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# Reciprocity – A New Factor to Restrict Investment from China into the United States?

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

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### 1. Introduction.

President Trump's recent state visit to China, and his remarks at the APEC CEO Summit in Vietnam,<sup>2</sup> refocused attention on the American administration's priority of promoting fair and reciprocal trade relations among nations. While President Trump and General Secretary Xi enjoyed or cordial dinner in Beijing's Forbidden City, leaders in both the House of Representatives and the Senate introduced legislation to strength the review process for foreign investment into the United States, with a particular focus on investment from China.<sup>3</sup>

One guiding principal that appeared both in President Trump's remarks in Vietnam, and in prior trade reform proposals from U.S. lawmakers,<sup>4</sup> is the principal of reciprocity – the idea that investors from China should only be permitted to do in the U.S. what investors from the U.S. are permitted to do in China. Although this approach has the appeal of “golden rule” fairness, implementation is likely to prove challenging, in particular when analyzing what U.S. investors in China are and are not actually permitted to do.

This update explores the potential difficulties a U.S. foreign investment policy that considers reciprocity might face, with a particular focus on the internet sector – an area that is heavily regulated in China due to that nation's own political system and internal security concerns. First, we provide an overview of the current U.S. foreign investment review process. Then we discuss the challenges that growth in investment from China possess for U.S. policy makers. Next we provide an overview of China's current foreign investment restrictions, with particular focus on the internet sector. Finally, we explore the implementation challenges that would need to be overcome in order to implement a reciprocity based U.S. foreign investment review process.

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<sup>2</sup> See the full text of President Trump's speech at the APEC CEO Summit here: “[Remarks by President Trump at APEC CEO Summit | Da Nang, Vietnam](#)”, posted at The White House on November 10, 2017.

<sup>3</sup> See “[Targeting China's Purchases, Congress Proposes Tougher Review of Foreign Investments](#)”, posted at the New York Times on November 8, 2017.

<sup>4</sup> Senator Chuck Schumer (D-N.Y.), the Senate minority leader, wrote a letter to then Treasury Secretary Jack Lew and then President elect Trump urging CFIUS to review investments from China more closely, and also raising the reciprocity concept. See “[U.S. Senator Calls for Further Probe of China's Wanda](#)”, posted at Variety.com on December 1, 2016.



## 2. U.S. Foreign Investment Review Process.<sup>5</sup>

In the United States, foreign investment review is led by the Committee on Foreign Investment in the United States (“CFIUS”, or the “Committee”), an interagency committee headed by the Department of the Treasury. CFIUS has the authority to review any transaction that could result in control of a U.S. business by a foreign person (a “Covered Transaction”).<sup>6</sup> Currently, the Committee only reviews Covered Transactions that it believes present genuine national security concerns.<sup>7</sup>

A greenfield or start-up investment does not fall within the definition of a Covered Transaction, and thus the Committee does not have the authority to review this type of investment.<sup>8</sup> In addition, deals involving foreign acquisitions of ten percent or less of a U.S. business by a passive investor are not Covered Transactions.<sup>9</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>10</sup>

The CFIUS review process is based on a voluntary notice system, meaning that parties to a Covered Transaction that might raise national security concerns can initiate a review of their transaction by filing a notice with the Committee.<sup>11</sup> There is no specified value threshold or other criteria that subjects a transaction to mandatory review. If CFIUS determines that a Covered Transaction does not present any unresolved national security concerns, the transaction will qualify for a “safe harbor,” meaning that the transaction will be exempt from subsequent prohibition or unwinding by the Committee.<sup>12</sup> Once parties decide to submit a transaction for CFIUS review, the parties must disclose a substantial amount of information, including the personal identifier information of senior officers, directors, and shareholders holding five percent or more of the foreign acquirer’s equity.<sup>13</sup>

Although the Committee is required to evaluate the national security risks associated with a Covered Transaction, the rules that guide the Committee do not define “national security.”<sup>14</sup>

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<sup>5</sup> For more details on the CFIUS review process see “[Advisory Report Urges Federal Government to Challenge China’s Semiconductor Industrial Policies](#)”, published by Pillar Legal, P.C. on March 3, 2017.

<sup>6</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>7</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>8</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.

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

<sup>10</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>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 31 CFR 800.402 (c)(6)(vi).

<sup>14</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](#).



Instead, the rules include an illustrative list of factors for the Committee to consider when deciding whether a Covered Transaction poses a national security risk, such as the potential national security-related effects on U.S. critical technologies, and 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>15</sup> Economic factors, including whether U.S. investors would be permitted to make a similar acquisition in the home country of the foreign acquirer, are not among the factor that the Committee considers under the current review process.

### 3. Investment from China and its Challenges.

As China's economy has grown, so too has investment from China into the United States. Although small as a percentage of total foreign direct investment, capital originating from China raises concerns with U.S. policy makers due to the highly publicized strategic goals of the PRC government and the degree of influence that the state has over private firms in China.

Investment from China into the United States has grown from US\$170 million in 1992,<sup>16</sup> the year that Deng Xiaoping completed his famous south China tour in an effort to revive stalled market reforms, to US\$15.5 billion in 2015.<sup>17</sup> In 2016, investment from China nearly tripled to US\$45.6 billion.<sup>18</sup> These numbers are, however, small when compared with total foreign direct investment into the U.S. of US\$3.3 trillion and US\$3.7 trillion in 2015 and 2016 respectively,<sup>19</sup> and when compared with investments from countries with closer U.S. ties such as the United Kingdom and Canada. In 2016, U.S. investments from the United Kingdom and Canada totaled US\$555.7 billion and US\$371.5 billion respectively.<sup>20</sup>

The PRC government has established and publicized a number of strategic economic goals, including becoming a leader in key technology sectors like semiconductors, artificial intelligence and high-end manufacturing. Beginning in 2014, the PRC government publicly declared its intentions to build an advanced and autonomous domestic semiconductor industry. China pledged to invest US\$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>21</sup> In 2016, several PRC government departments, including the National Development and Reform Commission and the Ministry of Science and Technology (the "Ministry of Science"), jointly formulated the "Internet Plus" artificial intelligence plan, which aims to speed the development of the artificial intelligence sector in China and create a market worth more than RMB 100 billion (US\$15.26 billion) over three years.<sup>22</sup> The Ministry of Science has also reportedly established a team of experts tasked with drafting a plan for the development of

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

<sup>16</sup> See "[U.S. direct investment data \(1980-2007\)](#)", posted at BEA.gov.

<sup>17</sup> See page 58 of "[Two-Way Street: 25 Years of US-China Direct Investment \(2016\)](#)", posted at Rhodium Group website in November 2016.

<sup>18</sup> See "[Politics Aside, Chinese Investment in the U.S. Is Booming](#)", posted at Fortune on March 15, 2017.

<sup>19</sup> The total foreign investment amount into the U.S. from 2014-2016 was US\$2.9 trillion, US\$3.3 trillion and US\$3.7 trillion, respectively; See "[Foreign Direct Investment in the United States](#)", posted at Select USA in July 2017.

<sup>20</sup> See "[U.S. direct investment data \(2008-2016\)](#)", posted at BEA.gov.

<sup>21</sup> See page 8 of the "[Report to The President Ensuring Long-Term U.S. Leadership in Semiconductor](#)", posted at Obama White House website in January 2017.

<sup>22</sup> See "[China Unveils Three-year Program for Artificial Intelligence Growth](#)", posted at China Daily on May 24, 2016; See also "[Internet + Artificial Intelligence Three Year Plan](#)" ([互联网+人工智能三年行动实施方案印发](#)) (Chinese), posted at Xinhua Net on May 26, 2016.



artificial intelligence through 2030.<sup>23</sup> Further, the Chinese Academy of Engineering has proposed an “Artificial Intelligence 2.0 Plan,”<sup>24</sup> which will advance a multibillion-dollar national agenda to provide extensive funding for basic and applied research and development with commercial and military applications.<sup>25</sup> Under the Thirteenth Five Year Plan, which was approved by the National People’s Congress of the PRC in March 2016, China is pursuing a policy agenda known as “Made in China 2025,”<sup>26</sup> which is focused on upgrading China’s industrial capabilities, especially the newly emerging technologies and businesses, and is aiming to create a market for high end manufacturing and new materials worth of RMB 12 trillion (US\$1.8 trillion) by 2020. Although starting from 2016, companies in China began facing challenges when applying for the required approvals to make offshore investments, foreign acquisitions in high technology industries are still very much encouraged by the PRC government.<sup>27</sup>

U.S. policy makers are concerned about the rise in investment from China due to these strategic goals of the PRC government, and because the state has more control over private companies in China than is prevalent in democratic countries. Notwithstanding more than thirty years of China’s “reform and opening-up policy”, which has greatly increased the role of the private sector in the economy, the government and the Communist Party of China (the “CPC” or the “Party”) still controls many aspects of life and the economy in the PRC. In CPC Chairman Xi Jinping’s own words, “The Party leads everything.”<sup>28</sup> As a result, irrespective of whether an investment from China originates with a state-owned enterprise or a private company, there are concerns among U.S. lawmakers that the decisions might be motivated by PRC government and CPC strategic goals.<sup>29</sup>

These factors have contributed to China’s rise in the ranks of CFIUS reviews. In 2011, 10 transactions out of 111 (9%) reviewed by CFIUS were led by investors from China, while CFIUS reviewed 25 deals lead by investors from the United Kingdom and 14 lead by investors from France.<sup>30</sup> By 2015, 29 transactions out of 143 (20.3%) reviewed by CFIUS were led by investors from China, placing China at the top of the CFIUS review list.<sup>31</sup> In the same year, however, China accounted for less than one percent of foreign direct investment into the United States (US\$15.5 billion/US\$3.7 trillion). Although official data from 2016 isn’t available yet, due to the rapid increase of China investments last year, the number of China transactions that were subject to CFIUS review probably continued to increase.

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<sup>23</sup> See “[Mr. Feng is Appointed as Specialization of China AI 2.0 Plan](#)” (冯建峰院长受聘担任中国人工智能 2.0 计划编制组专家) (Chinese), posted at [istbi.fudan.edu](#) on September 1, 2016.

<sup>24</sup> See “[Internet Become Healthcare Reform Driving Force](#)” (互联网成为医疗变革推动) (Chinese), posted at Xinhua Net on November 18, 2016.

<sup>25</sup> See “[Beyond CFIUS: The Strategic Challenge of China’s Rise in Artificial Intelligence](#)”, posted at Lawfare on June 20, 2017.

<sup>26</sup> See page 9 of the “[13<sup>th</sup> Five-Year Plan](#)”, posted by U.S.-China Economic and Security Review Commission on February 14, 2017.

<sup>27</sup> For more detailed discussion regarding China’s control of outbound direct investments, see “[China Further Tightens Control of Outbound Direct Investment](#)”, published by Pillar Legal, P.C. on August 28, 2017.

<sup>28</sup> See “[Party Leads Everything](#)” (党是领导一切的) (Chinese), posted at Sina on January 8, 2016.

<sup>29</sup> For more discussion of the topic, see “[CFIUS in the Age of Chinese Investment](#)”, published by Patrick Griffin in Fordham Law Review on March 30, 2017.

<sup>30</sup> See page 17 of “[2014 CFIUS Annual Report](#)”, posted at U.S. Department of the Treasury in February 2015.

<sup>31</sup> See page 17 of “[2014 CFIUS Annual Report](#)”, posted at U.S. Department of the Treasury in February 2015, and page 16 of “[2015 CFIUS Annual Report](#)”, posted at U.S. Department of the Treasury in February 2016.



#### 4. China's Foreign Investment Restrictions.

Notwithstanding the increase in CFIUS reviews of China investments into the United States, the American economy still remains largely open to companies from China. China's economy is not, however, equally open to U.S. companies, particularly in the internet sector, which is the focus of this update. While the U.S. has a single national level committee that reviews several hundred acquisitions per year for national security concerns, China categorizes all companies operating within its borders based on whether they are foreign-invested or domestic, and then limits the scope of activities that foreign-invested companies are permitted to undertake – whether through acquisitions, minority investments, cooperation arrangements or greenfield projects. As a result, many of America's internet giants have little or no presence in China, while China's internet companies are free to establish operations and complete most acquisitions and investments in the United States.

##### a. Foreign Investment Catalogue

The primary foreign investment restrictions in China can be found in the Foreign Investment Catalogue (外商投资产业指导目录), which for the purpose of foreign investment places all sectors of the economy into one of four categories: encouraged, permitted, restricted or prohibited. The telecommunication industry, for example, is classified as restricted,<sup>32</sup> while internet cultural activities and internet publishing services are classified as prohibited.<sup>33</sup>

In certain restricted industries, such as the telecommunication industry, foreign investment must take the form of an equity joint venture and the foreign ownership interest in the joint venture may not exceed fifty percent. In prohibited industries, such as those involving internet cultural activities and internet publishing services, foreign investment is not permitted in any amount. For example, the Ministry of Culture (文化部) (“MOC”) does not accept applications from foreign-invested enterprises for the required internet culture operation license and the State Administration of Press, Publication, Radio, Film and Television (国家新闻出版广电总局) (“SAPPRFT”) does not accept applications from foreign-invested entities for the required internet publishing service license.

##### b. Variable Interest Entity Structure

Notwithstanding these foreign investment restrictions, many of China's companies that operate in restricted or prohibited industries have received financing from foreign venture capital funds and have listed their shares on overseas stock exchanges.<sup>34</sup> These companies have achieved what they believe to be technical compliance with the foreign ownership restrictions by establishing a variable interest entity (“VIE”) structure in which a foreign-invested entity does not have a direct ownership interest in the domestic operating company that holds the licenses

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<sup>32</sup> See Section 21, Part 1 of the Negative List of the Catalogue of Restricted Foreign Investment Industries, in the Foreign Investment Catalogue, as amended in 2017.

<sup>33</sup> See Section 26, Part 2 of the Negative List of the Catalogue of Prohibited Foreign Investment Industries, in the Foreign Investment Catalogue, as amended in 2017.

<sup>34</sup> Internet companies in China with shares listed on overseas stock exchanges include: Tencent Holdings Limited, Alibaba Group Holding Limited, Baidu, Inc., Netease.com, Inc. and Sina Corporation.



required to operate in the restricted or prohibited industry.<sup>35</sup> The VIE structure has been in use since the first China internet companies listed their shares on NASDAQ in 2000.<sup>36</sup>

Although the VIE structure has been used to facilitate foreign venture capital investments and overseas public offerings for home-grown China businesses in restricted sectors, this same structure is generally not regarded as a viable means for truly foreign companies to enter restricted or prohibited sectors in China's domestic market. While some foreign companies have used the VIE structure to enter China's domestic market for internet culture activities and internet publishing, they have generally done so in a very low profile manner with careful consideration given to the branding of the domestic operating company's service platform so that they are not viewed as a foreign-invested company. High profile foreign companies generally do not view the VIE structure as a viable way to enter China's restricted or prohibited industries.

## **5. Reciprocity and its Challenges.**

If the U.S. were to revise the CFIUS review process to add an economic reciprocity factor to the list of factors that it considers when reviewing a foreign investment, the Committee would need to establish a procedure for determining or verifying the facts regarding reciprocal investments. In addition, in order to avoid confusion on the new scope of CFIUS review, clear guidance would need to be provided to the market on the weight that would be given to the reciprocity factor. Without this guidance, there could be a broad chilling effect on investment from China and other foreign markets that are less open to U.S. investment, or the Committee might be overwhelmed with notice filings.

From the perspective of the Committee, the most efficient way to gather data regarding whether or not a U.S. company could make a reciprocal investment in the country of the proposed foreign acquirer, would be to require the foreign acquirer to provide this information in the notice filing to CFIUS. The Committee would naturally need to verify the information provided by the foreign acquirer, which would require the allocation of additional resources to the Committee. During this process, however, some difficult policy questions are likely to emerge.

Looking to China's internet sector as an example, due to the fact that U.S. venture capital firms can and do invest in many China internet companies through VIE structures, would this sector be regarded as open to reciprocal U.S. investment? China's policies generally prohibit U.S. companies from establishing greenfield operations in China's internet sector, but with greenfield investments beyond the scope of CFIUS review would the Committee take this fact into consideration when evaluating reciprocity?

It would also be important to provide the market with clear guidance on the weight that the Committee would place upon a reciprocal investment factor in connection with review of a foreign investment. Would reciprocity be a decisive factor, which might result in an effective

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<sup>35</sup> For more information regarding the VIE structure, see "China's Foreign Ownership Restrictions and the VIE Structure", posted by Pillar Legal, P.C. in April 2017, which can be requested [here](#).

<sup>36</sup> Sina, NetEase and Sohu completed their initial public offerings, listing their securities on NASDAQ, in April, June and July of 2000, respectively. All three companies used a VIE structure to complete their initial public offerings.



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prohibition on investment from China in most U.S. internet businesses? Would reciprocity be given sufficient weight such that the risk associated with making a minority investment in a U.S. internet startup might cause potential investors from China to shy away from these opportunities? If the answers to either of these questions is yes, would such a result be in the best interests of the United States?

China's foreign investment restrictions are naturally driven by China's view of its own national interest. The internet sector, for example, is regarded by the Communist Party of China as extremely sensitive due to the potential for disseminating non-state sanctioned information broadly and facilitating organization among groups opposed to Party rule. As a result, changes to U.S. foreign direct investment policy are unlikely to affect whether or not the Party allows Facebook and Google to operate freely within China. If the Committee did heavily weigh the reciprocal investment factor, the awkward result might be a U.S. foreign investment policy guided by the strategic objectives of the Communist Party of China.