SECTION 3: THE CHINESE GOVERNMENT’S EVOLVING CONTROL OF THE NONSTATE SECTOR

Key Findings

• China’s government has developed numerous avenues through which to monitor corporate affairs and direct nonstate firms and resources toward advancing the Chinese Communist Party’s (CCP) priorities. Within this expanded framework of government control, traditional definitions of state control in an entity no longer apply because any entity may be compelled to act on behalf of the Chinese government’s interest, regardless of the state’s formal ownership.

• Control of Chinese firms is blurred, contrary to the precise division between state and nonstate firms implied in corporate ownership registration. Historically, nonstate firms have sought state investment to overcome political and regulatory barriers. China’s government is also now increasing investments in nonstate firms to advance its technology development goals and policy objectives, further obscuring the distinction between state and nonstate.

• Under General Secretary of the CCP Xi Jinping, the Party has systematically expanded its representation in corporate governance. Whereas traditional regulatory intervention in corporate affairs occurs through Chinese bureaucratic mechanisms prescribed by law, there are no such constraints on the CCP. Consequently, it can be impossible to identify the extent of the exercise of CCP influence.

• The CCP is also supplanting the role of Chinese government agencies in market monitoring and regulatory enforcement. While this may create the appearance of better regulated markets, replacing routine bureaucratic functions with CCP intervention both acknowledges the inherent weakness of Chinese state institutions and further undermines their effectiveness.

• Chinese corporate law affords the state unique and substantial governance rights as an investor and imposes a legal obligation to serve state development goals on all firms. By contrast, nonstate minority shareholders of publicly traded companies, including U.S. investors in China’s domestic equities market, are afforded minimal protections.

Recommendations

The Commission recommends:

• Congress direct the U.S. Securities and Exchange Commission to require that publicly traded U.S. companies with facilities
in China report on an annual basis whether there is a CCP committee in their operations and summarize the actions and corporate decisions in which such committees may have participated.

- Congress direct the Bureau of Economic Analysis at the U.S. Department of Commerce to amend its surveys of U.S. multinational enterprise activity in China to report on the presence and actions of CCP committees in the foreign affiliates of U.S. firms operating in China.

**Introduction**

While China’s leadership claims its economy is becoming more open, better regulated, and less dominated by the state, the opposite is true. Since General Secretary Xi assumed power in 2012, the Party has deepened its presence in the nonstate sector and begun supplanting the regulatory and administrative functions of China’s bureaucracy in the name of improved market integrity. The CCP is also evolving and increasing means to monitor, exert influence over, and intervene in corporate affairs. China’s government is simultaneously becoming an increasingly active investor in nonstate firms and mobilizing broad segments of the nonstate economy to contribute to its technology ambitions.

This section documents the various legal and political channels through which the CCP and China’s administrative state are extending their influence over Chinese firms. The proliferation of these channels is motivated by the CCP’s attempt to attain greater visibility into and control over China’s corporate sector. In principle, China’s authoritarian government does not need legal mechanisms (e.g., exercising shareholder voting rights) or political backchannels (e.g., placing CCP members on corporate boards) to intervene in corporate affairs. As China’s economy has grown, however, the complexity of economic activity has outpaced the evolution of channels for government oversight. In practice, therefore, the Chinese government’s power to direct firms’ activities often exceeds its awareness of and information on those activities. The CCP is consequently looking to increase government investment and CCP presence in nonstate firms to improve its ability to monitor corporate behavior and provide channels to steer corporate decision-making when it desires. The CCP is also using its internal anticorruption investigations to gather information on and punish corporate malfeasance, in place of China’s weak regulatory apparatus.

The outcome of these processes is a complex expansion of government involvement in China’s business environment. This expansion makes it increasingly difficult to distinguish between China’s state and nonstate sectors and heightens the risk that investment in Chinese companies ultimately supports CCP objectives that may counter U.S. interests and harm U.S. investors. (For more on the national security risks of U.S. investment in China, see Chapter 2, Section 4, “U.S.-China Financial Connectivity and Risks to U.S. National Security.”)

This section draws from the Commission’s March 2021 hearing, “U.S. Investment in China’s Capital Markets and Military-Industrial Complex”; consultations with government officials, industry experts, and academics; and open source research and analysis.
China’s Government Has Numerous Channels for Intervention in Corporate Decision-Making

Control of Chinese firms is often blurry, and the government has wide latitude to intervene in corporate affairs. Many nonstate firms welcome state-owned enterprises (SOEs) as shareholders to curry regulatory favor, while numerous subsidiaries of state-owned conglomerates have raised capital through partial privatization.\(^1\) Even when there are no government shareholders, firms with three or more employees that are CCP members must establish CCP committees, effectively offering the Party a seat at the table. The Chinese government also uses its extensive influence over the economy to guide commercial behavior without directly intervening in individual companies’ decision-making. Through policy incentives and control of the financial system, the government shapes the opportunities available to entrepreneurs, steering nonstate firms toward activities that advance state goals.

Three types of channels—legal, political, and economic—are used to influence the corporate sector, any combination of which may be operative for a given company. The complexity of these channels and the increase in the government’s potential for intervention demonstrates the limitations of current investment screening policy frameworks to safeguard U.S. national security and economic interests. Analysis of equity ownership to establish actual control, for instance, is less meaningful within an economy that grants the state extensive corporate governance rights even when it owns just a fraction of a percent in a firm.\(^2\)

1. **Legal channels to intervene in corporate decision-making.** Chinese law grants the state privileged status in the governance of any corporation for which it is a shareholder, regardless of its ownership stake.\(^3\) The state may exercise these rights through its extensive investment in the nonstate economy. This section describes in detail the nature of these rights and extent of state ownership, but this should not suggest that legal channels for intervention are of the greatest concern for U.S. policymakers. If anything, political and economic channels are in many cases more important but harder to identify and address.

2. **Political channels to influence corporate affairs.** In contrast to the state bureaucracy’s de jure mechanisms for intervention, the CCP is not bound by legal constraints. Within firms, the CCP is expanding its influence over management and personnel decisions through CCP committees. Chinese policy is prioritizing committee members’ joint appointments as corporate board members, particularly within SOEs. Within the market more broadly, it is supplanting regulatory agencies’ role in monitoring and enforcement.

3. **Economic channels to guide commercial behavior.** Policy incentives, such as subsidies, grants, and tax breaks, as well as corporate monitoring mechanisms, guide companies toward fulfilling the Chinese government’s objectives even without direct govern-
Legal Channels: State Investment in Nonstate Firms Is Widespread and Expanding

Much of China’s corporate sector remains controlled by the state bureaucracy. The state holds a minority stake in an ever-increasing number of nonstate firms, and state investment has been integral to the success of China’s largest nonstate firms. As China has retained strong elements of a state-led approach to economic management, the role of state ownership and investment remains an evolving mainstay of Chinese economic policy.

These trends have important consequences for U.S. investors. First, the state is legally afforded great privileges in the governance of Chinese firms. As a result, any state-invested enterprise, not just an SOE, can become subject to the Chinese government’s influence and control. Second, many ostensibly nonstate firms are actually state-invested enterprises, with the appointment of executive personnel serving as a key outcome of state investment.

Chinese Corporate Law Establishes Government Influence

In the 1990s China’s government introduced shareholding as a tool for streamlining and consolidating its control over market development. The system evolved to enable the state to preserve control even if its ownership of SOEs was diluted. Chinese law also grants the government a say in personnel decisions and other matters of corporate governance for any state-invested enterprise, regardless of whether the state is a controlling shareholder in those enterprises. Because the Chinese government has extensive investments in nonstate firms, special privileges for the state as a shareholder further extend government influence over the nonstate economy. Finally, Chinese law imposes obligations on all firms, state and nonstate, to comply with government supervision and “bear social responsibilities” such as participation in national development objectives.

State Shareholders Have “Super-Control Rights”

China’s corporate governance framework gives the state what law professors Li-Wen Lin and Curtis Milhaupt call “super-control rights,” applicable regardless of its stake in a firm. Established primarily in China’s State-Owned Assets of Enterprises Law, these rights extend beyond those available even to nonstate controlling shareholders and fall into three broad categories:

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1. **State shareholders have outsized influence in personnel decisions.** Regardless of its stake in the company, by law, the state may propose candidates for a firm’s board of directors or senior management to a shareholders’ meeting, or it may conversely propose the removal of directors or senior management.* In some cases, state shareholders can appoint candidates to a firm’s board of directors outright, rather than merely proposing them.† The state also has the authority to establish systems for manager performance assessment and remuneration standards, authorities otherwise vested in the board of directors. Furthermore, the state determines the pay and performance standards for any managers it appoints.⁹

2. **State shareholders have influence over any decision regarding transfer of state-owned assets.** The State-Owned Assets of Enterprises Law gives the state de facto veto power over proposed transfers of assets (e.g., mergers and acquisitions) that could impact the state’s rights and interests in a state-invested company, according to Harvard Law School fellow Tamar Groswald Ozery.¹⁰ Normally such transactions are the purview of the board, but Chinese courts have interpreted the law as invalidating otherwise legal contracts to transfer state assets because they did not have the State-Owned Assets Supervision and Administration Commission’s (SASAC) approval.¹¹

3. **Nonstate firms and their management have fiduciary obligations to state shareholders.** Beyond the normal fiduciary responsibilities of every company, the management of any nonstate firm is liable for any actions that cause loss of state-owned assets.¹²

**Shareholders of Public Companies Have Few Protections**

Aside from affording the state unique privileges, China’s broader corporate governance legal framework grants unconstrained authority to controlling shareholders, particularly state control over SOEs. Chinese law protects the ultimate authority of the controlling shareholder, limits the rights of public shareholders, and empowers the controlling shareholder to pursue its own goals at the expense of other shareholders’ interests.¹³ Dr. Groswald Ozery observes:

> [E]ven under an assumption of benevolent, well-coordinated, state asset management, the state as a controlling shareholder may direct the firm in pursuit of objectives that simply run counter to the interest of the firm as a profit-maximizing business. Examples of this in China include the use of state-controlled firms to advance geopolitical goals without

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* By contrast, a nonstate shareholder can only propose convening a shareholder’s meeting if it holds a 10 percent or greater stake and can only nominate candidates if it holds at least a 3 percent stake. Tamar Groswald Ozery, written testimony for U.S.-China Economic and Security Review Commission, Hearing on U.S. Investment in China’s Capital Markets and Military-Industrial Complex, March 19, 2021, 7.

† For example, in April 2020, a subsidiary of the state-backed China Internet Investment Fund acquired a one percent stake in Weimeng, an affiliate of Chinese social media giant Weibo. According to Weibo’s filings with the U.S. Securities and Exchange Commission, this third-party minority stake includes the right to appoint a director to Weimeng’s three-member board of directors. Yingzhi Yang and Brenda Goh, “Beijing Took Stake and Board Seat in Key ByteDance Domestic Entity This Year,” Reuters, August 17, 2021; U.S. Securities and Exchange Commission, Form 20-F Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for Weibo Corporation Fiscal Year ended December 31, 2020, April 22, 2021, 87.
sound expectations for economic return; harnessing management control to enforce broad social and political agendas, or to accelerate the implementation of market structure reforms; using state-controlled firms to implement special social tasks; and, as recently seen, to influence or even control capital market volatility.\textsuperscript{14}

Additionally, governance institutions that serve as a check on corporate malfeasance or poor management in other economies, such as those of the United States, are purposefully weak or constrained in China, enabling the controlling shareholder to make decisions that may harm minority shareholders with impunity.\textsuperscript{15} For instance, China lacks institutional investors and advocacy organizations that act on minority shareholders’ behalf,\textsuperscript{9} not to mention a free press that could hold corporations accountable.\textsuperscript{16} This prevents shareholders’ coalitions from exercising oversight capacity in a manner similar to other economies.\textsuperscript{17} Capital market regulations also constrain hostile takeover bids (i.e., buying a controlling interest in a listed firm through share purchases) and place stringent restrictions on foreign ownership.\textsuperscript{18} For example, in public equities markets, foreign investors are barred from acquiring more than a 10 percent stake in a Chinese company, and combined foreign ownership cannot exceed 30 percent in aggregate.\textsuperscript{†}

\textbf{State Investment Is Widespread and Integral to Major Nonstate Firms’ Success}

Ownership and control of Chinese firms is complex and does not reflect the distinct categories recognized in corporate registration, namely state-owned versus nonstate.\textsuperscript{‡} Two primary challenges make it difficult to determine actual control of Chinese firms:

\textsuperscript{9}Most institutional investors in China are part of the state-controlled financial system, so even if they collectively obtained a controlling interest in a firm, they would still act on the state’s behalf Tamar Groswald Ozery, “Unraveling China’s Capital Market Growth: A Political Economy Account,” University of Michigan Law School, June 2019, 57–58.

\textsuperscript{‡}These foreign ownership restrictions have led some global investment index providers to modify their exposure to select Chinese securities. For example, in March 2019, MSCI announced it would remove Han’s Laser Technology Industry Group Co., a Chinese manufacturer of laser processing equipment used in the production of smartphones and other high-technology products, from its MSCI China indices, citing concern about approaching the foreign ownership limit. MSCI’s decision followed an announcement from the Hong Kong stock exchange that it would halt buy orders from overseas investors in Han’s Laser Technology Industry Group Co. through the Shenzhen-Hong Kong Stock Connect, as foreign ownership was nearing a 30 percent threshold set by Chinese regulators. China Securities Regulatory Commission Vice Chairman Fang Xinghai stated after the Han Laser episode that regulators do not plan to raise limits on foreign holdings in stocks. MSCI, “Standard Announcements—March 06, 2019,” March 6, 2019; Reuters, “China Halts Foreign Purchases of Shenzhen-listed Stock as Inbound Investment Surges,” March 5, 2019.

\textsuperscript{‡}Nonstate firms, literally called “privately operated enterprises” (民营企业), are defined under Chinese business regulations as “economic units invested in or controlled (by holding the majority of the shares) by natural persons who hire workers for profit-making activities.” In general, an SOE simply refers to a firm in which the state owns a majority of shares, with various Chinese government agencies employing different precise definitions according to their mandates. Chinese business regulations recognize a number of other corporate forms with exclusively domestic shareholders, including joint ventures (i.e., between an SOE and a nonstate Chinese firm), collectively owned enterprises, cooperative enterprises, joint-stock cooperative enterprises, limited liability companies, companies limited by shares, and “other.” Except for cooperative and collectively owned firms, the other types may be considered SOEs or nonstate firms depending on if the controlling shareholder is a natural person or an SOE or state agency. Firms with foreign shareholders (excluding publicly listed firms with foreign portfolio investors) have separate types of business entities, further divided by whether foreign shareholders are domiciled in Hong Kong, Macau, and Taiwan, or in other locations. Zhu Jianlong, “Understand the Identification and Classification of China’s SOEs in One Article” (一文看懂我国国有企业的认定与分类), Lantai Law Firm, April 21, 2020. Translation; China’s National Bureau of Statistics and China State Administration of Industry and Commerce, Notice on the Revision of the Regulations Regarding
1. **Ownership does not correlate with control because the state's influence exceeds its equity.** When the state is a majority owner but does not own 100 percent of a firm's shares, it still retains complete control over that firm's operations because Chinese law protects the majority shareholder's interests. This applies for the many SOEs that have sold minority stakes on China's domestic exchanges to raise capital. Of 1,490 companies listed on the Shanghai Stock Exchange at the end of the August 2019, 655 (or 44 percent) were more than 50 percent state owned. On the Shenzhen Stock Exchange, 523 (or 22 percent) of 2,377 listed companies were more than 50 percent state owned at the end of 2020. Additionally, as described above, the state can intervene in corporate affairs even as a minority shareholder. The state is increasingly a minority shareholder in nonstate firms for three reasons. First, when China initially allowed privatization of SOEs in nonessential sectors, such as manufacturing, the state often retained a minority stake. Second, many private firms have sought state investors to benefit from political and regulatory privileges afforded by becoming an SOE's subsidiary. Third, under General Secretary Xi, China's government is actively expanding its portfolio of investment in nonstate firms to fund technological development led by the nonstate sector, improve returns on state capital, and increase government influence over nonstate firms.

2. **Elaborate corporate structures often make it difficult to identify the majority owner of a Chinese company.** For instance, a company may be the ultimate majority owner of a second-tier subsidiary (i.e., a subsidiary of a subsidiary) through several affiliates that themselves only hold minority stakes in the subsidiary. In such a case, it would appear the company has no immediate majority shareholder, unless one examines two tiers of shareholding to discover the common owner across multiple minority shareholders. These sorts of relationships are common within large Chinese SOEs, many of which are sprawling conglomerates. Under this structure, a holding company often oversees operations for numerous subsidiaries segregated by function and geography. Generally, they oversee at least one listed firm that represents the public face of the conglomerate and includes its high-value assets. In addition, conglomerates often have separate financing arms that provide commercial and investment banking services solely to corporate group members, and possibly a number of research institutes. The publicly listed subsidiaries, financing arms, and research institutes are in turn often shareholders in a number of state and nonstate firms, adding complexity to the corporate structure and making ultimate ownership difficult to trace. Moreover, SOE managers often purposefully create multilayered corporate structures.

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*Unless otherwise specified, within this section a “subsidiary” refers to any firm that is partly owned by another state or nonstate firm (i.e., the parent company), regardless of the parent company’s ownership stake. In the United States, subsidiary generally connotes a controlling, or greater than 50 percent, ownership stake.*
in attempt to evade government oversight. In many cases, successful nonstate firms have similarly elaborate structures. Among other reasons, they have often had to form joint ventures with local SOEs across China to gain access to regional markets.

Nonstate Firms Benefit from State Investment

As the corporatized state sector has taken shape, firms in China’s nonstate sector have concurrently sought to bolster their political and legal position by partnering with SOEs and welcoming state investment. Outside of legal guarantees, China’s SOEs enjoy political favoritism in receiving licenses and bank loans, as well as priority allocation of contract awards and subsidies to implement state policy objectives. State capital has also been sheltered from private sector competition via administrative monopolies forbidding nonstate firms to operate in certain high-value industries, such as telecommunications. Given weak institutional protections for private property and nonstate firms versus robust protections and privileged market access for the state, successful growth as a nonstate firm has often required aligning with state priorities and seeking political support through SOE partners. For instance, Chery, currently China’s largest auto exporter, was only able to obtain a license to manufacture automobiles in the late 1990s by selling a 20 percent stake to state-owned Shanghai Automobile, making it an SOE’s subsidiary under Chinese law.

State investment has become an important determinant of success for non-state firms. In a 2020 study tracing state investment patterns in nonstate firms via Chinese corporate registry data, a team of economists led by Tsinghua University professor Chong-En Bai found that the largest nonstate firms are far more likely to have state shareholders than their smaller counterparts. Importantly, nonstate firms grew faster after receiving state investment, suggesting that partial state ownership was critical to their success. Furthermore, nonstate firms with state shareholders have become politically important shareholders themselves in other nonstate firms, as have their subsidiaries. Within China’s corporate landscape, there is consequently a hierarchy of nonstate firms based on proximity to the state as a shareholder. Notably, the trend of state investment in nonstate firms has increased substantially. Be-

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*In China’s central SOEs, holding companies are completely owned by the state and directly owned by SASAC. Corresponding provincial and local state-owned assets supervision and administration committees own and oversee state-owned conglomerates at the respective levels of government.


‡Within the study, registered capital is used as a proxy for firm size. Under China’s Company Law, firms must subscribe a certain amount of funds, called “registered capital,” at establishment, with different minimum amounts depending on sector. A firm’s registered capital is the maximum liability creditors may collect in event of default, so it signifies a company’s financial resources and is closely considered by potential creditors. Consequently, the amount of registered capital is typically determined by the amount of real business needs a firm undertakes, and it can form a rough gauge of a business’ size. Registered capital is often increased without issuing new shares as a business expands in order to signal the health of a business to creditors and potential business partners. Chong-En Bai et al., “Special Deals from Special Investors: The Rise of State-Connected Private Owners in China,” NBER Working Paper 28170, December 2020.

between 2000 and 2019, the proportion of non-state firms with a state shareholder increased from 9.9 to 15.3 percent.\textsuperscript{35}

\textit{Under Xi, China’s Government Is Becoming a More Active Investor in the Nonstate Sector}

While nonstate firms have sought state investment to overcome regulatory and political barriers for decades, under General Secretary Xi China’s government is actively promoting increased state investment in nonstate firms. The 18th Third Plenum decision, the economic policy blueprint laid out by General Secretary Xi in November 2013, envisions a fundamental shift in the nature of state ownership of assets. Previous plans conceived of the government as an active manager directing day-to-day operations of majority state-owned firms in a limited number of sectors. By contrast, the Third Plenum decision and supplementary policies envision the government transforming into a passive asset manager holding minority stakes in a far greater swath of China’s economy.\textsuperscript{36} Chinese policymakers are pursuing policies that blur the lines between state and nonstate companies.\textsuperscript{37}

This change in the Chinese government’s relation to nonstate firms reflects a search for alternative means to achieve goals policymakers have not been able to meet, either by active management of SOEs’ corporate operations or by regulating the nonstate sector. Foremost, SOEs have not delivered the contribution to economic growth or innovation sought by state planners. At the start of General Secretary Xi’s tenure in 2012, SOEs’ return on assets had shrunk to 3.1 percent compared to 5 percent in 2007.\textsuperscript{38} The inefficiency was particularly extreme in industrial enterprises,\textsuperscript{*} where nonstate firms’ return on assets was over 9 percent, more than double that of SOEs at 4.5 percent.\textsuperscript{39} Critical to China’s technology ambitions, the outgoing Hu-Wen government publicly recognized that its attempts to instill state-led innovation had largely failed.\textsuperscript{40} Rampant fraud and the inability of the central government to overcome local blocs of vested interests compounded both SOE inefficiency and lack of innovative capacity.\textsuperscript{41}

Additionally, China’s government is uncomfortable with its inability to anticipate and control market fluctuations, which are often exacerbated by state intervention in the first place. In particular, the government has far less visibility into financial conditions and other important information for the nonstate sector, particularly for firms in which the state is not a shareholder.\textsuperscript{42} The consequences of this limited visibility became apparent during the stock market bubble and subsequent crash in 2015. Leading up to the crash, Chinese regulators had poor understanding of internet finance platforms that circumvented the state-run banking system and had augmented margin trading, such as peer-to-peer lending.\textsuperscript{43} Caught unaware of the extent stock prices had been inflated by leverage, authorities likely triggered financial panic through a series of regulatory missteps intended to reduce leverage.\textsuperscript{44}

According to Harvard Business School professor Meg Rithmire, the expansion of Chinese government’s nonstate investment portfolio in response to these challenges has occurred through multiple channels and in fulfillment of at least three distinct policy objectives:

1. **The government is offering financing to the nonstate sector through government guidance funds.** These funds aim to position the state as a venture capital (VC) investor leveraging nonstate sector dynamism to meet technology development objectives. Such funds form a pillar of China’s strategy to achieve indigenization goals under Made in China 2025. For instance, the National Integrated Circuits Industry Development Investment Fund, launched in 2014, aimed to allocate $21 billion to close the gap between China’s domestic semiconductor fabrication capabilities and those of international leaders. The semiconductor fund, which has been the most high-profile example of such a fund to date, has failed to achieve this stated goal. The fund has focused on building foundries, but most of the fabrication technologies acquired in China’s semiconductor push are generations behind cutting-edge international equipment. In many cases, construction has been halted before facilities are complete, and those that are finished have neither adequate talent nor sufficient research budgets to keep pace with industry developments. Despite these setbacks, the fund has facilitated critical advances in China’s chip design and packaging capabilities, and government guidance funds constitute an important evolution of both industrial policy and state ownership. The funds are discussed in further detail later in this section.

2. **The government is acquiring stakes in nonstate firms to seek a return on state-owned assets through “mixed-ownership reform.”** Central to the Third Plenum decision’s blueprint for restructuring China’s state sector, mixed-ownership reform has attempted to improve the efficiency of China’s state sector by inviting private capital and managerial expertise into nonstrategic sectors, such as hotel chains and other services, while allowing China’s government to concentrate on managing the operations of a smaller number of SOEs in critical sectors of strategic importance, such as energy, telecommunications, and technologies prioritized under industrial policy initiatives. The state does not necessarily divest from nonstrategic sectors, but reduces its role in actively managing firms in these sectors, transforming the administrative agencies that oversee them into capital managers. In practice, the program has tilted much more heavily

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*Some scholars liken the intent of the revised compound role of China’s State-owned Assets Supervision and Administration Commission to Singapore’s state-owned holding company Temasek. The government of Singapore set up Temasek in 1974 to manage the city-state’s investments but maintained distance from the company's day-to-day business operations. Singapore’s government had taken minority shares in many domestic firms to indicate its own confidence in local companies in order to encourage foreign investment and developed the holding company structure in part to address foreign investor concerns regarding the Singaporean government’s conflict of interest as a dual shareholder and regulator of much of its economy. In practice, SASAC, the CCP, and other government agencies maintain far more involvement in Chinese SOEs’ affairs than Temasek exercises in its portfolio companies. Wei Jie and Nicholas Ng, “Comparative Corporate Governance: Why Singapore’s Temasek Model Is Not Replicable in China,” *International Law and Politics* 51:1 (Fall 2018), 211–250, 219–221; Weng Shiyou, Zhou Zhe, and Chu Chu, “Chen Qingtai: The Breakthrough is in Managing Capital” (陈清泰: 突破口是"管资本"), *Caijing Magazine*, September 14, 2015. Translation.*
toward increased state investment in the nonstate sector rather than vice versa.52

3. By purchasing stocks to stabilize market turbulence, the government has become a shareholder of many listed nonstate firms. Through the “national team,” a group of state shareholding funds under the guidance of the China Securities Regulatory Commission, China’s government has intervened extensively in China’s stock market to arrest market downfalls.53 The most large-scale example of the national team in action was during China’s stock market collapse in 2015. Acting in concert, the national team, China’s social security fund and many subnational pension funds, and many SOEs bought shares in companies to prop up prices. Goldman Sachs estimated the national team spent $234 billion (renminbi [RMB] 1.5 trillion)* in July and August 2015, and in November that year Financial Times reported the national team owned 6 percent of China’s stock market.54 Since the 2015 crash, the state has retained a substantial portion of its shares and continues to employ similar tactics at a smaller scale during other periods of market turbulence.55 Because minority ownership gives the state more visibility into the financial condition of the companies in which it holds shares, regulators view the national team and similar tactics as a financial risk management tool.56 It also gives the state potential avenues to exercise control via its special rights as a shareholder.

The Chinese government is also expanding investment in nonstate firms to strengthen influence over the nonstate technology sector. In April 2021, the state-backed Chinese Internet Investment Fund took a one percent stake worth $308,770 in a domestic operating unit of Chinese social media giant ByteDance. 57 As part of the deal, a Cyberspace Administration of China official also became a board member of the ByteDance subsidiary.58 The move coincided with a government campaign to check the growing influence and anticompetitive behavior of Chinese technology firms. Separately, in September 2021, Bloomberg reported several Beijing municipal government-owned companies were considering acquiring a stake in ridesharing firm Didi Chuxing.59 The reports followed heightened regulatory scrutiny of the firm’s data management practices in the wake of its initial public offering on the New York Stock Exchange. (For more on Chinese regulators’ actions against top technology firms and Chinese companies listed overseas, see Chapter 2, Section 1, “Year in Review: Economics and Trade.”)

Government Guidance Funds Attempt to Combine Policy Imperative and Profit Motive

In financing industrial policy initiatives, China’s government has rolled out government guidance funds that adopt elements of the VC funding model.† Guided but not actively directed by the Chinese

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*Unless noted otherwise, this section uses the following exchange rate throughout: $1 = RMB 6.43.
†An alternative investment class that is not listed on a public exchange, VC helps firms seeking to commercialize unproven technologies by providing “patient capital,” as opposed to stock investors that typically expect to see immediate profitability. This funding might be used to meet high upfront costs to launch capital-intensive operations, to maintain or scale up operations during the period before a firm establishes a sufficient customer base to cover its operating costs, or to
government, these funds are intended to function as public-private partnerships. The funds are sponsored by central or local government agencies and usually focus on a specific strategic sector, such as semiconductor manufacturing or artificial intelligence. The sponsoring government agency typically contributes 20 to 30 percent of the fund's target capital, then seeks to raise the balance from outside investors, including both nonstate firms and financial institutions as well as SOEs and the state financial sector.60

First introduced by local governments in 2000 and then established at the central government level in 2013, these funds have proliferated rapidly since the release of Made in China 2025 in spring 2015 and the Chinese government's sharpened focus on technological development.61 Between the end of 2014 and June 2020, the total funding scope* of government guidance funds grew from less than $100 billion to roughly $1.7 trillion (RMB 11.3 trillion).62 Research by Chinese economic consultancy Zero2IPO counted 1,741 government guidance funds across all levels of government as of the first quarter of 2020.63 Since 2018, formation and fundraising have slowed in response to both declining economic growth and Chinese policymakers' concern about wasted investment and opportunities for fraud.64

Compared to standard private equity and VC funds, government guidance funds have a few distinct features unique to China's state-led science and technology system. First, to incentivize participation by nonstate capital, guidance funds offer a number of potential benefits. For example, a guidance fund's government sponsor may forgo their own investment or interest income or assume other investors' losses.65 Second, where they might not provide the depth of industry expertise and connections available from top Silicon Valley funds, China's government guidance funds are often able to provide connections to other institutions and resources within China's research and development infrastructure. As Zachary Arnold, research fellow at Georgetown's Center for Security and Emerging Technology, detailed in testimony before the Commission, funds may coordinate with state-led technology incubators and industrial parks to provide access to facilities or work with talent and recruitment programs to help startups secure human capital.66 Finally, because guidance funds have a mandate to focus on strategic technologies rather than simply generating return, startups seeking their investment do not have to compete against less technologically advanced companies that might be able to demonstrate a more viable business model.67

By contrast, funding patterns in Silicon Valley have trended toward favoring consumer-facing companies with less innovative technology but a shorter timeline to profitability (for further discussion on expand a workforce to meet production demand. A key driver of VC funds' success is their ability to pick promising business models and technologies and to help the companies they invest in succeed. Aside from providing financing, private equity and VC investors are often involved in their portfolio companies' operations, offering managerial expertise, business connections, and technical acumen. Robyn Klingler-Vidra, “When Venture Capital is Patient Capital: Seed Funding as a Source of Patient Capital for High-growth Companies,” Socio-Economic Review (October 2016): 1–18.

*Funding scope refers to the target value in the articles of agreement creating the fund, and not all funds have actually raised the target amount. Once the funds are raised, it can take years to deploy them to suitable investments. Barry Naughton, “The Rise of China's Industrial Policy 1978–2020,” Center for Chinese-Mexican Studies of the School of Economics of the National Autonomous University of Mexico, 2020, 105–106.
government guidance funds’ role in the economy, see Addendum I: Government Guidance Funds Struggle to Overcome Limitations of Previous Industry Policies. 68

**Political Channels: CCP Committees’ Involvement in Corporate Governance Is Rapidly Increasing**

The Chinese government’s potential control over corporate activity through legal channels has limits, insofar as these channels are codified in law and must be exercised through formal mechanisms, such as a shareholder’s meeting. By contrast, the CCP exercises influence through a variety of channels that have no legal constraints, even if they have a legal basis. 69 Though they are often complex and operate without procedural checks and balances, many of these channels are nonetheless highly routinized within the CCP’s vast administrative apparatus.†

**The CCP Committee Gains Prominence in Corporate Governance and Market Regulation**

Changes in the CCP’s role both within individual firms and across China’s capital markets impact U.S. investors in China’s economy. Within firms, the CCP’s role and ability to exert influence is becoming more deeply entrenched through CCP committees, among other mechanisms. CCP committees take on three functions: (1) overseeing personnel appointments and management decision-making; (2) coordinating political and ideological education; and (3) monitoring the behavior of employees, for instance to report on corrupt practices. 69 These are all existing functions of the CCP administrative apparatus, but committees enhance the ability of the CCP to exercise these functions within firms by strengthening coordination between the committees and the larger Chinese government bureaucracy, as well as increasing CCP members’ accountability to the Party and their employing firms. 70

In addition to these traditional CCP functions, China’s 2015 Guiding Opinions on restructuring SOEs prioritize joint appointments for CCP committee members as board members and state that the head of the corporate board should be the company’s CCP secretary. 71 The document also positions the CCP committee as parallel to the board in granting it capacity to oversee and audit major decisions. 72 Companies are also amending corporate charters to elevate CCP committees: between 2015 and 2018, nearly 90 percent

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* For instance, CCP committees have a constitutional and legal basis. The CCP constitution establishes the requirement that any firm with at least three CCP members must have a CCP committee and grants the committee a monitoring role, while China’s Company Law prescribes a role for CCP committees in any company based in China. Unlike legal channels for state control, however, the constitutional and legal bases for CCP committees impose no constraints on their capacities. Tamar Groswald Ozery, “Unraveling China’s Capital Market Growth: A Political Economy Account,” *University of Michigan Law School*, June 2019, 120–121.

† Other informal channels such as quasi-government trade associations and unions also impact Chinese firms’ behavior and are deeply connected to the CCP. Additionally, other CCP channels traditionally focused on political influence, such as the United Front, are now being recruited to increase CCP outreach to private firms. This section confines its discussion to CCP influence over corporate decision-making and monitoring of capital markets. Jason Arterburn, written testimony for U.S.-China Economic and Security Review Commission, *Hearing on U.S. Investment in China’s Capital Markets and Military-Industrial Complex*, March 19, 2021, 9–10; People’s Daily, “General Office of the CCP Central Committee Issues ‘Opinions on Strengthening the United Front Work of the Private Economy in the New Era’” (中共中央办公厅印发《关于加强新时代民营经济统战工作的意见》), September 15, 2020. Translation.
of SOEs adopted the policy, and almost 6 percent of nonstate firms implemented similar changes despite not being required to do so.\textsuperscript{73}

Concurrently, the CCP is supplanting the role of the state bureaucracy in implementing policy and enforcing regulation within China's capital markets. As part of General Secretary Xi's nearly decade-long anticorruption campaign, the CCP is dispatching inspection tours to investigate potential fraud and corporate malfeasance within Chinese SOEs as well as high-profile, ostensibly nonstate enterprises, such as property development conglomerate Wanda Dalian.\textsuperscript{74} In executing this campaign, the CCP's Central Discipline Inspection Committee appears to establish cooperation with CCP committees within a conglomerate's subsidiaries, gathering evidence of potential misconduct through financial records and other documents through committee members.\textsuperscript{75} The campaign has systematically progressed through different industries, including energy, healthcare, the financial sector, and both nonstate and SOE commercial and offshore investment vehicles.\textsuperscript{76} China's leaders view this as a necessary step to combat widespread corruption and self-dealing within China's state sector and among listed firms.\textsuperscript{77}

Notably, this CCP-led enforcement receives high-level collaboration from state bureaucratic institutions, with SASAC and the banking and securities regulators assisting in confiscating documents, freezing bank accounts, and other measures.\textsuperscript{78} Where this cooperation may give the illusion of a legally valid process, the Discipline Inspection Committee operates extralegally, and state agencies are obliged to cooperate without due process under China's 2017 National Supervision Law.\textsuperscript{79} Despite creating the appearance of greater market integrity, increased reliance on the CCP to ensure regulatory compliance in place of state institutions marks a retrogression in China's capital market development.\textsuperscript{80} This dynamic could ultimately lead to markets that not only have the potential for CCP intervention via political channels but also depend on these channels to function.

China’s Corporate Social Credit System Seeks to Guide Commercial Behavior

China’s emerging corporate social credit system (CSCS)* equips the CCP with an economic channel of corporate control. Officially launched in 2014 with the release of the \textit{Planning Outline for the Construction of a Social Credit System (2014–2020)}, the CSCS comprises a network of central and local government data-gathering initiatives designed to centralize regulation of companies registered in China. Though still under development, it aims to provide China's government a nationwide system to monitor all aspects of corporate behavior and administer automated regulatory responses to keep companies in line with the CCP's governance objectives.\textsuperscript{81}


\textsuperscript{†}Chinese policy and regulation does not formally distinguish between the corporate social credit system and the social credit system more broadly, which applies to individuals as well as firms. Certain types of data collected apply only to companies or individuals, however, while other categories may apply to both. Li Wang, "New Defaulters' Blacklists Released, Seriously Untrust-
The CSCS also equips the Chinese government with a tool to ensure only companies deemed reliable by the Party are able to participate in the Chinese market. It focuses on aggregating government and corporate compliance data to create “corporate social credit files” on every legal entity in China. As government departments collect information on firms, they create “blacklists” of “untrustworthy” companies found to have violated government regulations and “redlists” of firms with exemplary records. In testimony before the Commission, Nazak Nikakhtar, former Assistant Secretary for Industry and Analysis at the U.S. Department of Commerce, explained that placement on a government department’s blacklist can subject companies to an array of punishments, including higher taxes or business licensing difficulties. Additionally, when a company is blacklisted by one government regulator, the blacklist record is included in the company’s corporate social credit file. This triggers scrutiny from other regulators and can effectively bar that company from participating in the Chinese economy more broadly. Such inducements enable the CCP to compel compliance with Chinese law and alignment with CCP policy priorities, including among foreign firms. In place of hard controls currently governing market access, such as investment restrictions, the CSCS provides a framework of incentives to manipulate domestic and foreign firms’ behavior within and beyond China’s borders.

CCP Committees Increase Their Presence within Nonstate and Foreign Firms

In addition to elevated power within SOEs, CCP committees have focused on expanding their presence from SOEs to all firms. Since 1925, the CCP constitution has required that any organization with three or more CCP members form a party unit, but in practice the units have not always been active in nonstate and foreign-invested enterprises in China. China’s leadership renewed systematic efforts to build CCP committees in nonstate enterprises in the wake of the global financial crisis. Since assuming power in 2012, General Secretary Xi has accelerated this trend, making greater CCP involvement and direction in nonstate affairs, including presence within nonstate and foreign firms, a pillar of Chinese governance. In 1998, a mere 0.9 percent of nonstate firms had CCP committees, a figure that rose to 16 percent by 2008. By 2013, committee presence in nonstate firms expanded to 58 percent, and by 2017 it…

worthy Entities Involved in the Financial Sector Includes 400 New Additions” (10月失信黑名单出炉 金融领域新增严重失信人400家), People.cn, November 12, 2018. Translation.

* China’s National Development and Reform Commission segments blacklist behavior into three categories: “generally untrustworthy,” “seriously untrustworthy,” and “particularly seriously untrustworthy.” Companies deemed “particularly seriously untrustworthy” may be those found to have harmed the public interest by, for example, violating food and drug safety regulations, engaging in contract fraud, and making false advertisements, among other things. Kendra Schaefer, “China’s Corporate Social Credit System: Context, Competition, Technology, and Geopolitics,” Trivium China (prepared for the U.S.-China Economic and Security Review Commission), November 16, 2020, 31.
reached 73 percent, accounting for 1.9 million firms, according to the CCP Organization Department.92 China’s government has placed special emphasis on increasing the CCP’s oversight of China’s major technology companies, with the Financial Times reporting in 2017 that more than 35 such companies had quietly instituted committees.93 A newspaper run by China’s Ministry of Human Resources and Social Security reported in 2018 that among roughly 15,000 internet firms in Zhejiang Province, home to e-commerce giant Alibaba, more than 65 percent had established CCP committees.94

In addition, the CCP is seeking to establish CCP committees within foreign firms.* In 2016, around 74,000 foreign enterprises in China, roughly 70 percent of the total, also had CCP committees, compared with 47,000 at the end of 2011.95 One 2017 Reuters investigation found CCP committees had been used to influence investment decisions by foreign-invested firms in China, with two major multinational firms, Samsung and Nokia, confirming the presence of Party units in their China operations.96 The Reuters investigation also found that a major U.S. consumer goods firm reported that its CCP committee had pressured the company to locate a new facility in an area where the local government was attempting to draw investment, and the company agreed.97

Anhui Province Shows CCP Expansion in the Nonstate Sector Is Systematic

Far from an ad hoc campaign, the CCP’s growing presence within the private sector is the result of multipronged and systematic political mobilization. In their 2017 study of the expansion of CCP committees, University of Hong Kong professor Xiaojun Yan and PhD candidate Jie Huang examine the CCP’s coordinated approach to Anhui, a major agricultural province and household appliance manufacturing hub on the Yangtze River.98 They trace four key steps the CCP took to rapidly increase the penetration of committees throughout the province’s nonstate sector beginning in 2012:

• Establishing a separate organization with the sole purpose of expanding CCP presence in the nonstate sector. Where private sector engagement used to be the purview of a subordinate department within the provincial CCP organizational department, Anhui’s CCP established a separate committee, the Nonstate Economic Organizations and Social Organizations Working Committee, devoted to increasing CCP presence in the nonstate sector.99 Granted greater

* China’s Company Law requires all companies based in China, both foreign and domestic, allow the establishment of Party units to “carry out the activities of the Party” and to provide “necessary conditions” for these units to function if these companies employ three or more Party members. It is difficult to assess the influence of Party organizations in foreign enterprises. This is because foreign businesses may be reluctant to report their existence or complain about them out of fear of provoking retaliation from the Chinese government. The U.S.-China Business Council (USCBC) reported in 2018 that the state-owned joint venture partners of some USCBC member companies have tried to modify articles of association to support Party units within the joint venture and elevate their role in managerial decisions. Nicholas Borst, “Party Committees in Chinese Companies,” Seafarer, June 2021; Jérôme Doyon, “Influence Without Ownership: The Chinese Communist Party Targets the Private Sector,” Institut Montaigne, January 26, 2021; Jake Laband, “Fact Sheet: Communist Party Groups in Foreign Companies in China,” China Business Review, May 31, 2018.
authority within the CCP administrative hierarchy, the new committee established liaison offices with state agencies responsible for nonstate sector oversight, such as the bureau of industry and commerce that handles corporate registration.* 100

- **Sending “Party building instructors” to nonstate firms.** Reminiscent of Mao-era campaigns that mobilized cadres throughout China to communicate new political doctrine, Anhui’s provincial CCP sent teams of cadres to guide nonstate firms in Party building, dispatching roughly 10,000 instructors in 2013 alone. 101 The instructors simultaneously helped nonstate firms manage administrative and political resources while strengthening CCP operations within firms. 102

- **Recruiting entrepreneurs and awarding prestigious CCP posts.** By 2015, the CCP estimated that 20 percent of all nonstate entrepreneurs and half of the largest company founders had joined the CCP ranks. 103 To further incentivize membership, the CCP in some instances provided prestigious political appointments to nonstate entrepreneurs, including membership in legislative bodies or leadership positions in trade organizations. 104 These appointments can afford entrepreneurs preferential policy treatment, access to information, and political protection. 105

- **Positioning the CCP as business-friendly.** To overcome suspicions that increased CCP presence in nonstate firms would lead to political interference or undermine managers’ authority, the CCP focused on cultivating an image of the CCP as business-oriented. 106 For instance, CCP committees encourage their members to work harder and more efficiently, and CCP propaganda aimed at the nonstate sector promotes the results of CCP “demonstration brigades” that contribute to firm financial performance through innovation or resolving operational challenges. 107

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**Implications for the United States**

The CCP’s expanding ability to monitor, exert influence over, and intervene in corporate affairs is fundamentally changing the nature of government–corporate relations in China. Where the government has always played an outsized role in directing the allocation of resources in China, the political and policy mechanisms of this direction were generally heavy-handed. By contrast, the evolving legal, political, and economic channels for government intervention under General Secretary Xi are more complex and nuanced. To date, the expansion of these channels appears largely motivated by the CCP’s desire for greater oversight into market conditions and attempts to

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*In 2018, these bureaus were superseded by the State Administration of Market Regulation and its provincial bureaus.*
steer the nonstate sector toward advancing policy objectives. Their existence nonetheless lays the groundwork for more drastic government intervention in China’s corporate sector, with the CCP gaining a greater authority to shape corporate actions of both domestic and foreign companies operating in China.

As U.S. financial integration with China increases, the Chinese governments’ complex and expanding presence in China’s business environment poses distinct commercial and security risks to the United States. The CCP’s quest for greater control over the economy is moving China further away from a rule of law system that protects and provides adequate due process for market participants. Further undermining China’s politically weak and insufficiently empowered institutions, the CCP is using political channels, such as its anticorruption campaign, to carry out market regulation. Rather than strengthening market integrity by improving bureaucratic professionalization and authority, this campaign-style enforcement attempts to bolster top-down control of market outcomes. To the extent it is successful, it risks creating the appearance of better regulated markets and further drawing in foreign investors, without achieving any underlying improvement to market regulation or investor protection.

The Chinese government’s extensive footprint in China’s corporate sector also increases the likelihood that foreign capital invested in China’s economy will ultimately fund Chinese government objectives, including activities that may counter U.S. interests. Moreover, numerous avenues for Chinese government oversight challenge conventional regulatory frameworks for assessing whether entities are acting on behalf of foreign governments. For instance, U.S. trade and investment screening procedures often assess government control or influence via equity ownership. Such analysis is less meaningful when evaluating Chinese investors or investment targets, however, as the government is afforded special controlling rights over any firms in which it invests, regardless of its ownership stake. Moreover, the CCP is expanding its influence in corporate decision making and regulatory enforcement via channels that are effectively above the law. Because the CCP seldom acts through legal mechanisms, the nature and extent of its role in a particular company’s affairs may be impossible to trace.
Addendum I: Government Guidance Funds Struggle to Overcome Limitations of Previous Industrial Policies

Despite their attempt to introduce market forces into capital allocation, China’s government guidance funds are ultimately constrained by many of the same limitations plaguing China’s earlier models for financing industrial planning. These include:

**Ignoring market fundamentals.** Local government guidance funds in particular have a track record of chasing trends and making poor investment decisions by responding to policy signals without adequate due diligence on both the quality of their investment targets and the market potential for their products.108

**Duplicating investment.** The rapid proliferation of funds means investment supply has quickly outstripped a volume China’s startup environment can absorb. This leads to duplicative investment, with every provincial government hoping to fund, for instance, biotech start-ups with similar products or services, when natural market demand can support far fewer than the number receiving funding.109 Additionally, given the number of funds launched, demand for skilled investment managers far exceeds the available pool of talent.110

**Failing to raise funding.** Some of China’s past industrial policies have faltered as unfunded mandates, with the central government directing local governments or agencies to raise funding for implementation they ultimately could not find. Similarly, many guidance funds never find outside investors to raise their target funding amounts.111 Of a target size of $1.6 trillion (RMB 11 trillion), guidance funds had only raised just under $700 billion by early 2020.112

**Lacking appropriate investment avenues.** Even if they are fully funded, sometimes funds never find qualifying firms in which to invest, leaving the capital idling in bank deposits.113 Investment managers may overlook promising start-ups because they are too risky to meet the high fiduciary obligations for investments made with state capital.114 In other cases, viable start-ups may simply not exist in the sectors and geographies that government guidance funds intend to target. Because many government guidance funds are raised by provincial and local governments, they often aim to make investments in local firms, sometimes explicitly with the intent of drawing start-ups to a city to generate tax revenue.115 For instance, wealthy eastern provinces Guangdong and Zhejiang respectively require funds to deploy 60 and 80 percent of their capital locally, while coastal city Fuzhou requires all investments must be made within its province, Fujian.116 Despite guidance funds having raised $700 billion, there were only about $130 billion in total VC and non-venture private equity deals in China during 2020.117

**Fraud and self-dealing.** A chief reason for mediocre results in past state-led investment is rampant fraud and officials directing funds toward private gain, rather than advancing the goals of the state. Despite General Secretary Xi’s perpetual crackdown on corruption, government guidance funds introduce new channels for
fraud by entrusting government funds to investors that might not be part of the state bureaucracy and CCP personnel system (as SOE managers are), and thus are subject to less direct oversight and lighter penalties for appropriating state assets.
ENDNOTES FOR SECTION 3

Investments by QFIIs and RMB QFIIs” (关于实施《合格境外机构投资者和人民币合格境外机构投资者境内证券期货投资管理办法》有关问题的规定QFIIs), September 25, 2020, 5. Translation.


41. Tai Ming Cheung et al., “Planning for Innovation: Understanding China’s Plans for Technological, Energy, Industrial, and Defense Development,” University of California Institute on Global Conflict and Cooperation (prepared for the U.S.-China Eco-


