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## Advisory Report Urges Federal Government to Challenge China's Semiconductor Industrial Policies

### [U.S. TECH LAW UPDATE](#)<sup>1</sup>

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On January 6, 2017, the President's Council of Advisors on Science and Technology ("PCAST")<sup>2</sup> issued a report entitled *Ensuring Long Term U.S. Leadership in Semiconductors*<sup>3</sup> (the "PCAST Report"). The PCAST Report urged then President Obama to counter the policies of the People's Republic of China (the "PRC" or "China") that are designed to achieve a global leadership position in the semiconductor industry.

Given the role of semiconductors in connection with technological innovation, economic prosperity, and U.S. national security, the PCAST Report stresses the need for the U.S. to maintain dominance in this industry. The PCAST Report explains that long-term trends curbing the U.S.'s leadership in this field – including technological limits and shifting markets – are compounded by China's non-market industrial policies.

Beginning in 2014, due to China's own economic and national security concerns, the PRC government publicly declared its intentions to build an advanced and autonomous domestic semiconductor industry. China pledged to invest \$150 billion in public and state-influenced private funds over a 10-year period to develop China's domestic semiconductor industry, and asserted that those funds would be used to subsidize the development and acquisition of relevant technology.<sup>4</sup>

The PCAST Report indicates that China's industrial policies distort markets, undermine innovation, and pose a threat to U.S. national security.<sup>5</sup> Accordingly, the PCAST Report urges the U.S. to reshape the application of its national security tools to deter and forcefully respond to China's industrial policies.<sup>6</sup>

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<sup>2</sup> PCAST is a council of scientists and engineers chartered in each administration with a broad mandate to advise the President on science and technology.

<sup>3</sup> See generally [Ensuring Long Term U.S. Leadership in Semiconductors](#) issued by the President's Council of Advisors on Science and Technology on January 2017.

<sup>4</sup> See page 8 of the [PCAST Report](#).

<sup>5</sup> See page 2 of the [PCAST Report](#).

<sup>6</sup> See page 13 of the [PCAST Report](#).



## 1. Overview of the Committee on Foreign Investment in the United States (CFIUS)

The PCAST Report recommends using the Committee of Foreign Investment in the United States (“CFIUS”), an interagency committee headed by the Department of the Treasury, to scrutinize acquisitions of U.S. semiconductor-related businesses by PRC investors. CFIUS has the authority to review any transaction that could result in control of a U.S. business by a foreign person (each a “Covered Transaction”).<sup>7</sup> CFIUS only reviews Covered Transactions that it believes present genuine national security concerns.<sup>8</sup>

### a. CFIUS’s Review Process

CFIUS administers a voluntary notice system, which allows parties to initiate a review of their transaction by filing information regarding the proposed transaction with CFIUS.<sup>9</sup> There is no specified value threshold or other criteria that subjects a transaction to mandatory review. If CFIUS determines that the Covered Transaction presents no unresolved national security concerns, then the transaction will qualify for a “safe harbor,” meaning that it will proceed without the possibility of subsequent suspension or prohibition by CFIUS.<sup>10</sup>

CFIUS is required to complete an initial review of a Covered Transaction within 30 days after receipt of the notice. Following this review, CIFIUS may conduct an investigation of a Covered Transaction, which it must complete within an additional 45-day period, where: (1) the transaction threatens to impair the national security of the U.S. and that threat has not been mitigated; (2) a lead agency, designated as such by the Department of the Treasury, recommends an investigation; (3) the transaction is a foreign government controlled transaction; or (4) the transaction would result in foreign control of any critical infrastructure of or within the United States.<sup>11</sup>

CFIUS is authorized to impose and enforce conditions on Covered Transactions to mitigate national security concerns.<sup>12</sup> Following a recommendation from CFIUS, only the President has the authority to suspend or prohibit a Covered Transaction after finding that (1) there is credible evidence that the foreign interest exercising control might take action that threatens to impair U.S. national security; and (2) other provisions of law do not provide the President with adequate authority to protect U.S. national security.<sup>13</sup>

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<sup>7</sup> [Title 31, Part 800, Section 204](#) of the Code of Federal Regulations (“CFR”) defines “control” as the power to determine, direct, or decide important matters affecting an entity, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity. [Title 31, Part 800, Section 226](#) of the CFR defines “U.S. business” as any entity, irrespective of the nationality of the persons that control it, engaged in interstate commerce in the United States, but only to the extent of its activities in interstate commerce. [Title 31, Part 800, Section 216](#) of the CFR defines “foreign person” as any foreign national, foreign government, or foreign entity.

<sup>8</sup> See page 74569 of “[Office of Investment Security: Guidance Concerning the National Security Review Conducted by the Committee on Foreign Investment in the United States](#),” issued by the Department of the Treasury on December 5, 2008 and published in the Federal Register on December 8, 2008 (“[Guidance on CFIUS Review](#)”).

<sup>9</sup> See page 74569 of [Guidance on CFIUS Review](#).

<sup>10</sup> See page 74569 of [Guidance on CFIUS Review](#).

<sup>11</sup> See page 74569 of [Guidance on CFIUS Review](#).

<sup>12</sup> See page 74569 of [Guidance on CFIUS Review](#).

<sup>13</sup> See page 74569 of [Guidance on CFIUS Review](#).



A greenfield or start-up investment is not a Covered Transaction, meaning that CFIUS does not have the authority to review such an investment.<sup>14</sup> CFIUS only has the authority to review transactions that could result in control of a U.S. business by a foreign person. As such, deals involving foreign acquisitions of ten percent or less of a U.S. business by a passive investor are not Covered Transactions.<sup>15</sup> Similarly, certain minority shareholder protections that do not in themselves grant a foreign investor control over a U.S. business, do not result in a transaction being regarded as a Covered Transaction.<sup>16</sup>

## **b. National Security Considerations**

Although Section 721 of the Defense Production Act of 1950 (the “Defense Productions Act”) requires CFIUS to determine the national security risks of a Covered Transaction, the Defense Production Act does not define the scope of “national security.”<sup>17</sup> Instead, Section 721 provides an illustrative list of factors for CFIUS to consider in determining whether a Covered Transaction poses a national security risk. The following factors may be relevant to Covered Transactions related to the semiconductor industry:

- (1) the potential effects of the transaction on U.S. international technological leadership in areas affecting U.S. national security;
- (2) the potential national security-related effects on U.S. critical technologies;
- (3) the potential effects of the transaction on the sales of military goods, equipment, or technology to countries that present concerns related to terrorism, missile proliferation, chemical, biological, or nuclear weapons proliferation, or regional military threats;
- (4) the potential that the transaction presents for transshipment or diversion of technologies with military applications, including the relevant country’s export control system; and
- (5) whether the transaction could result in the control of a U.S. business by a foreign government or by an entity controlled by or acting on behalf of a foreign government.<sup>18</sup>

CFIUS may also consider any other factors it finds appropriate. These factors typically concern (1) the nature of the U.S. business over which foreign control is being acquired, and (2) the nature of the foreign person that acquires control over a U.S. business.<sup>19</sup> CFIUS has reviewed numerous Covered Transactions that have presented national security considerations because of

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<sup>14</sup> See the [Summary](#) of the “[Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons](#),” which were issued by the Department of the Treasury on November 14, 2008 and published in the Federal Register on November 21, 2008. The Department of the Treasury issued this summary on November 14, 2008.

<sup>15</sup> See page 74569 of [Guidance on CFIUS Review](#).

<sup>16</sup> See page 70705 of the “[Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons](#),” issued by the Department of the Treasury on November 14, 2008 and published in the Federal Register on November 21, 2008. These regulations implement the [Foreign Investment and National Security Act of 2007](#), a Federal law that amended the process by which CFIUS reviews the US national security implications of inbound foreign investments and became effective on October 24, 2007.

<sup>17</sup> See page 2 of [Section 721 of the Defense Production Act of 1950](#) as amended by the [Foreign Investment and National Security Act of 2007](#) and most recently by [Executive Order 13456 of January 23, 2008](#).

<sup>18</sup> See page 74569 of [Guidance on CFIUS Review](#).

<sup>19</sup> See page 74570 of [Guidance on CFIUS Review](#).



the nature of the U.S. businesses. Of particular relevance here, CFIUS’ review focuses on transactions that involve production of advanced technologies, semiconductors and other technologies with both commercial and military applications.<sup>20</sup> CFIUS also considers factors related to the identity of the foreign person that is acquiring control of a U.S. business, including: (i) whether the foreign person could use its control of a U.S. business to take action to impair U.S. national security; (ii) the degree to which the investor’s decisions are exercised independently from the controlling government; and (iii) the degree of transparency and disclosure of the purpose, investment objectives, institutional arrangements and financial information of the investor.<sup>21</sup>

Covered Transactions Processed by CFIUS from 2009 to 2014

| Year         | Number of Notices | Notices Withdrawn During Review | Number of Investigations | Notices Withdrawn After Commencement of Investigation | Presidential Decisions |
|--------------|-------------------|---------------------------------|--------------------------|---|------------------------|
| 2009         | 65                | 5                               | 25                       | 2   | 0                      |
| 2010         | 93                | 6                               | 35                       | 6   | 0                      |
| 2011         | 111               | 1                               | 40                       | 5   | 0                      |
| 2012         | 114               | 2                               | 45                       | 20  | 1                      |
| 2013         | 97                | 3                               | 48                       | 5   | 0                      |
| 2014         | 147               | 3                               | 51                       | 9   | 0                      |
| <b>Total</b> | <b>627</b>        | <b>20</b>                       | <b>244</b>               | <b>47</b>   | <b>1</b>               |

Source: 2014 CFIUS Annual Report to Congress<sup>22</sup>

In 2014, 24 transactions out of the 147 reviewed by CFIUS were led by investors from China (up from 21 reviewed transactions in 2013, and 23 in 2012).<sup>23</sup> President Obama blocked only one transaction out of the 627 transactions CFIUS reviewed between 2009 and 2014. On December 2, 2016, following a recommendation from CFIUS, President Obama blocked another transaction involving Fujian Grand Chip Investment Fund LP’s (“FGC”) acquisition of Aixtron SE’s (“Aixtron”) U.S. subsidiary.<sup>24</sup> FGC is part-owned by the PRC government and Aixtron is a German producer and innovator of semiconductor manufacturing equipment and technology. Aixtron-manufactured technology is used to create gallium nitride, a powdery yellow compound used in light-emitting diodes (LEDs), radar, antennas and lasers.<sup>25</sup> According to the Department of the Treasury, “the national security risk posed by the transaction relates... to the military applications of the overall technical body of knowledge and experience of Aixtron.”<sup>26</sup> Transactions such as this one would be subject to enhanced scrutiny by CFIUS should the U.S. government adopt the PCAST Report’s recommendations.

<sup>20</sup> See page 74570-71 of [Guidance on CFIUS Review](#).

<sup>21</sup> See page 74571 of [Guidance on CFIUS Review](#).

<sup>22</sup> See page 3 of the [2014 CFIUS Annual Report to Congress](#).

<sup>23</sup> See page 19 of the [2014 CFIUS Annual Report to Congress](#).

<sup>24</sup> See “Obama bars China’s Fujian from buying Aixtron’s U.S. business” posted at [Reuters.com](#) on December 2, 2016.

<sup>25</sup> See “Obama bars China’s Fujian from buying Aixtron’s U.S. business” posted at [Reuters.com](#).

<sup>26</sup> See “Obama bars China’s Fujian from buying Aixtron’s U.S. business” posted at [Reuters.com](#).



## 2. Ramifications of PCAST's Report

The PCAST Report recommends that the U.S. government “revisit its tools to ensure that they are sufficiently able to protect against actions that may unacceptably harm the country’s economic and security interests.”<sup>27</sup> The PCAST Report asserts that the U.S. government has focused, and should continue to focus, its inward investment restrictions and export controls on national security rather than narrow economic objectives.<sup>28</sup> As such, the PCAST Report recommends a direct and unilateral response to China’s industrial policies that present national security risks, violate trade rules and distort the global market.<sup>29</sup>

The PCAST Report identifies PRC industrial policies that can increase national security risks for the United States. Specifically, the PCAST Report explains that in the long-term, subsidies to technologies tend to reduce innovation, allow firms from China to sell below production costs and raise the risk of overcapacity, which in turn can increase market concentration in China and erode U.S. market share, damaging industry employment as well as innovation.<sup>30</sup> The PCAST Report also identifies unilateral PRC industrial policies that shift business to China while raising costs. These include forcing or encouraging domestic customers to buy from semiconductor suppliers in China only, forcing the transfer of technology from foreign firms in exchange for access to the China market and government-initiated theft of intellectual property.<sup>31</sup>

In addition, the PCAST Report recommends a series of steps for the U.S. government to take in order to effectively respond and counter the economic and national security threats raised by China’s industrial policies. First, the PCAST Report recommends that the U.S. works to improve transparency with respect to China’s policies through discussions in bilateral and multilateral forums. More specifically, the PCAST Report recommends that the U.S. clarify the types of measures that the U.S. believes are acceptable in connection with protecting national security.<sup>32</sup> Moreover, the PCAST Report recommends that the U.S. identify “areas in which the diffusion of particular semiconductor technologies, or control of particular companies, poses intolerable national security risks that cannot be mitigated through steps short of stopping their acquisition and, therefore, should be stopped to the extent possible.”<sup>33</sup>

If multilateral efforts fail, however, the PCAST Report recommends that CFIUS alter its assessment of national security threats. In order to deter PRC policies that threaten U.S. economic and national security, the PCAST Report recommends tying U.S. assessments of the national security threats posed by particular technology-related transactions to China’s industrial policies.<sup>34</sup> CFIUS could therefore bar Covered Transactions that individually pose no apparent U.S. national security threats if such transactions seem to do so in the larger context of China’s industrial policies.

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<sup>27</sup> See page 13 of the [PCAST Report](#).

<sup>28</sup> See page 13 of the [PCAST Report](#).

<sup>29</sup> See page 13 of the [PCAST Report](#).

<sup>30</sup> See page 9 of the [PCAST Report](#).

<sup>31</sup> See page 9 of the [PCAST Report](#).

<sup>32</sup> See page 13 of the [PCAST Report](#).

<sup>33</sup> See page 11 of the [PCAST Report](#).

<sup>34</sup> See page 14 of the [PCAST Report](#).



The PCAST Report also recommends that the U.S. government work with U.S. allies to strengthen global export controls and inward investment security.<sup>35</sup> The federal government regulates the export of goods with potential military uses. The most sensitive items are enumerated on the United States Munitions List,<sup>36</sup> which the Department of State oversees. Less sensitive goods that have both military and commercial applications, or dual-use technologies, are listed on the Commerce Control List,<sup>37</sup> which is administered by the Department of Commerce.<sup>38</sup> The PCAST Report recommends that the U.S. and its allies develop common principles for acceptable and unacceptable market behavior.<sup>39</sup> Specifically, the PCAST Report recommends that the U.S. help its allies build their administrative capacities to effectively implement appropriate controls and pursue needed investigations including technical assistance, training, and diplomatic support to identify risks and vulnerabilities and to remediate them.<sup>40</sup>

### 3. Potential Broadening of CFIUS's Legal Authority

The PCAST Report may encourage further legislative reform to broaden CFIUS's legal authority to regulate and restrict transactions related to semiconductors. Senate Majority Whip John Cornyn and Senate Minority Leader Chuck Schumer are both in the process of writing legislation to strengthen the authority of CFIUS.<sup>41</sup> In line with the PCAST Report's recommendations, Mr. Cornyn proposes heightened CFIUS scrutiny of technology acquisitions by firms from China. Mr. Schumer, on the other hand, is pushing to broaden CFIUS's authority even further, requiring it to consider the economic factors behind the deals it reviews.<sup>42</sup>

Mr. Schumer's current draft legislation echoes the suggestions of an advisory letter several members of Congress sent the White House's Government Accountability Office in September 2016. The letter proposes to require CFIUS to review the economic impacts of foreign investment and to take into account the receptiveness of investors' home countries to U.S. investment.<sup>43</sup> Moreover, the U.S.-China Economic and Security Review Commission's<sup>44</sup> most recent annual report to Congress also recommends that Congress amend the laws governing CFIUS to bar China's state-owned firms from acquiring or otherwise gaining effective control of any U.S. companies,<sup>45</sup> which would create a flat-out ban on acquisitions of U.S. businesses by China's state-owned firms. The U.S.-China Economic and Security Review Commission argues that China's Communist Party uses state-owned enterprises to advance national security objectives and these firms, therefore, should be prohibited from acquiring U.S. businesses.<sup>46</sup>

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<sup>35</sup> See page 14 of the [PCAST Report](#).

<sup>36</sup> See [Title 22, Part 121](#) of the CFR published in the Federal Register on July 22, 1993.

<sup>37</sup> See [Title 15, Part 774](#) of the CFR published in the Federal Register on March 25, 1996.

<sup>38</sup> See "How Export Controls Hurt National Security" posted at [Forbes.com](#) on June 2, 2015.

<sup>39</sup> See page 13 of the [PCAST Report](#).

<sup>40</sup> See page 14 of the [PCAST Report](#).

<sup>41</sup> See "Lawmakers Push for Tighter Scrutiny of Chinese Investment in U.S." posted at [WSJ.com](#) on February 21, 2017.

<sup>42</sup> See "Lawmakers Push for Tighter Scrutiny of Chinese Investment in U.S." posted at [WSJ.com](#).

<sup>43</sup> See [Senators' Letter to the Government Accountability Office Regarding CFIUS](#) posted on src.bna.com on September 16, 2016.

<sup>44</sup> The U.S.-China Economic and Security Review Commission is a congressional panel that monitors security and trade links between Washington and Beijing.

<sup>45</sup> See page 29 of the [2016 Report to Congress](#) issued by the U.S.-China Economic and Security Review Commission on November 2016.

<sup>46</sup> See "Congressional Panel Wants to Ban Chinese State Ownership of U.S. Companies" posted at [Fortune.com](#) on November 17, 2016.



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Given President Trump’s strong criticism of China’s trade and monetary practices, his administration will likely support broadening CFIUS’s legal mandate. Key members of Trump’s Cabinet have expressed the view that the CFIUS process does not adequately address trade issues. For instance, Commerce Secretary Wilbur Ross Jr. recently expressed concern during his confirmation hearings over China’s developing semiconductor industry and the U.S.’s ebbing market share.<sup>47</sup> He invoked the issue of reciprocal market access stating that it did not seem “reciprocal that the Chinese want to control entertainment and other media here and yet are denying our companies anything getting remotely close to that.”<sup>48</sup> This echoes the mounting sentiment among Congress that firms from China should be prevented from investing in the U.S. given the restrictions U.S. businesses experience in China.<sup>49</sup>

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<sup>47</sup> See “What Wilbur Ross Said About Trump and Cybersecurity at His Confirmation Hearing” posted at [Fortune.com](https://www.fortune.com) on January 18, 2017.

<sup>48</sup> See “What Wilbur Ross Said About Trump and Cybersecurity at His Confirmation Hearing” posted at [Fortune.com](https://www.fortune.com).

<sup>49</sup> See “Lawmakers Push for Tighter Scrutiny of Chinese Investment in U.S.” posted at [WSJ.com](https://www.wsj.com).