinese-Invested Firms

As noted above, the Chinese government has an explicit policy supporting overseas FDI, and it aggressively supports such investment with government funding and financing from state-owned banks. As part of its "going out" strategy, the Government of China has developed specific investment funds to promote outward investment in natural resources and in fields with technological promise.[6] In addition, China's Export-Import Bank and the China Development Bank have poured billions of dollars into supporting overseas investments, with credits that are reportedly available at highly concessional rates.[7] Furthermore, SOEs that benefit from direct Chinese government funding, and are subject to Chinese government policy direction, make up the vast majority of Chinese investment. These firms do not face the same market discipline or incentives as private firms. They can rely on state support to maintain losses that may never be recouped, and make other operating decisions on a non-commercial basis, in order to meet political or industrial policy goals.

The direct support and involvement of the Chinese government can give Chinese firms (and Chinese-invested firms) important advantages in the U.S. market that their competitors do not enjoy. When a U.S. firm has to obtain credit at market rates to finance its activities, but a Chinese firm can obtain financing at minimal or even zero percent interest from Chinese state-owned banks, it distorts competition in the United States market. Such state support permits a Chinese firm to make investments and acquire resources and technology it otherwise could not if it had to pay market rates for equity and finance. In addition, such state support may permit Chinese firms to make decisions regarding the sales prices of their goods and services that do not reflect market fundamentals and that undercut their U.S. competitors.

Current U.S. law does not adequately protect U.S. workers and firms from this type of unfair

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[6] Huang Webin and Andreas Wilkes, "Analysis of China's overseas investment policies," CIFOR Working Paper 79 (2011) at 12-13.

[7] Id. See also Terence P. Stewart, et al., China's Support Programs for Automobiles and Auto Parts under the 12th Five-Year Plan (Jan. 2012) at 60.

competition. Existing antitrust rules, for example, are based on assumptions about the profit-maximizing behavior of market actors that simply may not apply to certain Chinese firms. In the area of predatory pricing, the U.S. applies a recoupment test, under which pricing is only deemed anti-competitive if the predator is likely to eventually collect enough profits to make up for the losses caused by the predatory behavior.[8] The test is based on the theory that a predator who could not recoup its losses would either not engage in the predatory practices to begin with or will eventually exit the market, causing no long-term damage to competitors or consumers. A Chinese SOE, by contrast, may be able to rely on state support to maintain losses that may never be recouped, and engage in predatory pricing in order to gain U.S. market share in the furtherance of political or industrial policy goals. Such a firm could engage in predatory pricing behavior that causes severe damage to its U.S. competitors, but, under current law, such behavior would not be considered anticompetitive as long as the Chinese firm was not expected to recoup its losses.

In addition, existing anti-subsidy disciplines in U.S. countervailing duty law and at the World Trade Organization do not address the harm caused by competition with subsidized investors. U.S. countervailing duty law only addresses the injury caused by subsidized imports of goods, not investments by subsidized firms. WTO rules permit relief on the basis of harm in a range of markets, including third-country markets and the market of the subsidizing government itself, but these rules similarly focus on the harm that arises from competing with subsidized goods, not firms. Finally, though China committed to ensure that Chinese SOEs would make decisions on their purchases and sales on commercial terms when it joined the WTO, these commitments have never been tested. It is highly unlikely that the WTO would enforce such commitments regarding decisions that are made by SOEs operating outside of China.

II. Trade Distortions Linked to Chinese Investment

Several analysts have noted that one motivation for Chinese investment is access to markets that are otherwise restricted by trade barriers.[9] Such barriers may include prevailing tariff rates as well as duties imposed to counteract unfair trade practices, such as antidumping and countervailing duties. While U.S. trade remedy laws allow an antidumping or countervailing duty order to be expanded to cover imported parts that are used to assemble merchandise in the U.S. that would otherwise be subject to unfair trade duties, relief is only available if the assembly in the U.S. is insignificant and if the value of imported components is a significant portion of total value.[10] The Department of Commerce also considers affiliation between the assembler in the U.S. and the component exporter, among other factors. These rules may be inadequate to redress the harm that U.S. workers and firms may suffer if a Chinese company invests in the U.S. to evade trade remedies, especially where the investor's operations in the U.S. are not insignificant or where the investor is not directly affiliated with the Chinese component producer.

[8] Antonio Capobianco and Hans Christiansen, "Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options," OECD Corporate Governance Working Papers No. 1 (2011) at 21.

[9] Nargiza Salidjanova, "Going Out: An Overview of China's Outward Foreign Direct Investment," U.S.-China Economic & Security Review Commission Staff Research Report (Mar. 30, 2011) at 10-11.

[10] 19 U.S.C. Sec. 1677j(a).

In addition, Chinese SOEs in particular have been known to discriminate against non-Chinese producers in making sourcing decisions. The state-owned wind turbine producer Sinovel, for example, required its American component supplier to agree to a "localization schedule" under which components which it had produced with non-Chinese material would instead be produced with Chinese materials.[11] More recently, as part of an agreement to establish a joint-venture with a Chinese SOE to produce trucks, Daimler similarly agreed to "localize" the production of the truck engines to China.[12] While these agreements pertained to supply agreements and investments in China, the same motivations to fulfill Chinese industrial policies may lead Chinese investors to discriminate against non-Chinese goods when producing in the United States. Increased investment by such firms in the United States could result in increased imports from China, placing U.S. suppliers at a disadvantage.

There are currently no remedies available for workers or producers who may be harmed by such discrimination. WTO rules that prohibit discrimination against non-Chinese goods by the Government of China, for example, apply to its treatment of those goods upon importation into China – they would not apply to discrimination that takes place against foreign goods that are not imported into China. In addition, as noted above, while China committed to ensure that Chinese SOEs would make decisions on their purchases and sales on commercial terms when it joined the WTO, these commitments have never been tested, and it is highly unlikely that the WTO would enforce such commitments regarding decisions that are made by SOEs operating outside of China.

III. Competition for Resources and Technology

Part of the motivation for China's promotion of outward FDI is to gain access to valuable resources and technology.[13] As noted above, the Government of China has established two funds to support outbound investment dedicated specifically for these purposes. Chinese firms that use such government support may be able to outbid U.S. producers for critical resources and technology, negatively impacting U.S. competitiveness. In addition, Chinese firms may not only outbid their U.S. competitors but be able to monopolize access to the technology, harming the U.S. economy as a whole. While private firms operating on a commercial basis also make investment decisions in order to access resources and technology, in some cases decisions by Chinese firms in this regard (especially by SOEs) may be influenced by non-commercial factors such as government policy priorities.

For example, in 1995, a group of companies that included Chinese SOEs sought to acquire Magnaquench, the only U.S. producer of neodymium-iron-boron magnets.[14] The magnets are an

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[11] American Superconductor Corp. Form 8-K (June 5, 2008) at Ex. 10.1. See also American Superconductor Corp. Form 10-Q (Aug. 5, 2010) at 18.
[12] "Germany's Daimler to Make Trucks in China," Agence France Presse (Spet. 26, 2011); "Final Approval Issued by Chinese Authorities: Way Clear for Daimler's Truck Joint Venture with Foton," Daimler.com (Sept. 26, 2011).
[13] Huang Webin and Andreas Wilkes, "Analysis of China's overseas investment policies," CIFOR Working Paper 79 (2011) at 9. See also Nargiza Salidjanova, "Going Out: An Overview of China's Outward Foreign Direct Investment," U.S.-China Economic & Security Review Commission Staff Research Report (Mar. 30, 2011) at 7-9.
[14] Cindy Hurst, "China's Rare Earth Elements Industry: What Can the West Learn?" Institute for the Analysis of Global Security (March 2010) at 12. See also Karl P. Sauvant, "Investing in the United States: Is the US Ready for FDI from

important technology for MRIs, wind turbines, automotive motors, and a wide array of other applications. The magnets also have critical military applications, including target lasers, satellite communications systems, radar amplifiers, and more.[15] The investment was approved on the basis of a commitment from the investors to keep production of the magnets in the United States for at least five years.[16] The day after the five-year period expired, the investors closed the facility, laid off the workers, and took the equipment and technology to China.[17] By 2007, China had more than 130 enterprises engaged in manufacturing the critical permanent magnets; the U.S. had none.[18]

Current U.S. policies are insufficient to ensure that U.S. producers will be able to compete on a level playing field to acquire and maintain access to key resources and technologies. The Committee on Foreign Investment in the United States ("CFIUS") process, for example, is designed to screen foreign investment for national security concerns, but not economic security or competitiveness issues. Thus, while CFIUS applies heightened scrutiny to transactions involving SOEs that may impact national security, it does not screen investments for their economic impacts. In addition, while the Department of Justice reviews proposed mergers and acquisitions for potential competitiveness concerns, these typically relate to market dominance in general rather than specific concerns about strategic resources or technologies. Other countries do screen foreign investment for such issues. Australia and Canada, for example, apply a net benefit test when evaluating proposed foreign investment, and the test includes economic, as well as national security, criteria.

IV. Options for Policymakers

There are a number of options policymakers should consider to maximize the benefits, and minimize the potential threat, of Chinese investment in the United States. The U.S. should take a comprehensive approach to ensure, among other things, that:

1) U.S. workers and firms will not be undercut by unfair competition from firms operating in the U.S. that benefit from foreign government support or operate under the control of foreign government entities, including (but not limited to) the Government of China;

2) foreign investment does not undermine the effectiveness of our trade remedy laws nor entail discrimination against United States suppliers of goods and services; and

3) U.S. producers enjoy access to key resources and technologies on commercial terms and are not deprived of such access due to unfair competition with foreign investors.

U.S. policy should also draw on the principle of competitive neutrality, especially with regard to competition with China's SOEs. The OECD Guidelines on Corporate Governance of State-Owned

China?" Edward Elgar Studies in International Investment (2009) at 46.
[15] Cindy Hurst, "China's Rare Earth Elements Industry: What Can the West Learn?" Institute for the Analysis of Global Security (March 2010) at 13.
[16] Id.
[17] Id.
[18] Id.

Enterprises offer guidance in this area. For example, Chapter I of the Guidelines states that governments should ensure a "level playing field" in markets where SOEs and private companies compete "in order to avoid market distortions."[19] Thus, "SOEs should face competitive conditions regarding access to finance," and SOEs' relationships with state-owned banks and other SOEs "should be based on purely commercial grounds."[20] The OECD Guidelines also state that SOEs should disclose material information on all matters described in the Guidelines, including "[a]ny financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE," material transactions with related entities, and material risk factors.[21]

One way to meet these goals would be to get China to agree to binding obligations regarding its outbound FDI based on the principles of competitive neutrality. While the U.S. already secured some obligations from China regarding the operations of its SOEs in China's accession to the WTO, these obligations apply to those firms' operations within China – not to their investments abroad. New disciplines should, at a minimum, require transparency and disclosure as to the extent of state support, ownership, and control. All firms should be required to operate on the basis of competitive neutrality, with business decisions made on the basis of commercial considerations rather than government policies (whether those decision relate to pricing, sourcing, or acquisition of resources and technology). To be meaningful, such obligations would need to be enforceable through a dispute settlement mechanism and the prospect of economic consequences for non-compliance.

In addition, the U.S. should take proactive steps to seek enforcement of those obligations China has undertaken to date. At the WTO, for example, the U.S. should challenge prohibited subsidies such as export credits on terms that do not comply with the terms of the OECD arrangement, as well as SOEs' use of domestic content and technology transfer requirements in their procurement and investment contracts. If these rules prove to be effective, they may provide an appropriate template for future disciplines on the actions of SOEs outside of their home country boundaries. If not, those disciplines need to be not only expanded in scope but also strengthened in substance. In the context of the on-going Trans-Pacific Partnership negotiations, for example, parties are reportedly discussing the inclusion of rules that would discipline the actions of SOEs and seek to ensure that they behave on commercial terms. Such disciplines should also be included in the model Bilateral Investment Treaty the U.S. relies upon in negotiating investment agreements with other countries. These rules must set a high standard that addresses not only potential concerns with TPP or BIT partners, but also with other major trading and investing countries we may negotiate with in the future, such as China.

Whether or not the U.S. is able to secure binding commitments from China regarding its outbound FDI, the U.S. can take unilateral action to minimize the negative impacts such investment may have on the U.S. economy. Policymakers should first consider improving the process for screening new investments in the U.S., particularly investments by firms that are supported or controlled by foreign governments. Such investments should be reviewed from the standpoint of competitive neutrality, and be reviewed for their economic, as well as national security, implications. As a condition of investment approval, the

[19] OECD Guidelines on Corporate Governance of State-Owned Enterprises, Ch. I, chapeau.
[20] Id. at Ch. I, Sec. F.
[21] Id. at Ch. V, Sec. E.

U.S. should require such investors to disclose material information such as levels of government support and the basis for pricing and procurement practices. The U.S. should require that such firms operate in a manner that is consistent with competitive neutrality principles, meaning that prices, sourcing decisions, and other business decisions are made on a commercial basis and free from foreign government influence. To meet these commitments, the U.S. may also require that directors and officers of the U.S. entity be independent from the foreign government, consistent with Australia's practice in some cases.[22] The U.S. should require regular reporting and monitoring to ensure these commitments are met. In addition, when the Department of Justice reviews proposed mergers and acquisitions for competition concerns, it should take into account whether the investor benefits from foreign government support and whether the investor is owned or controlled by a foreign government entity and thus may operate in a manner that is not consistent with commercial considerations.

There must also be a means for U.S. workers and firms to seek redress where they have suffered competitive harm, or are threatened with harm, due to unfair competition with foreign investors. While certain tools already exist in domestic competition laws, these tools should be re-evaluated to ensure that they adequately address competition with firms that benefit from foreign government support or are controlled by foreign governments. Predatory pricing rules, for example, may need to be revised to permit alternative means of establishing predatory behavior where the firms involved are subsidized by the government or there are other indications that they do not operate on a commercial basis. Instead of applying the recoupment test to determine if prices are predatory, for example, cost benchmarks could be used to evaluate the prices charged. Evidence of foreign government influence on, or support for, pricing decisions may also be relevant to such inquiries. Competition laws should also be reviewed to determine whether discrimination against domestic origin goods on the basis of a purchasing firm's foreign government support or control rather than commercial considerations should be considered an anticompetitive practice.

Ultimately, the law should give a private right of action to U.S. firms and workers that have been harmed by subsidized and SOE investment in the United States. Such a right of action should cover harm due to anticompetitive behavior as well as harm stemming from discriminatory and non-commercial purchasing decisions. If harm is shown, the injured party should be entitled to compensation for lost revenues, lost wages, and other damages. Allegations of such behavior should also trigger an investigation by the screening mechanism proposed above to determine whether any of the conditions of investment approval have been breached.

In addition, domestic trade remedy laws may need to be strengthened to ensure they cannot be circumvented through foreign investment, particularly state-backed foreign investment. As noted above, current rules on circumvention of antidumping and countervailing duty orders through investments in domestic production depend, in part, on whether the domestic investment is insignificant and on the affiliation between the investor and the foreign component producer or exporter. To the extent such limitations pose an obstacle to effective enforcement of the unfair trade laws, they should be altered or eliminated.

[22] Greg Golding, "Australian regulation of foreign direct investment by sovereign wealth funds and State-owned enterprises: Are our rules right?" (2010) 38 ABLR 215, 227.

Finally, policymakers should ensure that the other policy tools we already do have available are being used to the furthest extent possible to minimize the risks that foreign government-backed investment from China (and other countries) may pose. The CFIUS process, for example, should exercise its mandate to protect national security concerns in the broadest sense of the term, and learn from the practices of other countries regarding the undertakings that state-owned investors are required to agree to when investments implicate national security concerns. Buy America rules may need to be examined to determine whether the fact that a bidder is an SOE or a subsidized firm should be taken into account when determining contract awards. Finally, the SEC should clarify that state support for, and control over, an enterprise are material items that require disclosure in the interest of protecting private investors. The terms of state assistance and financing to SOEs, the terms of supply and procurement contracts with state-owned suppliers and purchasers, and the relationship between a firm's directors and officers and the government should all be considered material information for which disclosure is required.

OPENING STATEMENT OF MARK E. PLOTKIN
PARTNER, COVINGTON & BURLING LLP

MR. PLOTKIN: Thank you. Thank you for inviting me to this hearing. I'd like to recognize my colleague Jonathan Wakely, who was deeply involved in drafting my testimony. Anything I say of value is ultimately attributable to him.

[Laughter.]

MR. PLOTKIN: My wife Teresa also is here, and I can tell you that after 25 years of marriage, she will confirm that all errors of any kind are attributable to me.

[Laughter.]

MR. PLOTKIN: In that regard, I was sorry to notice a typographical error in my written testimony. Commissioner Shea was one of my editors on the Journal on Legislation in law school, and I feel the need to apologize.

HEARING CO-CHAIR BARTHOLOMEW: Oh, he's quite an editor.

[Laughter.]

MR. PLOTKIN: So I carry guilt with me.

Chinese investment in the United States is a critical issue, and I appreciate being asked to offer my thoughts on the topic. My views are informed by my experience representing both American and Chinese companies in cross-border transactions before the Committee on Foreign Investment in the United States.

That experience leads me to the following points. The first is that I believe existing law is adequate to protect U.S. national security. CFIUS is a powerful institution because Congress crafted its statutory mandate with what I would term "living language," language that leaves the phrase "national security" undefined. That flexibility allows the CFIUS agencies the ability to weigh and address their individual equities and mandates during the course of a CFIUS review, and it also allows CFIUS to adapt to an ever-changing threat environment.

I'd like to offer two examples of that adaptability: cybersecurity and state-owned enterprises. If this hearing were held in 1988 when Exon-Florio was enacted, cybersecurity would not have been on anyone's mind. Today, one could justifiably wonder whether Exon-Florio should be amended to require a cybersecurity analysis for all CFIUS reviews given the current cyber threat landscape. Yet, cybersecurity already is a crucial element of almost all CFIUS reviews, not by statutory fiat but by prudent practice.

Among other things, CFIUS requires transaction parties to submit cybersecurity plans, a forward-looking requirement imposed almost five years ago by CFIUS, by regulation, long before cyber threats were a daily concern. Moreover, virtually every CFIUS mitigation agreement today involving a Chinese investor requires aggressive separation of IT networks to insulate the U.S. business from cyber attack.

Likewise, one could wonder whether statutory changes are needed to address today's investments by state-controlled entities. Yet, here, too, CFIUS has come to recognize the risk. Exon-Florio itself already contains a presumption of an additional 45-day investigation when a transaction involves a state-owned entity.

And, moreover, in practice, CFIUS has come to demand excruciating transparency from foreign investors, and, in particular, from state-owned investors. I have seen foreign government investors balk repeatedly at providing the intrusive personal and business data required by CFIUS, to the point where they will walk away from a potential transaction. By merely requiring this information, CFIUS reduces the pool of these investors to those willing to comply at a minimum with its stringent information requirements.

And these are just two examples of how CFIUS stays current. We can't know what our national security concerns will be next year, let alone ten years from now. I'd urge the Commission to take some comfort in this living language and to resist the temptation to recommend additional statutory mandates that could detract from CFIUS' flexibility.

I separately believe it would be a mistake to expand the CFIUS mandate to include a net benefit or economic test like that used by our neighbors to the north in the Investment Canada Act. The principles underlying an economic test are beyond the core competency of CFIUS. While sophisticated, the CFIUS staff and the member agencies lack the capacity to conduct complex economic analysis.

For that task, we have entire agencies of talented economists, diplomats and regulators whose existing mission is to promote a level playing field for U.S. business.

Moreover, CFIUS operates in strict secrecy. Secrecy in the conduct of an economic benefit test risks being perceived as protectionist, and if we were to implement a mechanism to review the economic benefits of transactions, I would submit that it should be transparent.

More Chinese investment does not mean that we are less secure. Appropriately tailored CFIUS mitigation can permit Chinese investment in the United States while actually enhancing U.S. national security. Notwithstanding that, some have suggested that we need reciprocity requirements in our laws that would deny the right to invest in the United States to countries that do not extend the same rights to U.S. companies. This approach is intuitively appealing. That said, while I strongly believe that we should advocate aggressively to open foreign markets to U.S. businesses, I also believe that to always insist on reciprocity would needlessly deny the United States the benefits of foreign investment in many instances.

It also would subject U.S. businesses to more discrimination when they try to invest abroad. With that said, CFIUS could benefit from additional resources. I often disagree with the committee staff, but I can't fault their tireless dedication to national security. These are not clock-watching bureaucrats. These men and women regularly work nights, weekends, and holidays with little appreciation, a punishing caseload, and endless badgering from lawyers like myself. More resources would advance national security and promote investment by ensuring that they have sufficient staff to evaluate transactions in a thorough and timely manner, and I would suggest that they're lacking in those resources today.

In closing, I note that encouraging foreign investment, protecting national security, and ensuring a level playing field for U.S. businesses are all important policy goals, and that fortunately these goals are not mutually exclusive.

Both our national security and our economic interests are best served when CFIUS can consider each foreign investment on a case-by-case basis, free of special constraints. I would encourage the Commission to resist recommending additional mandates for our national security review process and instead to consider how it can help empower CFIUS and our other institutions through additional resources.

Thank you very much.

PREPARED STATEMENT OF MARK E. PLOTKIN
PARTNER, COVINGTON & BURLING LLP

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

Hearing on Trends and Implications of Chinese Investment in the United States

Mark E. Plotkin[1]
Partner, Covington & Burling LLP
May 9, 2013

Thank you to the Commission and, in particular, to Commissioners Bartholomew and Wortzel for convening this hearing and offering me the opportunity to participate. Chinese investment in the United States is an important policy issue for our nation, and I am honored to be asked to contribute to the Commission's work in this regard.

The subject of this particular panel is "Issues for Policymakers" and I accordingly will focus on the current state of U.S. law and policy concerning Chinese investment in the United States. My perspective is informed by my experience as an attorney representing parties involved in cross-border transactions, including before the Committee on Foreign Investment in the United States, or CFIUS. Many of these cases have involved Chinese investors. In some instances I represent sellers of U.S. assets, while in other instances I advise Chinese buyers of such assets. In these circumstances, I have developed some views as to how our laws and policies governing foreign investment in the United States are implemented and how they impact trade, commerce and U.S. national security.

I have three principal points to offer the Commission.

First, I believe that existing U.S. law is adequate to protect our national security interests. Although I may disagree at times with how the law is implemented, I submit that the dedicated individuals and institutions charged with protecting our national security have available to them the necessary legal tools to carry out their duties effectively and efficiently. In particular, CFIUS is a powerful institution because the Congress wisely crafted its statutory mandate with what I term "living" language — language that permits the Committee and its constituent agencies to adapt readily to a constantly evolving national security landscape. I urge the Commission to resist recommending any additional categorical requirements that would impede the Committee's ability to evaluate each transaction on a case-by-case basis in the context of the current security environment.

Second, CFIUS as structured pursuant to the Exon-Florio amendment was expressly designed to

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evaluate whether a proposed transaction threatens to impair U.S. national security. I believe that it would be an error to expand the Committee's mandate to include assessing the economic effects of a transaction, such as through a so-called "net benefit" test. A net benefit test would be inconsistent with our country's longstanding policy of open investment, it would be outside of CFIUS's institutional competence, and it would be inappropriate for a regulatory body that operates in secret. It also would risk detracting from the Committee's core function of protecting our national security and could unintentionally lend credence to allegations that CFIUS is a trade barrier dressed up as a national security tool.

Third, we should remember that foreign direct investment and national security need not be zero sum in combination. More Chinese investment does not mean that we are less secure. The goal of our laws and policies should be two-fold: to encourage foreign investment *and* to protect national security. I have seen for myself that the two need not be mutually exclusive. Rather, handled correctly, appropriately tailored CFIUS mitigation can permit Chinese and other foreign investment in the United States while actually enhancing U.S. national security at the very same time. In this respect, CFIUS — when utilized adroitly — can be an economic and a security tool of equal force using just the existing legal authorities available today. Our nation and our people will be best served when we can pursue both our security and economic goals in a manner that is complementary rather than exclusive.

Let me turn first to the adequacy of existing law to protect our interests.

The Adequacy of Existing Law to Address Chinese Investment

U.S. National Security Review of Foreign Investment

As I mentioned, I believe that CFIUS's strength comes from the "living" language of its statutory mandate, which leaves the phrase "national security" undefined and subject to the Committee's interpretation and discretion. This flexibility is crucial because national security is not a static concept. Our security interests change as we evolve as a nation and as the world shifts around us. If this hearing were held in 1988 when the Exon-Florio amendment was enacted, the topic of cyber security never would have arisen. Now cyber security is a critical part of nearly every CFIUS review. As this Commission is well aware, the past decade has seen heightened focus on China as a strategic competitor and economic partner. And CFIUS has responded by intensifying its scrutiny of proposed Chinese investments. At the same time, other issues have faded. The fears about Middle Eastern investment that drove the creation of CFIUS in the 1970s, and the concerns about Japanese investment that were the impetus for the Exon-Florio amendment in the 1980s, have largely dissipated. None of us can imagine, let alone predict, the primary issues that CFIUS will face 20 years hence.

CFIUS's statutory mandate is simultaneously narrow in scope and vague in its application. The Committee has the power to review certain transactions to "determine the effects of the transaction on the national security of the United States."[2] The statute was amended in 2008 by the Foreign Investment and National Security Act ("FINSA") to specify that national security shall be construed to include

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[2] *See* Foreign Investment and National Security Act, 50 U.S.C. App. § 2170 (b)(1)(A)(i) (2012).

issues related to homeland security, but national security is not otherwise defined.[3] The statute provides a list of factors that the Committee must consider, but these factors are neither intended to be an exhaustive definition of the scope of national security nor are they treated as such in practice.[4] National security also is left undefined by the Department of the Treasury's regulations implementing FINSA.[5]

Because of this "living language," the CFIUS agencies are free to interpret national security consistent with their individual mandates and equities, instead of being locked into a rigid statutory box. Simply by way of example, the Department of Energy focuses on potential threats to our energy infrastructure, while the Department of Homeland Security concentrates on critical infrastructure, and the Department of Commerce scrutinizes compliance with export control regulations. Permitting the CFIUS member agencies to apply their own definitions of national security ensures that a broad range of interests are represented, weighed, and balanced as part of the review process.

Cyber security offers a topical and compelling example of how CFIUS has adapted to a changing national security landscape. Neither the Exon-Florio amendment nor FINSA make any mention of cyber security. Yet cyber issues play a significant role in nearly every review and investigation. The Commission may be considering whether to recommend a specific statutory requirement that CFIUS conduct a cyber security analysis for each transaction it reviews. I would caution against such a mandate for two reasons. First, it is unnecessary. As the threat of cyber attacks and cyber espionage has increased, I have seen CFIUS focus more acutely on cyber security in its reviews, investigations, and mitigation agreements, especially where there is a Chinese investor. The CFIUS regulations also specifically require the parties to submit details related to cyber security practices.[6]

Separately, unnecessary mandates have the potential to distract from other, more pressing national security risks presented by a transaction. I have never seen two transactions that were the same, or even largely similar. The nature and severity of the potential risks vary widely. In some cases, cyber security is the chief risk and should be the focus of the Committee's review. In other cases, it may be appropriate for the Committee to commit its resources elsewhere, such as assessing geographic proximity concerns (in CFIUS parlance, "persistent co-location") or regulatory compliance matters. A mandatory cyber security analysis would risk redirecting the Committee's limited resources from more pressing matters without offering any appreciable benefit.

The flexibility of the concept of national security is important for another reason. CFIUS's decisions can and do have a tangible and material impact on the foreign relations of the United States. I can tell you from experience that foreign embassies and governments take a very active interest in how their native companies are treated during the review process. It therefore is critically important that the CFIUS process reflect and complement the incumbent administration's broader foreign policy and national security priorities, within the parameters set by the Congress.

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[3] 50 U.S.C. App. § 2170 (a)(5).
[4] 50 U.S.C. App. § 2170 (f).
[5] 31 CFR § 800.
[6] § 800.402(c)(3)(viii).

In practice, no administration has sought to adopt an explicit definition of national security for CFIUS purposes, instead leaving that determination to the agencies' discretion. The agencies' views, in turn, are influenced and shaped by the President's agenda. If Congress attempts to influence the definition of national security that CFIUS applies through additional mandatory reviews, investigations, or assessments, there is a danger that the Committee will find itself at cross purposes with the administration, leading to a less integrated, less cohesive foreign policy.

I share this background to help explain why I believe the flexibility of the language in FINSA and the CFIUS regulations is so critical to the Committee's proper functioning. I would urge the Commission to resist recommending any changes that would limit the Committee's discretion in defining national security for purposes of reviews. It is neither practical nor prudent to amend the CFIUS statute each time the national security landscape changes. We cannot predict what security risks our country will face in ten years, or even next year, and we should not try. Instead, we should recognize that it is the living language of the CFIUS statute that makes the institution most effective year after year.

Finally, I would suggest that the Commission and Congress consider whether CFIUS and the Agency staff that support the Committee would benefit from additional resources. As the number of investigations conducted by the committee has increased year-by-year, so too has the workload. I have witnessed firsthand the tireless efforts of the Committee's dedicated civil servants. These are not clock-watching bureaucrats; these men and women regularly work nights, weekends and holidays with little appreciation and no recognition, and often with a punishing caseload. Additional resources would promote the twin goals of protecting national security and promoting investment by ensuring that they have sufficient staff to evaluate transactions in a thorough and timely manner.

State-controlled Entities and National Security

I recognize that investments from state-controlled entities, including state-owned enterprises ("SOEs") and sovereign wealth funds ("SWFs"), present unique challenges from a national security perspective. At the same time, these investors make valuable contributions to our economy. I would suggest to you that our national interests are best served if CFIUS is free to consider each such investment on a case-by-case basis and that additional statutory mandates targeted at SOEs and SWFs are both unnecessary and counterproductive.

There is always the possibility that a state-owned foreign investor may be motivated by political or national security considerations, rather than by purely commercial interests. At the same time, I believe that treating all entities with any form of government ownership stake or interest identically is unnecessary from a national security perspective, damaging to our economic interests, and will deservedly be seen as unfair by foreign observers.

SOEs are not a monolithic group. It is true that *some* SOEs are, in effect, organs of the state that operate with substantial direction from the government. Others are largely independent businesses with only incidental, historical or passive state ownership. And still others are in distinct phases of evolution on the continuum from state control to private control, with considerable conflict between the state and private stakeholders. To straitjacket all of these entities uniformly would be poor and unrefined policy.

If categorical protections are inadvisable, how then do we address the unique challenges that state-owned investors pose? I believe that we should require sufficient transparency from investors to permit CFIUS to make an informed decision about the risks of each individual transaction. The more transparent a corporation's governance and decision making, the more confidence we can have that its investments are motivated solely by business considerations. And, where there are credible risks, we can take appropriate steps to protect our security interests.

I note that, for transactions reviewed by CFIUS, we already demand an exceptional degree of transparency from investors, including SOEs. The CFIUS regulations require that all notices to the Committee contain a great deal of sensitive information. I can tell you from experience that foreign investors often are uncomfortable providing the level of detailed information sought by CFIUS. The foreign party is required to provide "Personal Identifier Information" about each and every officer and director, including date of birth, place of birth, "date and nature of foreign government and foreign military service," "national identity number, including nationality, date and place of issuance, and expiration date," and passport number, together with a detailed curriculum vitae.[7] The foreign party must also provide extensive information about its governance structure and ownership, including, where the ultimate parent is a public company, identifier information for any shareholder with an interest greater than five percent.[8] These data, once provided, are subjected to thorough analysis by CFIUS utilizing classified systems and databases.

In practice, some investors are simply unwilling to provide this information and self-select out of a potential transaction. Thus, by merely requiring this information, we reduce the pool of investors in the United States to those who are willing, at a minimum, to comply with our stringent information requirements. Moreover, state-controlled entities already are subject to additional scrutiny in the CFIUS process. Thus, FINSA creates a presumption that CFIUS will conduct an additional 45-day investigation for any transaction "that could result in control of a U.S. business by a foreign government or a person controlled by or acting on behalf of a foreign government."[9] This presumption may be overcome only if the Secretary of the Treasury and the head of the lead agency jointly determine . . . that the transaction will not impair the national security of the United States."[10] The authority may not be delegated to anyone other than the Deputy Secretary of the Treasury or the equivalent in the lead agency.[11] My experience is that this discretionary authority is rarely, if ever, utilized to shorten a review process.

In my view, these policies represent an appropriate balancing of the need to protect our national security while at the same time encouraging foreign direct investment. The informational requirements operate as a "gatekeeping" mechanism that deters investors who are unwilling to subject themselves to the deep scrutiny required by CFIUS. Similarly, the additional review requirements for foreign government-

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7 § 800.402(c)(6)(vi).

8 *Id.*

9 50 U.S.C. App. § 2170 (b)(2)(B)(i)(III).

10 50 U.S.C. App. § 2170 (b)(2)(D)(i).

11 *Id.*

controlled entities ensure that SOEs and SWFs receive appropriate scrutiny when they invest in the United States.
I urge the Commission not to recommend additional mandatory reviews for state-controlled entities. As I have noted, SOEs and SWFs are far from a monolithic group, and treating them as such penalizes responsible investors and contributes unnecessarily to the impression that the CFIUS process is arbitrary and unfair. It is worth recalling that foreign manufacturers — including from Japan, Germany, and China, among others — have created tens of thousands of U.S. manufacturing jobs without presenting appreciable national security threats. In the highly competitive mergers and acquisitions market, additional scrutiny and delay in CFIUS approval can be a crippling competitive disadvantage. To subject all state-controlled entities to such disadvantages diminishes the incentives for those foreign companies that have partial government ownership to be responsible and transparent in their management and ownership structures.

Instead, I believe that Congress and the administration should work with our allies and partners to promote good governance and improved transparency in state-controlled entities. Some significant efforts already are underway. The Organisation for Economic Cooperation and Development has published Guidelines on Corporate Governance of State-owned Enterprises, which lay out principles for how countries can more responsibly and transparently manage commercial enterprises in which they have a stake.[12] Similarly, the International Working Group of Sovereign Wealth Funds has established the "Sovereign Wealth Funds: Generally Accepted Principles and Practices," commonly known as the "Santiago Principles."[13] These efforts demonstrate that some SOEs and SWFs are committed to transparency and responsible investment. The United States should encourage such responsible corporate behavior by rewarding those companies that embrace transparency and good governance.

In sum, it is true that investment by state-controlled entities raises unique national security challenges. Our national security review system already recognizes this risk and includes substantial provisions to ensure that such investors are scrutinized appropriately. Additional categorical requirements would serve only to punish responsible investors and distract from more pressing security concerns. As with other areas, my experience leads me to conclude that CFIUS functions most effectively when it is afforded the flexibility to consider each case on its own merits without being constrained by categorical mandates or requirements.

State-owned Enterprises and Protection from Unfair Competition

As the Commission is well aware, the issues related to state-controlled enterprises are not limited to the implications for national security. Some SOEs receive substantial economic benefits from the state that threaten to distort markets and put American companies at an unfair disadvantage. But we are not powerless. The United States has a number of legal tools available to help promote a level playing field for U.S. businesses, including trade remedies and antitrust laws. I cannot say that these remedies are

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[12] Organisation for Economic Cooperation and Development, OECD Guidelines on Corporate Governance of State-owned Enterprises (2005), *available at* http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/34803211.pdf.

[13] International Working Group of Sovereign Wealth Funds, "Generally Accepted Principles and Practices (Oct. 2008), *available at* http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

perfect or sufficient to neutralize the benefits received by Chinese SOEs. But I am confident that these laws and institutions — not CFIUS — are the appropriate mechanism by which to address the potential economic edge of Chinese SOEs.

China's membership in the WTO provides the United States with a number of legal options to remedy the effects of subsidies and other benefits provided to Chinese SOEs. The Agreement on Subsidies and Countervailing Measures ("SCM Agreement") specifically prohibits export subsidies, *i.e.*, any subsidies that are provided on condition of export or local content.[14] Subsidies that are not contingent on export may be actionable, (*i.e.*, subject to countervailing duties or challenge through the WTO's dispute settlement mechanism) if they are "specific," (meaning they are provided to one industry, such as SOEs), provide a "benefit," and cause "serious prejudice."[15]

Of course, these trade obligations only benefit U.S. businesses if they are enforced. Last year President Obama created the Interagency Trade Enforcement Center, led by the U.S. Trade Representative, to coordinate efforts across agencies to better monitor and enforce the United States' trade rights around the world.[16] This is a step in the right direction, but more work is needed. I encourage the Commission to consider whether the administration, and in particular USTR, has sufficient resources to enforce existing our trade rights and to protect U.S. businesses.

Our antitrust laws, which provide remedies for such practices as price fixing and predatory pricing, provide another opportunity to protect against unfair competition. Earlier this year, a federal jury returned a verdict against two Chinese companies for conspiring to raise the price of vitamin C exported to the United States, marking the first time that Chinese companies have faced trial in the United States under U.S antitrust law.[17] The companies defended on the basis that they were merely adhering to government-mandated volume and pricing restrictions, an argument the jury clearly rejected. The Court entered judgment for treble damages in the amount of $162.3 million. Another avenue the Commission could investigate is whether the Department of Justice and the Federal Trade Commission can take additional steps to pursue enforcement actions against Chinese business that violate our antitrust laws.

I offer these examples not to say that our existing competition and trade regimes are sufficient to entirely protect our economic interests. I do, however, submit that the trade and antitrust regimes are the correct mechanisms for protecting U.S. businesses and promoting a level playing field.

CFIUS is an Inappropriate Mechanism for Economic Benefit Assessment

That leads to me to my second key point. The CFIUS framework is ill suited to evaluating the economic effects of a transaction, such as through a net benefit test like that required by the Investment Canada Act.

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[14] WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), art. 3.

[15] SCM Agreement, art. 2.

[16] See Press Release, The White House, "Executive Order -- Establishment of the Interagency Trade Enforcement Center" (Feb. 28, 2012).

[17] See In re: Vitamin C Antitrust Litigation (E.D.N.Y. 2012).

First, the principles underlying the net benefit test diverge significantly from the core purpose of CFIUS, which is to evaluate whether a transaction threatens to impair national security and take action, as necessary, to protect our security interests. The Committee's statutes, regulations, membership, policies, and procedures all revolve around this essential function. For this reason the Departments of Defense and Homeland Security are typically two of the most influential agencies in the Committee process. The professional CFIUS staff itself within the Department of the Treasury is relatively small and primarily serves a coordinating role. While highly sophisticated, I do not believe that this staff itself has the capacity to conduct the complex economic analysis that would be necessary to support a net benefit test.

Instead, we have entire departments and agencies full of talented economists, diplomats, and regulators whose mission is to promote a level playing field for U.S. businesses. They work for the Office of the U.S. Trade Representative, the Federal Trade Commission, the International Trade Commission, the Department of State, and the Department of Justice's Antitrust Division.

Second, CFIUS operates under an exceptionally rare amount of secrecy for a regulatory agency. All submissions are confidential and protected from public disclosure. The Committee's orders are not made public and it is not required to make any public report or explanation of its decision in any particular case. There is no opportunity for public hearing and, as was recently confirmed, the Committee's decisions are not subject to judicial review. This secrecy is essential to protect not only the national security interests of the United States, but also the highly sensitive personal and business information that is submitted to the Committee. I submit that such lack of transparency is inappropriate to the conduct of an economic benefit test and would risk devolving into unprincipled protectionism — or, at a minimum, would be perceived as such. If we are to have a mechanism to review the economic benefits of transactions, it should be transparent and subject to public scrutiny.

Finally, Canada's experience also cautions against adoption of a net benefit test. Although some support the idea of a net benefit test in principle, nearly every Canadian political party seems to agree that they do not care for it in practice, albeit for different reasons. Opponents criticize the test as unnecessary, inconsistent with free trade and investment, and lacking in intelligible standards. Supporters, on the other hand, lament that the power to block transactions has been used only twice. Recently, the Canadian government has increased the threshold amount to qualify a transaction for review under the test to $1 billion, from $330 million, reflecting in part the reality that the measure has been controversial and difficult to apply in practice.

The Interrelation of National Security and Foreign Investment

The final point I wish to make concerns the interrelation of foreign investment and national security. Some of the policy proposals I hear considered seem to assume that national security and foreign investment are zero sum calculations; that is, an increase in foreign investment necessarily leads to a correlative decline in our national security. This simply is not the case. We need not sacrifice valuable investment to protect our security interests, nor must we risk our national security in order to welcome investment. Both are worthy ends that can and should be pursued simultaneously and with equal vigor.

Our nation has a longstanding policy of openness to foreign investment. In May 2007, President George W. Bush issued a statement on the United States' openness toward foreign investment, called a statement on “Open Economies.”[18] In the wake of the Dubai Ports World controversy, the Bush Administration sought to reassure the world that the United States remained open to foreign direct investment. Similar policy statements were made by Presidents Carter, Reagan, and George H.W. Bush.[19] And in 2011, President Obama released a statement on the “United States Commitment to Open Investment Policy” that “reaffirms our open investment policy, a commitment to treat all investors in a fair and equitable manner under the law.”[20]

There is good reason for this rare, longstanding, bi-partisan consensus. Clear and convincing evidence shows that foreign direct investment contributes to a stronger manufacturing base, creates higher paying jobs, promotes investment in domestic research and development, and generates greater tax revenue. The White House Council of Economic Advisors has reported that U.S. affiliates of foreign companies in 2008 produced $670 billion in goods and services, 42 percent of which is concentrated in the manufacturing sector, and employed 5.7 million U.S. workers, or about five percent of the U.S. private workforce.[21]

The United States traditionally has been the world’s premier investment location, with twice as much foreign direct investment comes here as compared to second-ranked China in 2011. But our share of global foreign direct investment has dropped rapidly, from 37 percent in 2000 to 17 percent in 2011, due in large part to companies’ shifting capital to fast-growing developing countries like China.[21] These figures should be a caution to those considering additional requirements on foreign investors.

With the increasingly competitive market for foreign direct investment in mind, I want to address in particular the idea of applying reciprocity requirements to our trade and investment laws. Such a policy would, in effect, require that the United States deny the right to invest in the United States to countries that do not extend the same rights to U.S. companies. This argument fundamentally misapprehends the nature of foreign investment. Foreign direct investment benefits the United States regardless of whether U.S. companies are extended equivalent access to foreign markets.

This does not mean that we should not advocate vigorously and aggressively to open markets overseas to investment by U.S. businesses. We should. But to make approval for foreign investment contingent on reciprocity would unnecessarily deny the United States the benefits of foreign investment and risk additional tightening of international investment regimes. We should keep in mind that our national security review process is itself more restrictive than its counterparts in many of our most important

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[18] Press Release, The White House, President Bush’s Statement on Open Economies (May 10, 2007), *available at* http://2001-2009.state.gov/e/eeb/rls/prsrl/2007/84660.htm.

[19] James Jackson, “Foreign direct investment: current issues,” Congressional Research Service Report to Congress, April 27, 2007, at 6-7 (internal citation omitted).

[20] Press Release, The White House, Statement by the President on United States Commitment to Open Investment Policy (June 20, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/06/20/statement-president-united-states-commitment-open-investment-policy.

[21] Executive Office of the President, Council of Economic Advisors, “U.S. Inbound Foreign Direct Investment” (June 2011), *available at* http://www.whitehouse.gov/sites/default/files/microsites/cea_fdi_report.pdf.

[21] Organization for International Investment, Foreign Direct Investment in the United States: 2012 Preliminary Data (Mar. 20, 2013), *available at* http://www.ofii.org/docs/FDIUS_2012_Annual_Data.pdf.

trading partners and closest allies, some of whom have no formal process for evaluating the national security risk of foreign investment. Requiring reciprocity in our laws and policies — even if limited to China — I believe would risk subjecting U.S. businesses to similar requirements when they invest abroad.

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Encouraging foreign investment, protecting our national security, and ensuring a level playing field for U.S. businesses are all worthy and important policy goals. Fortunately, they also are goals that can be pursued simultaneously. I would encourage the Commission to resist the temptation to recommend additional statutory mandates for our national security review process. It is the flexibility to review each transaction on a case-by-case basis that makes CFIUS effective. Instead, I encourage the Commission to consider how it can help empower CFIUS and our other institutions through additional resources.

Thank you again for the opportunity to address the Commission. I would be happy to take your questions.

OPENING STATEMENT OF DEAN G. POPPS
FORMER ACTING ASSISTANT SECRETARY OF THE ARMY
ACQUISITION, LOGISTICS AND TECHNOLOGY

MR. POPPS: Good morning, and thank you. Thank you for the opportunity to appear here. I'm glad to be with many familiar faces in the room, and I'm somewhat struck by the irony that 41 years ago I started out as a doorman on the House gallery door, about 15 feet behind where you stand, and when I left in 19--

HEARING CO-CHAIR WORTZEL: Is that when she started as a staffer?

[Laughter.]

MR. POPPS: She was already Chief of Staff by that time. I was there during the Watergate years, '71 to '74, and it was quite an exciting time to be on the floor of the House, and I was telling some of you earlier that I was present when Jerry Ford was elected by the House of Representatives as Vice President, and I grabbed the resolution that was in the well of the House, grabbed it, ran it to him, and had him sign it. That was his first signature as Vice President of the United States.

I then ran after him down in the second floor as he went back to his office, and I said you're going to be the next President of the United States, and he had a pipe stuck in his mouth, and he said leave me alone, I don't want to start that, don't start that stuff.

[Laughter.]

MR. POPPS: So sharing some of these thoughts with many people out here today brought back a lot of memories, and I'm sure my late father never thought that I would go as far as coming up the hallway into a room to testify.

Some context on who I am, what I'm doing here. I sort of feel like the red-headed stepchild here today, but I'm glad to be here. I enjoy a challenge. I like to mix it up. I have submitted to you, co-chairmen, my testimony, my written testimony, along with two slides, and I ask that be accepted into the record, and that you give me permission after this if there is anything you wish enhanced or further materials, I'd like permission to provide those to the staff and to the Commission, and thank you for that permission.

As the Army Acquisition Executive and a political appointee of a workforce of close to 45,000 during 12 years of war, I had a really unique insight into how the Pentagon goes to war and how it procures goods and services, how it develops weapon systems and other equipment, and then takes that equipment, fields it, uses it, and then sustains it, and then demilitarizes it eventually.

So we've learned a lot of lessons over ten years of war, and I think some of those things may be relevant to the greater discussion about China and policies.

Following that assignment, and I stayed at the request of Dr. Gates until my successor was confirmed. I stayed beyond the normal hundred days because Dr. Gates wanted to have everybody in the acquisition communities in place until replacements got there. The potential for scandal was too great.

Following my retirement in 2010, a little while after, I took a long trip to China. I came back and became involved in a commission, founding a commission, a very small commission, almost on a volunteer basis, called the Strategic Materials Advisory Council, and what we got a burr under our saddles about was that we kept looking, those of us in the procurement community, at the strategic stockpiles of this country, and really looking and saying there's been a complete disintegration of strategic stockpiles over the last 20 years.

Don't quote me, but going back into the early '90s, we had some 99 warehouses with strategic materials and eight to ten to $12 billion worth of strategic materials. Today we have, I believe, less than two, and it's not clear who owns them, whether it's DLA, Defense Logistics Agency, or OSD, and now that we've become, "globalized," we don't have this strategic stockpile.

That alarmed me very much, simply because of the world that I lived in, the acquisition world of cost, performance, and schedules. As we started to debate those issues and do what we do as a small volunteer council, we were almost immediately thrown into, and this is probably why I think I resulted in being here today, the controversy over the sale of A123 Battery Systems of Elgin, Illinois, a company which had received many millions of dollars in green funds from this administration, quickly went into bankruptcy following that in a matter of months, and was at bankruptcy sale in Federal Bankruptcy Court in Delaware, in which there were several bidders. The high bidder eventually emerged as the Wanxiang Corporation from Shanghai, China, a very large group, both here and there, with significant ties to the government and significant ties to the People's Republic Army and to the Communist Party.

This took to the airwaves. Lou Dobbs called me. We had a vigorous debate during the month of January during a 45-day period. Mr. Plotkin, I don't know, you may have been involved in representing Wanxiang. All right. So I'm sitting next to, you know--

HEARING CO-CHAIR BARTHOLOMEW: Shall we separate you now?

[Laughter.]

MR. POPPS: --the lawyer for Wanxiang arguing the CFIUS case. Our point was, and still remains, that the CFIUS case is pretty weak. CFIUS is a law, it was enacted in the 1970’s, that is not well understood or implemented by the various agencies.

I certainly can tell you that my experience with CFIUS cases in the Department of the Army, and I had responsibility for those, was pretty superficial and mostly driven by political processes or desires for trade or investment and really not a full examination of the national security issues, it’s basically a box-checking exercise. I do happen to know because of my pals in my network that Army, for instance, non-concurred in the sale of this company to Wanxiang, but that was not a vote that carried the day because there had to be a Navy vote and an Air Force vote and a final DoD vote, probably controlled by the Secretary or

Deputy Secretary himself, and that's how the whole thing went down.

Our objection about this purchase was that our best research, especially from the Jet Propulsion Laboratory and other National Labs, was that these lithium-ion phosphate batteries really gave--and the kind of research, development and production and implementation that A123 Battery Systems was capable of--really gave the United States about an eight-to-ten year advantage over any adversary.

And these lithium-ion batteries are batteries that fit in military satellites and in advanced combat vehicles. They fit in all kinds of places, in avionics. They fit in submarines, any place where there needs to be a renewable stored energy source. So we really had something there that was way ahead of itself and something that gives us the advantage of what we do at the Pentagon.

Let me pause and bring the Pentagon in. What's my job and what's been the job of other people at the Pentagon? We are the force generating and we are also the equipment and training generating for the combatant commander. That's how we've been organized since Goldwater-Nichols. The combatant commander says I have a mission, you've given me a mission, and I need. All right. And that's what the whole building does, come up behind that combatant commander, just as we have with CENTCOM and with many other combatant commanders, including now more emphasis towards PACOM, and we provide the what-you-need.

And so it really has been the policy before me, during me, and after me at the Pentagon that our job is to provide the kind of equipment and the kind of technology and the kind of resources that never allow a soldier, sailor, airman, Marine to be in a fair fight, but to be absolutely in a dominant position. And the theme we always had was "see first and kill first." So that was our position, and that's our approach to our industrial base.

We live in a world--a couple more thoughts, and again I'm just summarizing my other testimony--we live in a world of cost and performance and schedule. That's the world that I live in. I need to be able to know what my costs are. I need to know that they're tied down. I have to make sure that that program runs on time and on schedule to get to the warfighter, and I have to make sure that it's performing according to the tested standards, pass safety standards, and can become a legacy weapon such as the Abrams or Bradley or any of the other legacy systems we have, B-52, Apache helicopters, all of the things that have become renown legacy weapon systems.

To do cost, performance and schedule, it seems to me it's self-evident that you need control of your supply chain and you need control of critical materials and critical stockpiles. That you cannot have a narrative spun as it's being spun now by the Pentagon's defense-industrial base Deputy Assistant Secretary, and this administration, that, well, it goes a little bit like this, we live in a global economy, and when we need it, we can just get it because there's a lot of providers, and I'm just sort of telling you in my world of cost, performance, schedule that really does not work.

HEARING CO-CHAIR BARTHOLOMEW: Okay. Mr. Popps, I hate to interrupt you, but we're going to have to ask you to just quickly summarize the rest of it.

MR. POPPS: I'll summarize. All right. I'd like to disagree a bit with Mr. Plotkin. I say I think CFIUS needs a redoing top to bottom. What keeps me up at night is simply this: with regard to what we need to provide combatant commanders, you can sell the hay, you can sell the land, then you can sell the barn, and you can sell the cow, and then you wake up one morning wondering why you don't have milk or why it's ten times more expensive or why you have to wait in line for it.

So I really think that there is a huge disconnect, ma'am, at the very top of government to not take these very simple, self-evident facts and connect them into a greater strategy and come up with a policy that protects exactly what I've outlined.

PREPARED STATEMENT OF DEAN G. POPPS
FORMER ACTING ASSISTANT SECRETARY OF THE ARMY
ACQUISITION, LOGISTICS AND TECHNOLOGY

U.S.-China Commission Hearing on Chinese Investment in the U.S.
May 9, 2013
Testimony before the U.S.-China Economic and Security Review Committee
Submitted by
Dean G. Popps
Former Army Acquisition Executive,
Former Acting Assistant Secretary of Defense for Acquisition, Logistics & Technology, and
Former Director of Iraq Reconstruction and Program Management

Distinguished members of the Commission, it is a high honor and privilege to appear before you today to share my thoughts on the trends and implications of Chinese investment in the United States with regard to my particular area of defense expertise, namely, defense acquisition. My testimony reflects nearly 8 years of experience, from 2003 through 2010, both at the Pentagon and in the theaters of war in Iraq and Afghanistan, from both the standpoints of procurement of major systems within the Department of Defense and the Department of the Army programs of record, as well as contingency wartime procurement of weapons, goods, services and reconstruction and nation building infrastructure programs in non-permissive environments. It also reflects my post-government experience. In all instances, my testimony reflects my own opinions and not necessarily the organizations or businesses with whom I am affiliated.

My bottom line up front is that China's aggressive, unfettered pursuit and transfer of manufacturing capabilities, raw materials, key technologies and intellectual property, equity investment in, or acquisition of, US companies exposes our defense industrial base to unacceptable risk. The processes by which top policymakers assess this risk, including the CFIUS process, have been relatively ineffective at safeguarding important strategic assets, including critical defense contractors and subcontractors.

My testimony is not based on a pro- or anti-China position. China is a major power and must be accorded that status and attention. My concerns and my desire to testify today center on our US needs for independent defense strengths and capabilities in our supply chain.

Meanwhile, Chinese governmental and non-governmental entities are perusing our defense industrial base from multiple directions. Individual business transactions, on their face and taken separately, appear innocuous. Yet, taken as a whole, they seem to indicate that Chinese firms (with the support and cooperation of their own government and with Communist Party ties) will own game-changing capabilities at every step of the supply chain.

Thus, with US foreign interests almost entirely focused on the Middle East, the entire US defense industrial base and supply chain has become critically at risk to our loss of control and options.

To win conflicts and wars, to project American power and exceptionalism, to support our NATO, Middle East, and Asian allies and coalition partners, and to protect American interests abroad, we must own and control our critical defense and national security supply lines and industries. In recent years, the Department of Defense and White House policy makers seem to have fallen into a false argument that, because we now live in an era of globalization, the US can persistently rely on the amorphous "global community" to supply us with critical materiel and technologies when and if we need them, at prices we are willing to pay, and within the timeframes (or "surge" needs) that we require.

My observations about our own system are that all government procurement rests on the basic principles of cost, performance (of the program if developed from scratch), and schedule. To meet these principles our military-industrial complex relies heavily on government organic capabilities in its labs and depots and on the capabilities of a US contractor industrial base on which we have relied even more heavily after 1974, when we became an all-volunteer, non-conscripted, and much smaller and capable military.

Today's battle space, for our nation, has three players: (1) The warfighter, (2) the expeditionary civil servant, and (3) the expeditionary contractor. All three are highly integrated into the mission and all three run nearly the same risks of casualties, particularly when forward based. All three rely completely on the strength of our supply chain and our commitment to an industrial policy and its ability to surge for war, which requires maintaining expertise and stockpiles in times of peace.

Some of my observations during my government tenure that reflect on today's hearings and affect our outcomes are:

- Our reliance on large system integrators and larger and larger prime contractors in an era of globalization in which our government may or may not have the expertise to understand and analyze and assess the risk factors in the subcontractor base, including reliance on Chinese influence, real or oblique.
- Our organizational inability to have visibility into the second and third tiers of sub-contractors on our major and lesser defense acquisition programs from the standpoint of corporate origins and legal structures to the authenticity of materials, goods and services.
- Our alarming vulnerabilities along the supply chain for strategic and critical materials. From FY1992 through FY2006, The US has sold $6.1B of $7.2B worth of strategic materials since 1992 (an 85% reduction) from its stockpiles and the number of warehouses went from 99 to 3.
- The loss of defense programs, technologies and intellectual property either by cyber theft, theft of trade secrets, legitimate mergers and acquisitions, and subsequent transfer of entire companies to, primarily, China, and the resulting impairment to our supply chain and in turn our national security.

Following my retirement in April of 2010, I became involved in the founding of the Strategic Materials Advisory Council (SMAC). The Council conducts grassroots advocacy campaigns to promote the reliable, long-term supply of strategic and critical materials and associated technologies. The Council is committed to equitable international trade for U.S. companies and those of allied nations, while ensuring a secure and reliable industrial and technology base for U.S. national security. I am pleased that many outstanding defense and science professionals have joined the Council in this effort.

The Council's clear objective is to respond to threats to the U.S. industrial base and the critical materials supply chain and associated technologies. The mission is to ensure a reliable, long-term supply of strategic and critical materials and the technologies associated with them to support American economic and national security interests through the adoption of U.S. government policies and industry initiatives that promote domestic and allied nation production, research, recycling and workforce development. This will be achieved by supporting development of domestic resources and promoting cooperation with key allied nations. The Council provides advice and counsel to industry, government, and other stakeholders.

In the last six months, I would offer a major example of our US government's "not seeing the forest for the trees" and of its having a "head in the sand and not connecting the dots" approach to foreign acquisitions of U.S. technologies.

A123 Systems – a U.S.-based manufacturer of advanced lithium-ion batteries that was awarded nearly $250 million in U.S. taxpayer-funded stimulus grants – provides critical electrical storage for various applications, including civilian and military vehicles and satellites, renewable energy sources involving key US infrastructure, and other deployable power systems. The company entered into numerous research and development contracts with the Department of Defense and but was allowed to be sold at bankruptcy to a major Chinese company with significant ties to the Chinese Communist Party.

The U.S., through its ineffective and flawed CFIUS process, compromised our nation's intellectual property and manufacturing capabilities by allowing this sale. This occurred despite strong congressional inquiry and "non-concurs" from key agencies, including the U.S. Army.

As the Strategic Materials Advisory Council noted:

> "For over thirty years, China has pursued an overt economic strategy of acquiring both natural resources and promising technologies. This strategy creates Chinese dominance of entire supply chains for selected materials and related technologies. Allowing Wanxiang to acquire A123 Systems would continue this trend and make the U.S. dependent on an unreliable foreign source for yet another critical defense component. For example, China has a near monopoly of rare earth production that allows it to manipulate the supply for a range of defense and renewable energy products, including nickel-metal hydride battery production. The U.S. must not allow China to acquire a similar position with A123's lithium-ion battery technology and dominate its supply chain as well."

The Committee on Foreign Investment in the Unites States ("CFIUS") failed to apply common sense to the A123 transaction and focused on economic and business investment advantages instead of adequately evaluating national security risks.

My concerns about the CFIUS process are based on two issue sets: (1) the unreliability of certain foreign firms and (2) the strength (or weakness) of U.S. industry. As an example and to answer the "free trade economists," one must acknowledge that, though it has a voracious economy, China is not a free trade state. Trade with China is different. The Chinese government – and military – support and often own Chinese industries. We should not be fooled by the duality that, to the West, Chinese firms present themselves as capitalist free trade entities. Through previously well investigated activities, such as notable, well-publicized cyber-attacks and the ensuing reports (see the Mandiant Report) we must recognize that the Chinese business sector and the state are one in strategy and policy, if appearing tactically to be different.

In all wars, our nation's qualitative military edge came about because of our supply chain strength. Military advantage relies on the US industrial base. We are experiencing an unacceptable erosion of that qualitative edge through the factors listed about and many other factors that have come to the attention of the Commission.

Members of the Commission, I appreciate the opportunity to appear briefly before you today to further this national conversation and am happy to take your questions.

Exhibit 1: Elements of Chinese Industrial Strategy

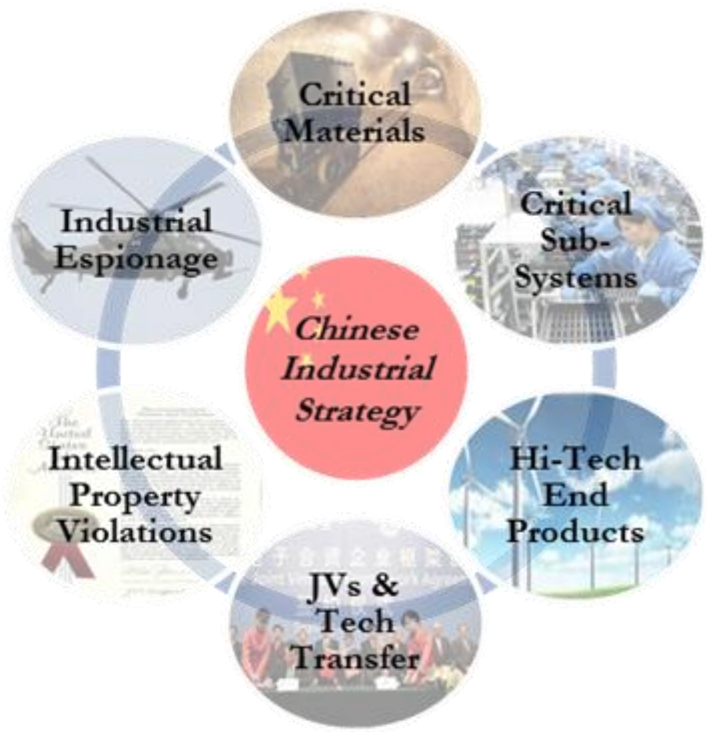

Exhibit 2: Nonfuel Mineral Resource Dependence

2000 U.S. NET IMPORT RELIANCE FOR SELECTED NONFUEL MINERAL MATERIALS

Commodity	Percent	Major Sources (1996-99) [1]
ARSENIC TRIOXIDE	100	China, Chile, Mexico
ASBESTOS	100	Canada
BAUXITE and ALUMINA	100	Australia, Guinea, Jamaica, Brazil
COLUMBIUM (niobium)	100	Brazil, Canada, Germany, Russia
FLUORSPAR	100	China, South Africa, Mexico
GRAPHITE (natural)	100	China, Mexico, Canada
MANGANESE	100	South Africa, Gabon, Australia, France
MICA, sheet (natural)	100	India, Belgium, Germany, China
QUARTZ CRYSTAL	100	Brazil, Germany, Madagascar
STRONTIUM	100	Mexico, Germany
THALLIUM	100	Belgium, Canada, Germany, United Kingdom
THORIUM	100	France
YTTRIUM	100	China, Hong Kong, France, United Kingdom
GEMSTONES	99	Israel, India, Belgium
BISMUTH	95	Belgium, Mexico, United Kingdom, China
ANTIMONY	94	China, Mexico, South Africa, Bolivia
TIN	86	China, Brazil, Peru, Bolivia
PLATINUM	83	South Africa, United Kingdom, Russia, Germany
STONE (dimension)	80	Italy, Canada, Spain, India
TANTALUM	80	Australia, China, Thailand, Japan
CHROMIUM	78	South Africa, Kazakhstan, Russia, Zimbabwe
TITANIUM CONCENTRATES	76	South Africa, Australia, Canada, India
COBALT	74	Norway, Finland, Zambia, Canada
RARE EARTHS	72	China, France, Japan, United Kingdom
BARITE	71	China, India, Mexico, Morocco
POTASH	70	Canada, Russia, Belarus
IODINE	69	Chile, Japan, Russia
TUNGSTEN	68	China, Russia, Bolivia
TITANIUM (sponge)	62	Russia, Japan, Kazakhstan, China
ZINC	60	Canada, Mexico, Peru
NICKEL	58	Canada, Norway, Russia, Australia
PEAT	52	Canada
SILVER	52	Canada, Mexico, Peru
SILICON	48	Norway, South Africa, Russia, Canada
DIAMOND (dust, grit, and powder)	47	Ireland, China, Russia
MAGNESIUM COMPOUNDS	45	China, Canada, Austria, Australia
MAGNESIUM METAL	40	Canada, Russia, China, Israel
COPPER	37	Canada, Chile, Mexico
BERYLLIUM	35	Russia, Canada, Kazakhstan, Germany
ALUMINUM	33	Canada, Russia, Venezuela, Mexico
PUMICE	33	Greece, Turkey, Ecuador, Italy
LEAD	24	Canada, Mexico, Peru, Australia
GYPSUM	22	Canada, Mexico, Spain
SULFUR	22	Canada, Mexico, Venezuela
NITROGEN (fixed), AMMONIA	21	Trinidad and Tobago, Canada, Mexico, Venezuela
CEMENT	20	Canada, China, Spain, Venezuela
IRON ORE	19	Canada, Brazil, Venezuela, Australia
IRON and STEEL	17	European, Union, Canada, Japan, Mexico
MICA, scrap and flake (natural)	17	Canada, India, Finland, Japan
PERLITE	15	Greece
SALT	15	Canada, Chile, Mexico, The Bahamas
TALC	12	China, Canada, France, Japan
CADMIUM	6	Canada, Belgium, Australia
PHOSPHATE ROCK	1	Morocco

[1] In descending order of import share

Additional mineral commodities for which there is some import dependency include:

Gallium	France, Russia, Kazakhstan, Canada	Rhenium	Chile, Germany, Kazakhstan, Russia
Germanium	Russia, Belgium, China, United Kingdom	Selenium	Philippines, Canada, Belgium, Japan
Indium	Canada, China, Russia, France	Vanadium	South Africa, China
Mercury	Canada, United Kingdom, Kyrgyzstan, Spain	Vermiculite	South Africa, China
		Zirconium	South Africa, Australia

2011 U.S. NET IMPORT RELIANCE FOR SELECTED NONFUEL MINERAL MATERIALS

Commodity	Percent	Major Import Sources (2007–10)[1]
ARSENIC (trioxide)	100	Morocco, China, Belgium
ASBESTOS	100	Canada, Zimbabwe
BAUXITE and ALUMINA	100	Jamaica, Brazil, Guinea, Australia
CESIUM	100	Canada
FLUORSPAR	100	Mexico, China, South Africa, Mongolia
GRAPHITE (natural)	100	China, Mexico, Canada, Brazil
INDIUM	100	China, Canada, Japan, Belgium
MANGANESE	100	South Africa, Gabon, China, Australia
MICA, sheet (natural)	100	China, Brazil, Belgium, India
NIOBIUM (columbium)	100	Brazil, Canada, Germany, Russia
QUARTZ CRYSTAL (industrial)	100	China, Japan, Russia
RARE EARTHS	100	China, France, Estonia, Japan
RUBIDIUM	100	Canada
SCANDIUM	100	China
STRONTIUM	100	Mexico, Germany
TANTALUM	100	China, Germany, Kazakhstan, Australia
THALLIUM	100	Russia, Germany, Kazakhstan
THORIUM	100	France, India, Canada, United Kingdom
YTTRIUM	100	China, Japan, France, United Kingdom
GALLIUM	99	Germany, Canada, United Kingdom, China
IODINE	99	Chile, Japan
GEMSTONES	98	Israel, India, Belgium, South Africa
GERMANIUM	90	China, Belgium, Russia, Germany
BISMUTH	89	China, Belgium, United Kingdom,
DIAMOND (dust, grit and powder)	89	China, Ireland, Republic of Korea, Russia
PLATINUM	88	Germany, South Africa, United Kingdom, Canada
ANTIMONY	87	China, Mexico, Belgium
RHENIUM	87	Chile, Netherlands, Germany
STONE (dimension)	85	Brazil, China, Italy, Turkey
POTASH	83	Canada, Belarus, Russia
VANADIUM	80	Rep. of Korea, Canada, Austria, Czech Republic
BARITE	78	China, India
SILICON CARBIDE	76	China, Brazil, Vietnam, Norway
TIN	76	Peru, Bolivia, Indonesia, China
COBALT	75	China, Norway, Russia, Canada
SILVER	75	Mexico, Canada, Peru, Chile
ZINC	73	Canada, Peru, Mexico, Ireland
TITANIUM (sponge)	69	Kazakhstan, Japan, China, Russia
TITANIUM MINERAL CONCENTRATES	68	South Africa, Australia, Canada, Mozambique
PEAT	63	Canada
CHROMIUM	60	South Africa, Kazakhstan, Russia, China
PALLADIUM	56	Russia, South Africa, United Kingdom, Norway
MAGNESIUM COMPOUNDS	53	China, Canada, Brazil, Austria
NICKEL	47	Canada, Russia, Australia, Norway
SILICON (ferrosilicon)	42	China, Russia, Venezuela, Canada
NITROGEN (fixed), AMMONIA	41	Trinidad and Tobago, Russia, Canada, Ukraine
GARNET (industrial)	39	India, Australia, China, Canada
GOLD	36	Mexico, Canada, Colombia, Peru
TUNGSTEN	36	China, Bolivia, Canada, Germany
COPPER	35	Chile, Canada, Peru, Mexico
MAGNESIUM METAL	35	Israel, Canada, China
PERLITE	27	Greece
SULFUR	24	Canada, Mexico, Venezuela
SALT	22	Canada, Chile, Mexico, The Bahamas
BERYLLIUM	21	Russia, Kazakhstan, Japan, Russia
MICA, scrap and flake (natural)	20	Canada, China, India
VERMICULITE	20	China, South Africa, Australia, Brazil
ALUMINUM	13	Canada, Russia, China, Mexico
GYPSUM	13	Canada, Mexico, Spain
PHOSPHATE ROCK	13	Morocco, Peru
IRON and STEEL	9	Canada, European Union, China, Mexico
IRON and STEEL SLAG	8	Japan, Canada, South Africa, Italy
CEMENT	6	Canada, China, Republic of Korea, Mexico
PUMICE	5	Greece, Mexico, Iceland, Montserrat
DIAMOND (natural industrial stone)	3	Botswana, South Africa, Russia, Namibia
LIME	1	Canada, Mexico
STONE (crushed)	1	Canada, Mexico, The Bahamas

[1] In descending order of import share.

PANEL II QUESTION & ANSWER

HEARING CO-CHAIR BARTHOLOMEW: Thank you, so we're going to move into questions starting with my co-chair, Dr. Wortzel.

HEARING CO-CHAIR WORTZEL: Thank you all for your time and your submission.

I have a question for Mr. Plotkin and a question for Mr. Popps. Mr. Plotkin, on CFIUS, my impression is that companies may seek review, but the rules and ways that individuals and other government agencies may seek review are kind of opaque, and if that perception is correct, can you suggest changes to the process that would make it more transparent and coherent and where the American public could be assured that these reviews are taking place?

For Mr. Popps, if you had to pick a few specific technology areas, what do you think are the most critical ones to defense?

MR. PLOTKIN: Thank you, Commissioner. I agree that CFIUS is very much an opaque and black box process for everybody, including for the lawyers who practice before CFIUS; it's a challenge and it can be frustrating at times.

As you know, CFIUS today will not even acknowledge that it is reviewing a transaction if asked. I do think that it is important for the public to know that CFIUS is reviewing transactions. I think that it would inspire a lot of confidence in the process and give people a sense of comfort that these transactions are being reviewed; they are reviewed very, very closely in a very changed CFIUS environment from what CFIUS once was.

I personally would be supportive of CFIUS being more transparent in indicating that it has reviewed particular transactions or that it is in the process of reviewing particular transactions. I think that's information that can certainly be provided to the Congress in a more transparent way than is the case today.

And I candidly think that the regulations of CFIUS could be enhanced to provide more information to foreign investors as to what kinds of issues CFIUS takes into account when CFIUS is reviewing a transaction. You get into a CFIUS review, and if you do enough CFIUS reviews, you can anticipate the likely kinds of issues and concerns that CFIUS is going to have.

We spend a lot of time, as does the Treasury Department, going to other countries and trying to explain the kinds of concerns and issues that CFIUS has. I do think that CFIUS could probably do more to publicize the kinds of issues and concerns that are on its plate, and that would alert companies and the public to the fact that these issues are being considered.

HEARING CO-CHAIR WORTZEL: And it's an adversarial process; isn't it? So different government agencies may take different positions?

MR. PLOTKIN: Yes. I think CFIUS would characterize it as a consensual process, which is in many respects adversarial. The net benefit for national security is that because it is a consensual process, any one agency can ultimately veto an approval, and so you can convince all of the member agencies that a transaction makes sense and doesn't present a risk to national security, but at the very last minute, one agency can come in and decide that it's going to be a problem.

In that sense, I think it would be good for the public to know that CFIUS operates that way, and that there is not a single agency or a pro-investment philosophy that is carrying the day within the CFIUS process.

HEARING CO-CHAIR WORTZEL: Thank you.

Mr. Popps, specific technology areas?

MR. POPPS: Yes, Doctor, thank you.

I think that technologies that relate to renewable energies, just like batteries, fuel cells and things, are so critical because that's really going to reflect into the 22nd century. I think that any technologies related to cyber security and IT, particularly the semiconductor industry. It is so critical that we not allow that to escape the secure supply chain that we need. Hard materials, rare earths and other things, that are needed for avionics, and even simpler things that are needed, magnets, that are needed for precision munitions and for guided missiles, are all types of things that need to be protected.

Our satellite capabilities, one of the things that I note with interest, we no longer have any commercial ability to launch satellites. When we want to launch commercial satellites, we have to go to foreigners, either to Baikonur in Kazakhstan, or Arianespace with the French, or we go to China, and now China is trying to talk to us about hosted payloads.

So, in effect, what does that mean? It means that the government rather than buying service from a particular satellite would take its sensor suites, all of its processing, and put it up onto a payload with China, and this is the discussion that's going forward. And I'm saying wow, there is nobody participating and talking about the relative merits or demerits.

Anything in aviation, Doctor, with regard to, like I said, avionics, composites, blade technology, all of that stuff, has to remain in the United States or we run the risk of not getting it. And when is the worst time? It's when we need the surge. I don't have to remind you great patriots that I took note, and I think no one else did, that yesterday was V-E Day, Victory in Europe, and a reminder that 280,000 U.S. soldiers lost their lives in that war.

In the end, how did we win? We won because we were able to surge from our defense-industrial base both in the Atlantic and Pacific, and I think this is what I said keeps me up at night. We are losing that capability to control our supply chain, to be assured of the integrity of that supply chain, meaning that there is not counterfeit stuff in it, there's not defective stuff.

We are losing control of the shipping lanes. Even if we were to rely on those, nine of the ten largest ports in the world are Asian. So we've lost control of that. And that can only go into a bad conclusion.

I would want to say something to Mr. Plotkin, and not to provoke him, but I don't think that CFIUS ever saw a deal it didn't like because if you go back over the 30 or 40 year history, I think other than Dubai Ports, there's never been a no, and while these mitigation strategies are put in place by lawyers and law firms, I often find them lacking.

With regard to A123, supposedly the R&D government part was carved out to a brand new or new company that was going to handle all that. Look, with cross-licensing agreements and all the things that occur here, I think it would be a stretch not to assume that the Chinese purchasers could not or would not get their hands on that technology as well.

Thank you.

HEARING CO-CHAIR BARTHOLOMEW: Thank you.

Commissioner Wessel.

COMMISSIONER WESSEL: Thank you. Thank you, all, for being here, and I assume, Mr. Popps, we can probably talk at great length about Evy and some others from the past, but we'll do that on our private time.

[Laughter.]

COMMISSIONER WESSEL: You know who I'm talking about.

MR. POPPS: You caught me.

[Laughter.]

COMMISSIONER WESSEL: I have a lot of questions. Mr. Popps, sitting on the government side of the table, and you sat on the government side of the table as well for so long, I have to tell you that CFIUS is also a black box for many of us.

Mr. Plotkin, you used the term "consensual," and as a lawyer, consensus is still a term of art that is defined occasion by occasion unfortunately.

When we looked at several CFIUS transactions and then tried several years later to have an assessment of whether the terms of the agreement were lived up to, I think we came up really wanting. So a transaction may occur, and then several years later, we find that the resources to assess whether there's been leakage, whether the terms have fully been complied with, have left us really wanting. Magnequench, I think, is a great example.

I think there are examples with a number of transactions that have come in the last couple of years.

Mr. Popps, to the consensus issue and your comment about the Army, it appears this administration wants to have an open-arms policy as it relates to foreign investment.

MR. POPPS: Yes, yes.

COMMISSIONER WESSEL: And I detect that that is having an impact on the CFIUS participants. Can you respond to that and let us know how consensus can be developed and how individual or White House approaches may help drive the process?

MR. POPPS: Well, thank you, and I'm really stepping out here.

I mean I served in a political appointee world, and we all know that in this town, we have, especially at the Pentagon, four sets of players. We have the appointees, and then we have the careerists, and then we have the people in uniform, and then we have the ever-present government contractors, and what I really found in this last instance, even though I was not there but sort of monitoring it with my abilities to go back into the system and find out what was going on, is that this was an extremely politically-driven process.

You know, the President and that team wanted to get this done. Wanxiang is a very big and powerful player with huge connections to the Communist Party. If I'm not mistaken, their chairman is the number four guy in the Communist Party over there. There were significant ties to the Illinois delegation and to Chicago.

Four days before the CFIUS decision was to be rendered, I think on January 30th, two former White House Chiefs of Staff from Chicago traveled to Beijing. So I can only assume, or at least one had a representative for the purpose of seeking investment in Chicago in distressed real estate or posturing Chicago as a place for Chinese investment.

So it seemed to me that if you have two former White House Chiefs of Staff on a mission to get China to invest in Chicago, how contradictory is it to then tell them that they don't believe that they want them to invest in a company in Elgin, Illinois? Very contradictory.

So as I said, I believe Army scientists and Army operators at the level and the program level that I used to work at, to include those at Aberdeen Proving Ground and those within the Pentagon, objected to the A123 Battery situation, but, again, those decisions can then be overruled because at the end of the day, with the 15 or 18 person process, there is one person who gives the vote for the Department of Defense, and my guess is it's the Deputy Secretary of Defense.

And, again, that's a political process. That's an administration appointee. So I think that's the inherent problem. We don't know enough. Talk about follow-up. Where is the study that follows up on all these promises? And this would be good to follow A123 the same way-- well, you promised to create all these jobs. That was part of the reason congressional delegations were beating up on everything. I want to see in three or four years if those jobs haven't been moved to China, and then what's really left in Elgin, Illinois?

I also think a very minute point here in the law, but it might be interesting to get someone familiar with bankruptcy law to ask why the government didn’t have a seat at the creditors committee in A123 bankruptcy. So depending on the numbers you accept, it was either 250 million, or maybe A123 had only drawn down 180 or something, but whatever they drew down, they drew down a huge amount, but the government did not have a creditor representative at the creditors. So where is the parity in that? It seems like we're just doing it all backwards.

HEARING CO-CHAIR BARTHOLOMEW: Mr. Plotkin, it seems only fair that you would have the responsibility to respond if you have any comments that you want to make?

MR. PLOTKIN: Thank you, Commissioner.

I do. I would want to say that I actually did notice the V-E Day anniversary. I'm sensitive to it in part because my college roommate and I toured the landing beaches of Normandy three weekends ago, and one of the things that I remember thinking while we were there--it was an incredible experience. I bet you've probably been there. It's really quite something-- One of the things I was thinking about was if the people who were engaged in those landings at the time could have any imagination about our global economy, our interaction with Germany, with Japan, with Italy, today, and also to see how we interact with China.

In that regard, I have a number of comments also to respond to Commissioner Wessel's point. I've negotiated many national security agreements with CFIUS over the years, and I think, like anything, a lot of this depends on where you sit. I've had national security agreements that lost their meaning some years ago because the facts that justified the imposition of the national security agreement at the time have become outdated or obsolete or the like, yet those national security agreements live on and continue to be rigorously enforced by CFIUS in a way, to a point that lawyers like myself will argue is absurd. If there was a threat, the threat has evaporated, but nonetheless, we're devoting resources to enforcing every national security agreement to the nth degree. I completely agree with Mr. Popps -- I think that there was a time when CFIUS very much was a "check-the-box" type of operation and probably was very much influenced politically. And I do think that there are significant errors in the past, in CFIUS' past, and Magnequench is one of those errors.

The good news, I think, is that Magnequench was almost 20 years ago. And, in particular, I think that people within the CFIUS process, the professional staff, and the people who oversee the process are scarred--I can't think of a better word than that--by some of those past errors like Magnequench.

I think that people are scarred by some of the public debate that goes on in cases like the Dubai Ports debate, and what we see when we are participating in the CFIUS process is an extraordinary concentration of resources by all of the CFIUS agencies and an incredible level of attention at the highest possible levels, as well as from the staff level. I have sat in meeting after meeting with deputy secretaries of the Treasury, deputy secretaries of Defense, under secretaries, and the like, who are probing and testing and wanting to understand what about this technology and what about that technology?

Everybody has their piece of the pie and wants to ask about this particular software or that particular component, and has all the ITAR been excluded, and how can we be sure of that, and you need to have an audit to make sure that all the ITAR is excluded.

And so I would suggest that in the current era, post-9/11, post-Dubai Ports, post-Magnequench, you have an extraordinarily different CFIUS committee today that engages in rigorous enforcement, investing a tremendous amount of resources, and that it is a very vigilant committee with respect to national security.

HEARING CO-CHAIR BARTHOLOMEW: Thanks.

Commissioner Slane.

COMMISSIONER SLANE: Thanks. Thank you all for coming.

I have several questions. Mr. Popps, was there any effort to try to save A123 Batteries through the Defense Production Act?

MR. POPPS: Not to my knowledge.

COMMISSIONER SLANE: Was it just too far gone?

MR. POPPS: I believe that by the time the department got wind of where it was in the business sense, it was too far gone.

COMMISSIONER SLANE: My other question is I believe that it was under the Clinton administration, they changed the procurement mandating that they go worldwide for procurement of defense items, and do you advocate pulling back and having a lot of those items now having to be procured domestically?

For example, I understand that 80 percent of the semiconductor purchases by the Department of Defense are from overseas. Only 20 percent are here in the United States. When we talk to the Department of Defense, they say we can't get them here because it's so costly to build the plants, and we have no choice now. So it's sort of we've made our bed here. But do you advocate that we pull back and start to require more items be purchased domestically?

MR. POPPS: So, Commissioner, kind of a dual answer. I think that as it relates to critical materials, what we need to do is relax, for instance, some mining standards and some EPA standards and so forth, which may or may not happen. I realize that's an imperfect world to daydream in, but we need to mine and refine our ores and our critical materials here, and then we need to stockpile them here.

What is being offered today as kind of a solution is why we don’t send ships overseas, get all these materials. Who knows where they come from, who knows what standards--they haven't been produced under the same American standards. Somehow bring them here, stockpile them here, and then we've solved the problem. I think that's not a solution to the problem.

With regard to foreign companies being able to operate in the United States, certainly we have excellent examples of British Air, BAE, and other companies from France and elsewhere. I sit on some of those boards. We have proxy and special security agreement boards which allow a foreign company to bring its goods and products to its American subsidiary, a wholly American-controlled subsidiary, because there are outside directors, some like myself and others in this room, who assure that the firewall is down and report on even an hourly and daily basis to the Defense Security Service.

So there is a mechanism in place when you need the talent of other people, and you need what they make. We may decide to buy a plane, a helicopter or something for a particular mission that's not being made here.

We have a corporate structure that works because those outside directors can put that firewall down and make sure that there is no FOCI issue--foreign ownership control or interest.

But I think I'm talking about a slightly different variation now in saying, and it's really back to my cow and hay and barn, once all of those things go and go to other people, how are you able to control your supply chain?

That's the issue that I've wrestled with consistently, and my former colleagues over at Department of Defense say you're worried about the wrong thing because we'll always be able to go on the Internet or we'll always be able to get this, that and the other thing, and we're living in a global economy.

And I say I get that. I'm not here to bash anybody. I'm not here to try to change the facts of how we are today, but if we cannot protect our defense-industrial base and some of the critical things that I mentioned to Commissioner Wortzel and others, if we can't have a carve out, we're going to wake up one morning and find out that we don't have any milk.

COMMISSIONER SLANE: Thank you.

Ms. Drake, quickly, I'm worried about the influx of Chinese state-owned enterprises coming into the United States. It really hasn't happened yet, but everybody tells me it's coming, and your testimony indicates that our remedies are really not adequate to deal with that. Can you talk a little bit about that?

MS. DRAKE: Sure, I'd be happy to. I believe our current remedies are absolutely inadequate to deal with the potential down sides of investment by Chinese state-owned enterprises in the United States. That's because, as everyone has noted, CFIUS only looks at national security concerns, and there are agencies that would look at economic concerns, such as the Department of Justice. But they do that on the basis of tests that assume the investor operates on commercial principles. They really need to think about whether or not there should be an additional test for investors that are owned by the state or significantly supported by the state or have other links to foreign governments, and what competitive concerns those investments might pose, and review them from that perspective rather than traditional market actor perspective.

Once that investment is in the United States, there are other concerns, for example, predatory pricing. Right now, under our law, pricing is only considered predatory if the company could eventually recoup those losses and be profitable. The idea is, well, no market actor would engage in predatory pricing that would eventually put them out of business because that just doesn't make any sense.

But a state-owned enterprise with bottomless pockets of a foreign government certainly could engage in that practice to gain market share, to gain access to technology, brand names, resources, other things that are important from a political perspective and a policy perspective but aren't necessarily market considerations. So we need to consider how do we look at predatory pricing in that context, and that's just one example.

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR BARTHOLOMEW: Thanks.

I'll take the opportunity to ask a question. I think one of the things that I struggle with in all of this is also time frame. Ms. Drake, particularly, you know, George Becker when he served here on this Commission was one of the first people who were really raising the issue, and I've been here ten years. He was here longer than that, but raising the issue of Magnequench and also the importance of rare earth minerals at a time when people were just looking like what are you talking about? What is this? This doesn't mean anything.

And so I'm struck listening here, both Mr. Plotkin, you saying that these national security agreements live on, even if the circumstances have changed, with the issue that in Magnequench, one day after their five-year agreement was over, they shut down and took everything away.

How do we have a process that has enough foresight to be able to pull together all of the issues that have been raised here, to be able to recognize that there are critical things--I happen to think employment is a critical thing also--but there are critical things here that we need to be thinking more in the long-term? I don't know that there's a specific answer, but I would ask any of you. Ms. Drake, we'll start with you.

MS. DRAKE: I absolutely agree. I was very struck when Mr. Popps was identifying some critical technologies, and pretty much everything he listed is in Chinese development plans. The 12th Five-Year Plan listed many of those items as strategic and emerging industries, and their time frame is they want to be the global leader in those industries in 2030.

So it's a five-year plan, but it's about where they want to be in 2030, and they're identifying these technologies and official government policies, and they're devoting the resources to make sure that they meet those goals.

Obviously they don't have elections every two years and every four years, so that can help with long-range planning, but we certainly need to figure out how we are also planning in a similarly long range and thinking about where is the economy going to be, not just in the next two or five years, but ten, 20, 30 years, and how we can maintain our competitive edge in that future economy.

HEARING CO-CHAIR BARTHOLOMEW: Mr. Plotkin, I know CFIUS is transaction by transaction, and you're engaged in one way or another in these transactions, but, again, to me, it's the bigger picture of how any of those individual transactions might figure into a bigger whole in terms of product or technology as well as the time frame. So any observations that either you or Mr. Popps have, I'd appreciate.

MR. PLOTKIN: Again, I wish you could see what I see. What I see is the way that the professional bar, the CFIUS bar works in dealing with CFIUS, in that we will approach members of the CFIUS agencies informally with the concept of a potential transaction.

We develop these relationships over time so we have a certain level of comfort going forward. Asking somebody from the Defense Department or Homeland Security, based on your prior experience, how is this going to be received if this transaction were to be proposed to the Committee?

A perfect example is when a Chinese client is looking at a possible rare earths transaction, and the answer today is don't even waste your time. We don't bring forward transactions like investments in rare earths, for example, because there's an understanding within the CFIUS Committee that, one, there was an issue with Magnequench, but more generally, one of the issues that we see the Defense Department, in particular, looking at are long-term supply needs for DoD.

They also are looking at questions like where is the defense-industrial base going; how will this particular transaction either hurt the U.S. defense-industrial base or augment the resources of the PLA or others in the future in a way that could be adversarial to the United States?

So in the CFIUS of today, 2013, not the CFIUS of the 1990s or maybe even 15 years ago, I personally see a much greater appreciation and sense for the long-range needs of the country.

HEARING CO-CHAIR BARTHOLOMEW: It's difficult sitting here to reconcile your experience with CFIUS with Mr. Popps' concerns about both how the process plays out, the politicization of the process and product, and product itself. Mr. Popps.

MR. POPPS: If I may, ma'am, I'll just say that I don't think that business is our friend in this process, and I've said it repeatedly in the media and on television. Business will do whatever business has to do. If it can find cheaper profits overseas, and if it can find a quick sale of its company, and it can find investors to get to the next round, we can't count on the United States Department of Chamber of Commerce, for instance, to use that as an example, to protect America's national security. This has to be the job of the government, and my repeated admonition has been the government needs to do its job.

Mr. Plotkin has a job to do. He has a client. He has a Chinese company who desires to do this or that. It's within his ethical bounds and responsibilities to go and advocate for that. But he's not responsible for the national security.

Someone has to connect the dots on all this. I firmly state and disagree that anybody at DoD is doing this right now. Again, I think it's because we don't understand and know--and this is a whole other topic--the organizational design of a division of government, an agency of government, the Department of Defense, that defies organizational design review. It's an institution that exists nowhere else on this planet and may never.

So the question is how do you manage that process? How do you manage that? And we need, someone needs to take responsibility for connecting the dots at the very top. I would assert--and last sentence--I would just assert that that probably has to come out of the National Security Council, and my bet is that no one has that rose.

HEARING CO-CHAIR BARTHOLOMEW: Thank you.

Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you all for being here. Mark, it's been many years. What was the title of your article?

MR. PLOTKIN: Oh, I'm glad you asked me that.

[Laughter.]

MR. PLOTKIN: I'll remember it as soon as we finish.

VICE CHAIRMAN SHEA: It was that good. I'm going to pick on you a little bit. You had a sneaky little adverb in your oral testimony. You said if the U.S. always insists on reciprocity, it would drive up investment.

I've never known the U.S. to insist on reciprocity ever, and I was wondering, could you envision the U.S. sometimes insisting on reciprocity as a tool to open up Chinese markets to U.S. companies?

MR. PLOTKIN: Jonathan, did you put the word "always" into my testimony?

[Laughter.]

MR. WAKELY: He threw me under the bus.

MR. PLOTKIN: I'm very good at that.

It's a great question. I think that, to be honest, reciprocity is a genie that, once out of the bottle, is going to be very hard to put back into the bottle. I can imagine that we can get to issues that concern us involving cases of closed markets and the like without resorting to reciprocity.

There are our trade laws and trade agreements, WTO and the like. There are other mechanisms that we can use. I'm quite concerned about the issue of reciprocity. Today our national security review process already is a more stringent process than that used by most of our allies. Other countries, including China, obviously, have very restricted investment regimes, including regimes that prohibit investment in certain sectors entirely. But our CFIUS regime is often held up by other countries as an example of a trade barrier in the United States and the like, which I don't think it is.

If we were to engage in rolling out concepts like reciprocity, even on a selective basis, I really am very concerned that it would be utilized against us by countries that have an interest in trying to further block U.S. investment into those countries.

VICE CHAIRMAN SHEA: Okay, thank you. I asked this question to the previous panel so I'm going to repeat it. Your colleague at Covington, former Secretary of the Department of Homeland Security Michael Chertoff, has said publicly that the Chinese government is engaged in an effort to leapfrog technologically by using cyber espionage to steal U.S. and other Western countries' technologies, and he says that we should use all our economic, diplomatic, and technological tools at our disposal.

The Mandiant report identified four strategic emerging industries. Four of the seven in the 12th five year plan are being targeted by this one specific PLA unit in Shanghai. Do you feel as a matter of policy, it would be legitimate for the United States to restrict investment by Chinese state-owned enterprises in those specific industries that the U.S. government has identified, assuming it has, are the object of Chinese cyber espionage on a massive scale?

MR. PLOTKIN: So let me think about how to approach that question because there are several pieces there, and I'll have to speak to Secretary Chertoff when I get back to the office.

VICE CHAIRMAN SHEA: Okay.

[Laughter.]

MR. PLOTKIN: I also read the DoD annual report earlier this week, which focused quite a bit on cyber espionage. Cyber espionage and cyber attacks from China are a serious problem. I think everybody can agree on that, including the lawyers who represent private parties from China.

And I think that we--and again I see this as a practitioner--I think that the U.S. government is already restricting Chinese investment in sensitive industries. For example, this Commission has seen the fact that CFIUS has rejected prior investments by Huawei Technologies in the United States. There are other transactions that CFIUS turns down where it's not publicized because often times, and this is a statistic that the Commission doesn't see, and the Congress doesn't see, the number of transactions that are brought to CFIUS that are then withdrawn because CFIUS makes clear to the parties that this transaction is not going to get approved. The transaction parties have a choice at that point to either withdraw the transaction or to let it go forward and get a formal disapproval.

For the most part, transaction parties do not want to get a formal disapproval. So I regularly see CFIUS discourage or prepare to block Chinese investment and investment from certain other countries, as well, in particular areas of sensitive technology. I don't know that we need a broader effort in that regard because I think CFIUS guards the door quite well.

VICE CHAIRMAN SHEA: Thank you very much.

HEARING CO-CHAIR BARTHOLOMEW: Commissioner Fiedler.

COMMISSIONER FIEDLER: I listened carefully to your testimony on CFIUS law doesn't need to be changed, and then Elizabeth's discussion of economic security. Am I wrong in thinking that the CFIUS current statute allows the United States government to decide if an economic issue is a national security issue?

MR. PLOTKIN: I suppose what one could say is that because the term "national security" is not defined by the statute, it is open to interpretation, which it is.

COMMISSIONER FIEDLER: Well, I'm interpreting everything I'm hearing today is that we have a national security policy by market price. Sort of a Walmartization of national security, driving prices lower, lower, lower, lower. I'm the responsible government official, I should buy it even if it's from Tajikistan.

For some ideological reason, the cost of our defense is exorbitant if we have to save the rare earths industry or we have to mine it or we have to make sure that semiconductors are produced in an innovative way in the United States, that, oh my, we might we have to spend government money. I had a similar experience. I was a soldier. I didn't see anybody hesitating to squander my life, but I see people hesitating to squander a couple of bucks for national security.

Aren't we talking about money here, just the cost of doing it? So, yes, I understand the United States is in a--but every time I listen to everybody, I can't get anybody to tell me that money is dangerous. Investment money is not dangerous. People are dangerous, you know. We are in an extremely, it seems to me, dangerous mix of economics and national security that no one seems to want to tussle with a definitive answer.

We say we have globalization as if what? That's an observation of what exists, not what ought to be. So we accept the conditions of globalization on our national security. I'm not sure that, I think I agree with you that the law allows us to. I agree with you that there ought to be more economics in the discussion, and I think that has the impact on the supply chain that you seek. Am I missing something here? I don't expect you to agree with me, but I'm trying to see that--we're doing partial debates here in the United States. We're talking about a little--but we're not talking about the whole. We're not talking about a coherent--and I'm staying away from the term "industrial policy." The Chinese have a better strategic sense of their national interests than the United States government does, according to your testimony.

MR. POPPS: If I might respond to that quickly. It's because of the way they're organized and the way we're organized. We're organized for stovepipe debates that all stay at the tops of the stovepipe and never get connected at the top.

COMMISSIONER FIEDLER: Be careful of authoritarian versus democracy going there. I don't think that that's really an issue. I think the issue becomes whether or not we're actually talking about it as a people, and certainly we are today.

MR. POPPS: Not so much about form of government but just simply organization. When you get beyond the Department of the Army, I don't know where you go to have a discussion like the one you want to have, and that's the problem. Whereby once the policy is settled on in China by the Communist Party, the bureaucracy will follow and private industry and state-owned enterprises will follow.

COMMISSIONER FIEDLER: The only place to have that discussion is in the Congress of the United States.

MR. POPPS: Are they capable of that discussion?

COMMISSIONER FIEDLER: Absolutely capable of it.

HEARING CO-CHAIR BARTHOLOMEW: Any other comments from our witnesses?

MR. PLOTKIN: Just quickly. In part because, as Mr. Popps called me out, I was involved in the Wanxiang A123 transaction, and because I was an attorney in that transaction, it's difficult for me to say much about it. And so I've been trying to be careful not to say anything about it, but I would say that, with great respect, I disagree vigorously with Mr. Popps' assessment of how that transaction was handled by CFIUS.

I believe that as with the other cases in which I'm involved. I'm an advocate, but I'm also an American, and I care very much about our national security. I work closely with Secretary Chertoff. I work closely with my new colleague, Senator Kyl, and others who also care deeply about national security, and I think we're very much of the same mind on these kinds of things.

In transactions in which we've been involved, I see them run through a gauntlet of CFIUS review in which CFIUS essentially neuters the technology that's potentially risky or potentially at issue until you get to the point where there is generally nothing left of national security sensitivity at the end of the day that ultimately can become foreign controlled. That is what I see. I see a very rigorous and dedicated process.

HEARING CO-CHAIR BARTHOLOMEW: Thank you.

Commissioner Tobin.

COMMISSIONER TOBIN: Thank you, Madam Chair.

Your question, and Commissioner Fiedler's and Slane's really address my original wonderings. So let me ask a different question. Mr. Popps, you mentioned that we've lost control of the supply chain, and that concerns all of us here. Mr. Plotkin, what do you say to him and to those of us actually who are concerned about the supply chain, not the particular transaction, but the supply chain? Say, for example, a Boeing, which has its parts provided by everywhere, what would you recommend, given what you've seen at CFIUS and understanding that what Mr. Popps says is truly important, that we not miss out on good milk, to use his metaphor?

MR. PLOTKIN: First of all, I agree with Mr. Popps that we can't rely exclusively on business to address these kinds of supply chain issues, which the government has to be deeply involved. These issues come up in aviation, they come up in telecommunications, and we see all the time a lot of angst and concern within the CFIUS Committee, within American companies and other agencies within the government about supply chain security.

My own view, and we talk about this within the firm all the time, is that the only way to get to a secure supply chain solution is a partnership between the U.S. government and U.S. companies where they work out a solution for screening what goes into the supply chain in particular industries.

Today there is an ad hoc system. If a particular company in critical infrastructure wants to procure from a foreign company where that foreign company raises concerns within the U.S. government, today the mechanism available to the U.S. government is essentially a sort of economic and moral suasion, to pick up the phone, call the CEO and say you really want to do that? You really want to see your government contracts go away? And that is one method of affecting how the supply chain works, but it's very much an ad hoc method. There really should be a mechanism, and I strongly endorse doing that.

COMMISSIONER TOBIN: Describe what it might look like.

MR. PLOTKIN: I could imagine a public-private commission or partnership between, for example, the Department of Homeland Security and the Federal Communications Commission and the telecommunications providers. Where people with a technical security background from both the government side and the industry side sit down and work out guidelines and standards for the evaluation of components of the telecommunication supply chain and set standards the way standards have been set in the chemical industry and in the transportation industry and by the Food and Drug Administration and the like.

There are plenty of examples of how regulatory bodies working with and learning from private industry what they need, what the economics are and the like, can work out an economically viable approach that doesn't rely purely on an ad hoc or an extraordinarily expensive one-off solution.

COMMISSIONER TOBIN: Thank you.

And Ms. Drake, let me ask. You discussed trade distortion, antidumping, and SOEs involvement. Can you give us a couple of specific examples and what you would propose legally to rectify that?

MS. DRAKE: Sure. Thank you, Commissioner. I'd be happy to.

One issue that we have in the trade remedy world is when a domestic industry or a group of domestic workers together file a petition for relief from unfairly traded imports, the Department of Commerce needs to determine whether there is sufficient industry support for such a petition. That includes domestic producers' positions and domestic workers' positions. Under the law, they will disregard opposition to a petition if that opposition comes from a company that either directly imports the item that's being looked at or that is related to a foreign producer of that item.

But under current law, they would not be authorized to disregard opposition from a state-owned firm invested in the United States from that country as long as it wasn't an importer or wasn't related to a foreign producer. So you may have a state-owned firm that opposes such relief on political grounds or what have you, not because of a commercial relationship. That opposition could undermine the ability of domestic industries and workers to get relief from unfairly traded imports.

Another example is under current law, there is an ability to counteract circumvention of antidumping and countervailing duty orders if a company invests in the United States to perform sort of minor assembly. So the order was on a car, and all they did was, you know, latch the doors on, but they imported all the parts. You could get the order expanded to cover the parts as well, to ensure that the domestic industry enjoyed the relief that they originally got.

But that kind of relief is available in only very limited circumstances. So if you have an SOE, for example, that is coming in or even not an SOE, a Chinese firm that's coming into invest to do those sort of assembly operations, but does more than minor assembly, that's supported by the state in doing it, that's bringing in more and more of the Chinese inputs because it has discriminatory sourcing policies, that may not be reachable under the current anti-circumvention system.

So those are the kinds of improvements and strengthening that folks should look at.

COMMISSIONER TOBIN: Thank you.

HEARING CO-CHAIR BARTHOLOMEW: Commissioner Cleveland.

COMMISSIONER TOBIN: I will come back for further later.

COMMISSIONER CLEVELAND: At the considerable risk of sounding like I might be in the position of defending Rahm Emanuel or Mayor Daley, I want to talk a little bit about the politicization that you mentioned, Mr. Popps.

And I'm a little bit confused because having sat through the CFIUS process many times years ago, the Deputy Secretary of Defense may cast the vote, but, Mr. Plotkin, could you clarify how many agencies are involved, and on average how long the process takes for your clients?

MR. PLOTKIN: There are nine member agencies and five additional observer agencies. In addition, if there are other agencies that are non-members or observers, they can become involved as well. By statute, CFIUS undertakes an initial 30- day review that can then go into an additional 45-day investigation if CFIUS deems it necessary.

It was the case ten years ago where roughly 90 percent of the cases were cleared in the first 30 days. Today, I think it's closer to--Jonathan, if you remember--40 to 50 percent of cases these days are going to investigation and running the full 75 days.

COMMISSIONER CLEVELAND: And at the end of that 75-day period, roughly what proportion of those cases end up withdrawn?

MR. PLOTKIN: Approximately five percent.

COMMISSIONER CLEVELAND: And how many cases on average during the year go before the CFIUS Committee?

MR. PLOTKIN: It was reasonably consistent, at roughly 150 cases a year leading up to the economic crisis, and then, following a drop for several years, the pace has picked back up to 110 to 120 cases annually.

COMMISSIONER CLEVELAND: And most of those are approved?

MR. PLOTKIN: Yes, I think the vast majority of those are approved.

COMMISSIONER CLEVELAND: But in point of fact, the CFIUS process--I mean to suggest that the process is politicized because they're all approved doesn't speak to what happens before it comes into CFIUS?

MR. PLOTKIN: It doesn't speak to what happens before it comes into CFIUS, and it doesn't speak to the cases that are withdrawn because they're not going to be approved.

COMMISSIONER CLEVELAND: Approved, right. And a hundred and some cases go to CFIUS. How many discussions would you say that you or attorneys like you have privately informally to sort of test the waters on cases?

MR. PLOTKIN: Virtually every week I'm calling somebody in a CFIUS agency to test the prospects for a particular transaction.

COMMISSIONER CLEVELAND: My final question has to do with Wanxiang, understanding your client confidentiality. The suggestion was that somehow because two Chiefs of Staff, former Chiefs of Staff, went off to Beijing before the deal was closed, was politicizing it. Was Wanxiang--was this a novel investment in Illinois for Wanxiang or did they have a long-standing relationship with other investments and other facilities so that this was a known company that Illinois had done business with over a period of time?

MR. PLOTKIN: Wanxiang is one of those relatively unusual Chinese companies that has been in the United States for many, many years. It makes its professional home in Illinois and supports, I think, several thousand jobs in Illinois. So, no, there wasn't anything new about Wanxiang or its interests.

COMMISSIONER CLEVELAND: I don't know who the two Chiefs of Staff you're referring to, but I'm assuming it's Daley and Emanuel, the fact that they would go to China to conduct business on behalf of the state may or may not have been related to the CFIUS process at that particular point?

MR. PLOTKIN: I can say with all honesty that it's news to me that they made a China trip. I hadn't heard that before, and I've done enough CFIUS cases to know that I can't see how that would be related in some respect to the CFIUS case.

COMMISSIONER CLEVELAND: I just think we ought to be careful about suggesting that processes that are incredibly complicated and involve multiple agencies and a lot of staff time somehow turn on the vote of a deputy secretary, who may or may not be political, and somehow suggest that the staff is subjected to the political whims of the deputy. I would not want to suggest that these people are any less patriotic because the deputy is in the position of casting a final vote as opposed to the process that preceded it.

MR. PLOTKIN: If I may, as a general matter, when the deputy secretary gets involved, it's typically not a good thing from our perspective.

COMMISSIONER CLEVELAND: That was my perspective as well.

MR. PLOTKIN: It's something we're usually very unhappy about because it typically means that the staff has briefed up a transaction that is moving toward an approval, and somebody puts their hand up and says, now, wait a second, we're not going to get tarred with this one.

COMMISSIONER CLEVELAND: Thank you.

HEARING CO-CHAIR BARTHOLOMEW: Commissioner Reinsch.

CHAIRMAN REINSCH: Thank you.

I have a question for Ms. Drake, but, first, Mr. Plotkin, picking up on something that Commissioner Cleveland said, can you estimate the number of cases where the 75 days is effectively extended by withdrawals and then refilings?

MR. PLOTKIN: We typically withdraw and refile--Covington and Burling typically withdraws and refiles cases at the 75th day generally two times a year.

CHAIRMAN REINSCH: Out of how many?

MR. PLOTKIN: Out of approximately 12-15 cases in a year.

CHAIRMAN REINSCH: Thank you. Ms. Drake, let me pursue one of the remedies that you discuss, the economic benefit concept, and I want to understand a little bit more about how that decision-making process would work.

Let's hypothesize a Chinese SOE with all the advantages that both you and the other panelists, and actually the previous panelists identified as ways in which they could take advantage--unlimited capital and subsidies, et cetera. So let's assume that one of those comes in here and either wants to acquire a failing plant or wants to create a greenfield plant in a sector that competes with existing U.S. production.

I'm trying to figure out how you determine the net economic benefit? You have jobs being either created or maintained that wouldn't have existed or disappeared. You've got other jobs that are presumably being jeopardized by the creation of this new entity. How do you weigh those things?

MS. DRAKE: I think that's a very good question. I think it would really be on a case-by-case basis. One issue would be the net employment impact so looking at the positive employment impacts and any potential negative impacts.

CHAIRMAN REINSCH: Net just in terms of numbers, you mean?

MS. DRAKE: Numbers, quality of jobs, the skills associated with those jobs.

CHAIRMAN REINSCH: So if the new entity is creating more jobs than are being threatened, it's okay?

MS. DRAKE: I would say employment impacts would be one aspect, but I don't think that should be the only aspect that should be looked at. I think there should also be a review of what impact the proposed investment would have in terms of access to resources and technologies that are of economic importance, not just national security importance traditionally defined, but economic importance, strategic economic importance.

CHAIRMAN REINSCH: Give me a definition--can you give me an example of a technology or resource that you think would not meet a national security definition that would meet an economic definition?

MS. DRAKE: Hybrid, technology for hybrid vehicles, I would think that that's something that's going to very important to economies, and China has identified that as an emerging area where it wants to become a leader. So if there were investments that would impact the ability of the United States to retain control or leadership over technologies that are key to hybrid vehicles, even if didn't impact national security concerns, I think that's something that should be taken into account in a net benefit analysis. They may also--

CHAIRMAN REINSCH: Though it would probably produce less fuel consumption in China.

MS. DRAKE: Excuse me?

CHAIRMAN REINSCH: Even though it would produce less fuel consumption in China were they to adopt the technology.

MS. DRAKE: The question I think is not whether the technology is good or bad. The question is do we believe that foreign investment, state-owned foreign investment, that results in less sort of market access to that technology is in the long-term economic interests of the United States. It's the same as the Magnequench issue basically, that China saw this as long term investment. Five years was nothing to them. As of 2007, they had 130 producers of those magnets, and we have zero. So, of course, then they restrict the exports of rare earths, et cetera. So I think that is something that should be taken into account.

I think another issue that a net benefit analysis would want to look at in addition to employment, in addition to access to resources and access to technology, it should also be looking at the sort of sourcing practices of the company and whether it might impact trade balance. You would want to look carefully at that company to see whether they make their sourcing decisions on a commercial basis or whether they're influenced by the government, whether the board of directors and the officers of the corporation can operate independently from government influence.

So I think there are many. I wouldn't want to limit ahead of time the kinds of factors that might be relevant to such an analysis.

CHAIRMAN REINSCH: Well, in my example, I had already posited it was an SOE, which I mean--

MS. DRAKE: Right.

CHAIRMAN REINSCH: --I think they would fail your last several tests by definition.

MS. DRAKE: Well, China claims that certain state-owned enterprises operate on commercial terms, and that they are formally separate from government control through the SASAC. So those kinds of claims I think should be--there can be state-owned companies that have certain firewalls and safeguards in place designed to ensure that they operate on commercial terms in certain lines of their business. That's the sort of thing that we would want to look at if it was an area of concern.

CHAIRMAN REINSCH: That's helpful. Thank you. I'd just comment, I think that debate raises a whole host of more complicated questions, including political questions that the national security debate can at least in part avoid. The national security debate may be hard fought within the government and probably should be. At least hypotheses should be tested and so on, but when the President stands up and says I think there's a national security risk here, and I'm going to prohibit this transaction, I don't see anybody ever second-guessing him in that situation.

In the case you're talking about, you're going to have the governor of the state where the new plant is coming in saying this is really important, this is 2,000 jobs, and those are actually short-term benefits. The jobs that are going to be potentially lost, let's assume certainly lost, are downstream and theoretical. It's not clear what governor is going to step in at that point because they're not always readily identifiable, particularly if it's a sector, steel being a good example, where you've got multiple competitors in multiple states.

It seems to me it's a much more complicated and, therefore, much more controversial calculation, but that's just an editorial. Sorry.

HEARING CO-CHAIR BARTHOLOMEW: Okay. Thanks.

We have one Commissioner who has asked for a second round, and that's Commissioner Wessel.

COMMISSIONER WESSEL: And I will try and make it quick, although the response may be longer, Ms. Drake. You're talking, and I appreciate your testimony because I think you raise a really important issue, which--about the question of SOEs that will be operating in the U.S. market, not in a trade sense, but in a greenfield or other way. I believe it was Commissioner Slane who said the wave hasn't really started.

In fact, we have a number of transactions--Lennar, Sinopec, Tianjin Pipe--that I think raise in the trade sense or in the economic sense, a clear and present danger there.

How should we be viewing their investments here? Let's take Sinopec. We had an oil company tubular good case that the U.S. won against China last year, two years ago, whenever it was. Sinopec announces, and the Wall Street Journal article indicates, they are essentially going to source their entire domestic operation here from China, but the output of that product, output of that enterprise, is going to be energy. It's not the oil country tubular good or any other kind of steel or other item.

So the item doesn't enter commerce. And even if it did, it's still hard to understand how we reach it. What would you as an attorney representing a domestic firm that had concerns about its competitive position against that Sinopec facility or some other facility, what would you want to know? How would you want to structure the law? I looked at Sherman, Clayton, Lanham Act, many others, I don't see a good fit.

MS. DRAKE: Thank you, Commissioner Wessel.

I agree that there's no obvious recourse or basis in current law to provide a domestic firm--I'm assuming an energy producer that's competing with Sinopec with the assurances that they won't be undercut by competition. Obviously, if it's because Sinopec is more efficient or more productive or whatever, they should be undercut, but the question is whether or not the fact that it can benefit from government subsidies or other government support is giving it an unfair competitive advantage?

And so one of the issues I tried to think about in my testimony is whether or not it would be possible to create some private right of action for domestic firms or domestic workers who are harmed by competition with foreign investment in the United States that's either subsidized or state-owned or controlled by a foreign government and to seek remedies for harm that's caused by that competition. The kinds of factors that we look at for harm from imports include lost market share, lost sales, price undercutting, price depression or suppression.

Now, some of those may sound familiar from the antitrust context, but it's sort of a different rubric that's looked at, and there has to be a causal tie to the imports. So obviously you'd want to create some sort of test to ensure there was a causal tie to the foreign investment, and then you would also need to make sure that that cause is not due just to market competition, but it's due to some other factor that is considered to be distorting competition, whether it be subsidies, whether it be government direction and control, pursuit of industrial policies or political goals rather than commercial policies.

There is no perfect model for something like this, but I think you could draw on the trade remedy regimes. You could draw on some of the principles of competitive neutrality that the OECD has been looking at, and you could draw somewhat on the antitrust laws, but there is no perfect fit under the existing legal framework.

COMMISSIONER WESSEL: If you could, after the hearing, maybe respond to questions or work with our staff just to say what are some of those issues we need to deal with? How would we even know that their inputs are below market price?

MS. DRAKE: Right.

COMMISSIONER WESSEL: What would you as an attorney, how would you want to be empowered to find that out? What starts the case? How would you do discovery? If no existing law gives us the tools, what kind of laws do we want to--or what legal framework do we need to provide to make sure that we can adequately address this problem?

MS. DRAKE: Of course. I'd be very happy to do so.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR BARTHOLOMEW: Thank you very much. Thank you to all of our witnesses, and I want to acknowledge the work of the Commission staff in pulling this together and thank Nargiza particularly for finding an interesting and thought-provoking group of witnesses.

[Applause.]

HEARING CO-CHAIR BARTHOLOMEW: So thank you very much. With that, we're closed. The next hearing is on June 6. Great. Thank you all so much.

[Whereupon, at 12:32 p.m., the hearing was adjourned.]