

**THE FOREIGN INVESTMENT CLIMATE IN CHINA:
PRESENT CHALLENGES AND POTENTIAL FOR REFORM**

HEARING
BEFORE THE
U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED FOURTEENTH CONGRESS
FIRST SESSION

WEDNESDAY, January 28, 2015

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**UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW
COMMISSION**

WASHINGTON: 2015

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the “Consolidated Appropriations Resolution, 2003,” Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of the Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the “Consolidated Appropriations Act, 2008,” Public Law No. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December); as amended by the Carl Levin and Howard P. “Buck” McKeon National Defense Authorization Act for Fiscal Year 2015, P.L. 113-291 (December 19, 2014) (regarding responsibilities of the Commission).

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

March 16, 2015

The Honorable Orrin Hatch

President Pro Tempore of the Senate, Washington, D.C. 20510

The Honorable John A. Boehner

Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR HATCH AND SPEAKER BOEHNER:

We are pleased to notify you of the Commission's January 28, 2015 public hearing on "the Foreign Investment Climate in China: Present Challenges and Potential for Reform." The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a) and amended by Pub. L. No. 113-291, Section 1259 B) provides the basis for this hearing.

At the hearing, the Commissioners received testimony from the following witnesses: Maureen K. Ohlhausen, Commissioner, Federal Trade Commission; Mark A. Cohen, Special Counsel, U.S. Patent and Trademark Office; Robert D. Atkinson, Ph.D., President, Information Technology and Innovation Foundation; Dan Harris, Founder/Partner, Harris Moure; Written statement from Oded Shenkar, Ph.D., Ford Motor Company Chair in Global Business Management, The Ohio State University; Abbot (Tad) Lipsky, Jr., Partner, Latham & Watkins; Xiao-Ru Wang, Ph.D., Principal, Charles River Associates; William Kovacic, Global Competition Professor of Law and Policy and Director, Competition Law Center, George Washington University Law School; Written statement from Gil Kaplan, Partner, King & Spalding; Lucille Barale, Visiting Professor, Georgetown University School of Law; Joshua Eisenman, Ph.D., Assistant Professor, University of Texas at Austin, Lyndon Johnson School of Public Affairs and Senior Fellow for China Studies, American Foreign Policy Council; and Scott Kennedy, Ph.D., Deputy Director, Freeman Chair in China Studies and Director, Project on Chinese Business and Political Economy, Center for Strategic and International Studies. The hearing assessed the most recent and pressing challenges facing foreign firms operating in China, with a spotlight on China's Anti-Monopoly Law enforcement, and the potential for China's planned reforms to create a more transparent, cooperative, and fair environment for foreign investors.

We note that prepared statements for the hearing, the hearing transcript, and supporting documents submitted by the witnesses are available on the Commission's website at www.USCC.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2015 Annual Report that will be submitted to Congress in November 2015. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Reed Eckhold, at (202) 624-1496 or via email at reckhold@uscc.gov.

Sincerely yours,



Hon. William A. Reinsch
Chairman



Hon. Dennis C. Shea
Vice Chairman

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THE FOREIGN INVESTMENT CLIMATE IN CHINA: PRESENT CHALLENGES AND POTENTIAL FOR REFORM

WEDNESDAY, JANUARY 28, 2015

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in Room G-50 of Dirksen Senate Office Building, Washington, DC at 8:30 a.m., Chairman William A Reinsch and Commissioners Daniel M. Slane (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF CHAIRMAN WILLIAM A. REINSCH HEARING CO-CHAIR

CHAIRMAN REINSCH: Good morning everybody, and welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2015 Annual Report cycle. We're starting off in fine style in this magnificent enormous room. I don't think we're going to have an SRO crowd but, in any event, we're glad you're here, and you're all welcomed.

We also encourage our audience to attend other hearings throughout the year. Speaking of which, our next hearing will be on February 18, and it will examine China's space and counterspace programs. Future hearing topics this year include China-Central Asia relations, China's offensive missile forces, and China's 13th Five-Year Plan.

More information about the Commission, its Annual Report, and its hearings is available on the Commission's Web site at www.USCC.gov.

Today's hearing will seek to assess the most recent and pressing challenges facing foreign firms operating in China with a spotlight on China's Anti-Monopoly Law enforcement. This hearing will also seek to evaluate the potential for China's planned reforms to create a more transparent, cooperate and fair environment for foreign investors.

Throughout 2014, foreign companies across the United States, Europe and Asia have issued a growing number of complaints with regard to the operating environment in China. Some of their concerns, like stiffer competition from Chinese companies and rising labor costs, are routed in China's slowing economic growth.

Perhaps more distressing are recent complaints from foreign businesses with regard to their treatment by Chinese regulators. As reported by numerous business groups this year, their concerns range from increased scrutiny and regulatory enforcement to procedural and due process shortcomings.

Some foreign companies worry that increased Chinese regulatory

activities have seemed to focus disproportionately on foreign investors, putting them at a disadvantage compared to domestic firms.

However, we note there are differing views to be considered in evaluating China's implementation and enforcement of rules governing foreign investment, some of which we look forward to hearing today.

To help us better understand the complexity of this issue, we are joined by a number of experts from the administration, industry, legal and academic fields. We look forward to hearing from each of you.

Let me now turn to the hearing co-chair, Commissioner Dan Slane, for his opening remarks, and then I'll introduce the administration panel.

Dan.

**PREPARED STATEMENT OF CHAIRMAN WILLIAM A. REINSCH
HEARING CO-CHAIR**



U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

***Hearing on the Foreign Investment Climate in China:
Present Challenges and Potential for Reform***

**Opening Statement of Chairman William A. Reinsch
January 28, 2015
Washington, DC**

Good morning, and welcome to the first hearing of the U.S.-China Economic and Security Review Commission's 2015 Annual Report cycle. As this year's Chairman, I want to thank you all for joining us today. We appreciate your attendance and we encourage you to attend our other hearings throughout the year.

Our next hearing on February 18 will examine China's space and counterspace programs. Future hearing topics this year include China-Central Asia relations, China's offensive missile forces, and China's 13th Five-Year Plan. More information about the Commission, its annual report, and its hearings is available on the Commission's website at www.USCC.gov.

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Let me now turn to hearing co-chair Commissioner Dan Slane for his opening remarks.

**OPENING STATEMENT OF COMMISSIONER DANIEL M. SLANE
HEARING CO-CHAIR**

HEARING CO-CHAIR SLANE: Thank you, Chairman Reinsch, and good morning to everyone.

I'd like to begin by thanking Senator Deb Fischer and the Senate Rules Committee for securing this room for us today.

One of our panels this morning will seek to evaluate China's implementation and enforcement of its Anti-Monopoly Law. By international standards, antitrust laws should protect competition by preventing undue concentration of market power and abuse of market dominance. While China has indeed used its Anti-Monopoly Law to achieve this goal, foreign firms and business groups have complained that China's recent enforcement activities appear to promote the country's industrial policy goals at the expense of foreign firms.

Over the last year or so, foreign companies have been forced to cut prices or cap technology licensing fees without conclusive evidence of anticompetitive conduct under threat of investigations to the benefit of Chinese national champions in strategic industries.

The resulting environment does not protect competition but rather promotes protectionism and discrimination.

Today, our expert witnesses will help shed light on the role of international policy and other noncompetitive factors in China's enforcement and implementation of the Anti-Monopoly Law and other laws affecting foreign investments.

We also will discuss how U.S. and China's regulatory authorities are working together to bring China's antitrust enforcement closer in line with international legal standards.

We will hear from experts on the first three panels before adjourning for a lunch break at 12:45. After lunch, we will reconvene in this room at 1:45 for the final panel, which will focus on the impact of China's recent and planned reforms on the foreign investment regime.

Finally, I'd like to thank members of our staff, Lauren Gloudeman and Paul Magnusson, for their hard work on pulling this hearing together. I'll now turn to the Chairman to introduce the administration's panel.

**PREPARED STATEMENT OF COMMISSIONER DANIEL M. SLANE
HEARING CO-CHAIR**



U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

**Hearing on the Foreign Investment Climate in China:
Present Challenges and Potential for Reform**

**Opening Statement of Commissioner Daniel Slane
January 28, 2015
Washington, DC**

Thank you, Chairman Reinsch, and good morning, everyone. I would like to begin by thanking Senator Deb Fischer and the Senate Rules Committee for securing this room for us today.

One of our panels this morning will seek to evaluate China's implementation and enforcement of its Anti-Monopoly Law. By international standards, antitrust law should protect competition by preventing undue concentrations of market power and abuse of market dominance. While China has indeed used its Anti-Monopoly Law to achieve this goal, foreign firms and business groups have complained that China's recent enforcement activities appear to promote the country's industrial policy goals at the expense of foreign firms.

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**ADMINISTRATION PANEL INTRODUCTION BY CHAIRMAN WILLIAM A.
REINSCH**

CHAIRMAN REINSCH: Thank you.

In our first panel this morning, we'll discuss U.S. government engagement with China on its Anti-Monopoly Law enforcement activities, as well as the impact of China's intellectual property policies on its enforcement of competition law.

We're pleased to welcome Maureen Ohlhausen, who was sworn in as a Commissioner of the Federal Trade Commission on April 4, 2012. Prior to joining the FTC, Commissioner Ohlhausen was a partner at Wilkinson Barker Knauer where she focused on FTC issues, including competition law, privacy and technology policy.

She previously served at the FTC for over a decade, most recently at that time as Director of the Office of Policy Planning where she led the FTC's Internet Access Task Force.

Next we welcome Mark Cohen. Mr. Cohen serves as Senior Counsel to the U.S. Patent and Trademark Office. He rejoined USPTO as Advisor to the Under Secretary and later as Senior Counsel for China in the Office of Policy and International Affairs in 2012 after serving as a visiting professor at Fordham Law School.

Prior to that time, he served as Director, International Intellectual Property Policy at Microsoft, Of Counsel to Jones Day's Beijing office, and Senior Intellectual Property Attaché at the U.S. Embassy in Beijing.

In total, he has over 30 years private, public sector, in-house and academic experience in China and transition economies with a principal focus on technology trade and intellectual property.

So we have two people here who are clearly experts in the field and also well-placed by virtue of their current assignments to take up today's topic. We're honored to have both of you here and look forward to your testimony. We are hoping to have you confine yourselves to seven minutes each. Your full statements will be put in the record, and then that will leave plenty of time for questions.

Commissioner Ohlhausen, we'll start with you, and then we'll do Mr. Cohen next, and then we'll have questions after you both conclude. Go ahead.

**OPENING STATEMENT MAUREEN K. OHLHAUSEN
COMMISSIONER, FEDERAL TRADE COMMISSION**

MS. OHLHAUSEN: Good morning. Thank you to the Commission for inviting me to testify today, though I do want to mention that my remarks are just my own and not those of the Federal Trade Commission.

I want to focus my remarks this morning on China's AML enforcement and some of the recent developments spurred in part by continued engagement of U.S. officials with their Chinese counterparts as well as with prominent Chinese academics and practitioners.

Over the last few years, we've seen a significant ramp-up in Chinese antitrust enforcement, including against Western companies, which has highlighted many of the differences between the Chinese regime and others in the world.

A number of critics, including American businesses, claim that China is using its antitrust law to promote industrial policy and domestic competitors. Because China is a leading global economic power, however, it is in our mutual interest to find a way to move forward harmoniously and fruitfully.

It is for these reasons that I have made engagement with China a top priority. Since becoming a commissioner, I've traveled to China five times, participated in bilateral talks with the Chinese here in the United States, and hosted top Chinese enforcers on several occasions. In these discussions, I've repeatedly extolled the values of predictability, fairness and transparency in enforcement and outlined six actionable goals for competition agencies:

First, competition-based factors should guide policy and enforcement decisions;

Second, industrial organization economics should form the foundation for agency actions;

Third, competition regimes should abide by commonly-accepted best practices including those developed by voluntary organizations like the International Competition Network, or ICN;

Fourth, competition agencies should afford parties fundamental due process, including the right to a defense, the right to local and international counsel of their choosing, notification of the legal and factual basis of an investigation, and meaningful engagement with agency staff and decision-makers;

Fifth, transparency into agency analyses and actions is critical for promoting self-regulation and honoring due process rights of parties;

Sixth, and finally, competition agencies should cooperate with their counterparts internationally.

During my discussions in and about China, people have told me that while the Chinese look to more mature competition agencies for guidance, they are focused on creating an enforcement program with "Chinese characteristics." Over time, I've come to realize that "Chinese

characteristics" may include, as a practical matter, relying on non-competition factors to examine mergers, acquisitions and conduct with an eye to promoting domestic industry.

In fact, China's AML, itself said to have Chinese characteristics, explicitly provides for the consideration of non-competition factors such as protecting social public interest and promoting the healthy development of the socialist market economy.

With respect to merger review in particular, the AML provides that when reviewing a transaction, China's Ministry of Commerce, or MOFCOM, should consider factors such as the influence of the concentration of business operators on national economic development.

In addition, Chinese characteristics could mean encouraging immediate economic gains by extracting additional value from intellectual property by reducing the protection of intellectual property rights, particularly the right of exclusion. We are hearing a lot of criticism of Chinese actions in these areas.

Importantly, and on a positive note, we appear to be seeing a serious response to U.S. government engagement by Chinese enforcers that could signal improvement in their approach to these issues. It's also appropriate to recognize that the concerns with AML enforcement in China are not unique. Many new antitrust regimes face limits on staff and their experience, as is the case in China, although with China the importance of our economic relationships makes getting past these limitations all the more important.

Let me elaborate a few minutes on each of these points. As I mentioned a minute ago, China's AML expressly provides for consideration of non-competition factors. As I'm sure you'll hear later today, many observers and industry participants believe that the Chinese government has enforced the AML to promote and protect Chinese industry in certain cases.

The U.S. Chamber of Commerce and the U.S.-China Business Council issued critical reports a few months ago on the state of competition enforcement in China.

A second topic of concern is China's approach to issues at the intersection of the antitrust and intellectual property laws, including licensing practices and standard-essential patents. I believe in strong intellectual property protection to promote innovation and consumer gains in any country. China has been exploring how to apply the AML to intellectual property rights. It appears to be moving to a system that favors short-term economic gain from reduced intellectual property protections, including the right to exclusion and to fair compensation based on free negotiation of licensing terms and marketplace competition.

For instance, MOFCOM has reached merger settlements in recent years in which it has mandated Fair, Reasonable and Non-Discriminatory, or FRAND, commitments on patents that are not essential to an industry standard. This is different from our practice in the U.S.

In addition, at a policy level, the State Administration for Industry and

Commerce, SAIC, has been working on IP guidelines similar to those the FTC and DOJ issued in the 1990s and seeking public comments.

Some aspects of these proposals reflect international norms. For example, SAIC removed a suggestion in an early draft that patent pools, which are typically evaluated under the rule of reason here, are presumptively unlawful.

Other features of the proposed rules could serve to devalue IP rights, however, which will be felt most acutely by IP-intensive Western businesses. For example, SAIC intends to apply the essential facilities doctrine to intellectual property rights, a doctrine that has faced serious criticism by the Supreme Court in the United States and has yet to be applied to patents anywhere in the world.

In addition, many people are concerned about SAIC's proposals to impose liability on a patentee based on royalty terms it demands on essential patents, including patents not voluntarily contributed by the owner to a standard setting body.

This would expand liability to patentees not subject to FRAND licensing obligations commonly imposed by standard-setting bodies on contributed technology that becomes part of the standard.

Moreover, China has elsewhere taken a similar view of imposing FRAND requirements on SEP holders in other policies and rules. As FTC Chairwoman Ramirez pointed out in a speech last year, imposing liability on patent holders who have not made a FRAND commitment or premising antitrust liability solely on royalty terms, for example, excessive pricing in the absence of any evidence of hold-up, is a break from practice at the FTC, the DOJ and Europe.

My experience dealing with Chinese officials provides me with three insights that may help the government and business to engage them effectively over the coming years.

First, continued dialogue and cooperation at all levels of the federal government can have a positive impact. Thus, for example, this past year's U.S.-China Joint Commission on Commerce and Trade, or JCCT, resulted in Chinese commitments of increased ability of counsel to attend meetings with the AML enforcement agencies, more transparent penalty procedures, and competition-based remedies.

These results would not have come about without continuous and determined engagement by federal officials on these issues. This is a notable advance, and it is merely one example of the FTC's cooperation with other U.S. government agencies.

More broadly, the U.S. antitrust agencies' dialogue with China's antimonopoly enforcers and others stretches back to before the AML was passed. Since the AML's passage, we've conducted a robust program of technical assistance to share with China's new enforcers our best substantive and procedural practices for antitrust enforcement.

We've also established a regular senior-level dialogue through a memorandum of understanding with China's three AML enforcement

agencies. The combination of these engagements, we believe, has contributed significantly to putting much of China's AML enforcement on the right track even if concerns continue regarding aspects of that enforcement.

A second insight I can offer is that shining a light on discrepancies or biases in Chinese enforcement or competition policies can also be effective. In response to the Chamber report, the Chinese antitrust agencies' heads responded with a joint press conference. They argued that their processes are fair, transparent and follow regulations, and, of course, this press conference was followed by the commitments made at the JCCT. These actions suggest to me that China's enforcers want to be accepted internationally as serious and disciplined, and indeed their enthusiasm for engaging with the FTC and DOJ, both in China and the United States, and attentiveness to our experiences suggest a serious commitment to gaining international acceptance.

A third and final lesson that I can share today is that American enforcers need to be very clear about the reasons underlying our decisions. We must remember that we have an audience in China that can easily misunderstand, misinterpret or even misuse our actions when they are unclear.

I think our goal should be to carefully explain our decisions and avoid making decisions that could be perceived as protectionist to prevent the possibility of misunderstanding or misuse.

Thank you, and I look forward to your questions.

**PREPARED STATEMENT OF MAUREEN K. OHLHAUSEN
COMMISSIONER, FEDERAL TRADE COMMISSION**



United States of America
Federal Trade Commission

***Hearing on “The Foreign Investment Climate in China:
U.S. Administration Perspectives on the Foreign Investment Climate in China”***

**Testimony of Maureen K. Ohlhausen¹
Commissioner, Federal Trade
Commission**

**before the U.S.-China Economic and Security Review
Commission Dirksen Senate Office Building
Washington, DC 20510**

January 28, 2015

Good morning. Thank you to the Commission for inviting me to testify today. I want to focus my remarks this morning on China’s AML enforcement and some of the recent developments spurred in part by continued engagement of U.S. officials with their Chinese counterparts as well as with prominent Chinese academics and practitioners. Over the last few years we have seen a significant ramp-up in Chinese antitrust enforcement, including against Western companies, which has highlighted many of the differences between the Chinese regime and others in the world. A number of critics, including American businesses, claim that China is using its antitrust law to promote industrial policy and domestic competitors. Because China is a leading global economic power, however, it is in our mutual interest to find a way to move forward harmoniously and fruitfully.

It is for these reasons I have made engagement with China a top priority. Since becoming Commissioner, I have traveled to China five times, participated in bilateral talks with the Chinese here in the United States, and several months ago hosted top Chinese enforcers for an informal breakfast in conjunction with the ABA Antitrust Spring Meeting. In these discussions, I have repeatedly extolled the values of predictability, fairness, and transparency in enforcement and outlined five actionable goals for competition agencies: ***First***, competition-based factors should guide policy and enforcement decisions. ***Second***, industrial organization economics should form the foundation for agency actions. ***Third***, competition regimes

¹ The views expressed in these remarks are my own and do not necessarily reflect the views of the Federal Trade Commission or any other Commissioner.

should abide by commonly-accepted best practices, including those developed by voluntary organizations like the International Competition Network or “ICN.” **Fourth**, competition agencies should afford parties fundamental due process, including the right to a defense, the right to local and international counsel of their choosing, notification of the legal and factual basis of an investigation, and meaningful engagement with agency staff and decision makers. **Fifth** transparency into agency analyses and actions is critical for promoting self-regulation and honoring due process rights of parties. **Sixth**, and finally, competition agencies should cooperate with their counterparts internationally.

During my many discussions in and about China, people have told me that while the Chinese look to more mature competition agencies for guidance, they are focused on creating an enforcement program with “Chinese characteristics.” Over time, I have come to realize that “Chinese characteristics” may include, as a practical matter, relying on non-competition factors to examine mergers, acquisitions, and conduct with an eye to promoting domestic industry. In fact, China’s Anti-Monopoly Law or “AML,” itself said to have Chinese characteristics, explicitly provides for the consideration of non-competition factors such as protecting “social public interest” and “promoting the healthy development of the socialist market economy.”² With respect to merger review in particular, the AML provides that when reviewing a transaction, China’s Ministry of Commerce, or “MOFCOM,” should consider factors such as “the influence of the concentration of business operators on the national economic development.”³ In addition, Chinese characteristics could mean encouraging immediate economic gains by extracting additional value from intellectual property by reducing the protection of intellectual property rights, particularly the right of exclusion. We are hearing a lot of criticism of Chinese actions in these areas.

Importantly, and on a more positive note, we appear to be seeing a serious response to U.S. government engagement by Chinese enforcers that could signal improvement in their approach to these issues. It is also appropriate to recognize that the concerns with AML enforcement in China are not unique. Many new antitrust regimes face limits on staff and their experience, as is the case in China, although with China the importance of our economic relationship makes getting past these limitations all the more important. Let me elaborate for a few minutes on each of these points.

I. Application of Non-Competition Factors

As I mentioned a minute ago, China’s AML expressly provides for consideration of non-competition factors. Subsequent to passage of the AML, the Legislative Affairs Commission of the NPC Standing Committee issued a doctrine known as the “Three Musts,” to guide enforcement of Article 4 of the AML.⁴ This doctrine includes a directive for the state to

² Art. 1, China Anti-Monopoly Law (effective Aug. 1, 2008), available at http://www.china.org.cn/government/laws/2009-02/10/content_17254169.htm.

³ *Id.* at Art. 27.

⁴ Translation of Legislative Affairs Commission, *Interpretation of the Anti-Monopoly Law of the People’s Republic of China*, Law Press China (2008) at 4, as found in U.S. Chamber of Commerce, *Competing Interests in China’s Competition Law Enforcement: China’s Anti-Monopoly Law Application and the Role of Industrial Policy* at 24 (Sept. 9, 2014) (quoting same), available at

implement competition rules consistent with the socialist economy. These “musts” include bearing “in mind the requirements to enlarge and strengthen, concentrate and improve the market competitiveness of our enterprises, [and] macro-coordinate the relations between anti-monopoly and the implementation of national industrial policies....”⁵

As I am sure you will hear later today, many observers and industry participants believe that the Chinese government has enforced the AML to promote and protect Chinese industry in certain cases. The U.S. Chamber of Commerce and the U.S.-China Business Council issued critical reports a few months ago on the state of competition enforcement in China. According to the USCBC report, “[C]oncerns raised by international observers during the AML drafting process – such as the role of industrial policy considerations in competition reviews, lack of due process, and insufficient transparency – remain relevant based on China’s initial enforcement efforts.”⁶

II. Antitrust and Intellectual Property

A second topic of concern is China’s approach to issues at the intersection of the antitrust and intellectual property laws, including licensing practices and standard essential patents. I believe in strong intellectual property protection to promote innovation and consumer gains in any country. As the U.S. Supreme Court has said, strong intellectual property protection creates “an incentive to inventors to risk the often enormous costs in terms of time, research, and development. The productive effort thereby fostered will have a positive effect on society through the introduction of new products and processes of manufacture into the economy....”⁷

China has been exploring how to apply the AML to intellectual property rights. It appears to be moving to a system that favors short term economic gain from reduced intellectual property protections, including the right to exclusion and to fair compensation based on free negotiation of licensing terms and marketplace competition. For instance, MOFCOM has reached merger settlements in recent years in which it has imposed “Fair, Reasonable, and Non-Discriminatory” or FRAND commitments on patents that are not essential to an industry standard. This is different from our practice in the United States.

In addition, at a policy level, the State Administration for Industry & Commerce (SAIC) has been working on IP guidelines similar to those the FTC and DOJ issued in the 1990s⁸ and seeking public comments. Some aspects of the proposals reflect international norms. For example, SAIC removed a suggestion in an early draft that patent pools, which typically are evaluated under the rule of reason here, are presumptively unlawful.⁹ Other features of the

https://www.uschamber.com/sites/default/files/aml_final_090814_final_locked.pdf [hereinafter Chamber Report].

⁵ *Id.*

⁶ The U.S.-China Business Council, *Competition Policy and Enforcement in China*, 5 (Sept. 2014), available at <http://uschina.org/reports/competition-policy-and-enforcement-china>.

⁷ *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 480 (1974).

⁸ U.S. Dep’t of Justice and Fed. Trade Comm’n, *Antitrust Guidelines for the Licensing of Intellectual Property* (1995), available at <http://www.justice.gov/atr/public/guidelines/0558.htm>.

⁹ American Bar Association Section of Antitrust Law, Section of Intellectual Property Law, and Section of International Law, *Joint Comments on the SAIC Draft Rules on the Prohibition of Abuses of Intellectual Property Rights for the Purposes of Eliminating or Restricting Competition* 6, July 9, 2014, available at

proposed rules could serve to devalue IP rights, however, which will be felt most acutely by IP-intensive Western businesses. For instance, SAIC intends to apply the essential facilities doctrine to intellectual property rights, a doctrine that has faced serious criticism by the Supreme Court in the United States and has yet to be applied to patents anywhere in the world. In addition, many people are concerned about SAIC's proposals to impose liability on a patentee based on royalty terms it demands on essential patents, including patents not contributed voluntarily by the owner to a standard setting body. This would expand liability to patentees not subject to FRAND licensing obligations commonly imposed by standard-setting bodies on contributed technology that becomes part of a standard. Moreover, China has elsewhere taken a similar view of imposing FRAND requirements on SEP holders in other policies and rules. As FTC Chairwoman Ramirez pointed out in a speech last year, imposing liability on patent holders who have not made a FRAND commitment or premising antitrust liability solely on royalty terms, for example "excessive pricing" in the absence of any evidence of hold-up, is a break from practice at the FTC, the DOJ, and Europe.¹⁰

III. Effective Federal Responses

My experience dealing with Chinese officials provides me with three insights that may help the government and business to engage them effectively over the coming years. First, continued dialogue and cooperation at all levels of the federal government can have a positive impact.

Thus, for example, this past year's U.S.-China Joint Commission on Commerce and Trade (JCCT) resulted in Chinese commitments of increased ability of counsel to attend meetings with the AML enforcement agencies, more transparent penalty procedures, and competition based remedies. These results would not have come about without continuous and determined engagement by federal officials on these issues. This is a notable advance, and it is merely one example of the FTC's cooperation with other U.S. government agencies.

These are issues that I and my colleagues and staff at the FTC, along with the Antitrust Division at DOJ, have regularly raised in our dialogue with Chinese officials. In fact, the staffs of our two agencies were directly and closely involved in the drafting and discussions with China regarding these outcomes during the JCCT. Indeed, these commitments to take steps to improve the fairness of China's AML enforcement procedures, including greater transparency and improved opportunities for parties to defend themselves, is welcome and one of the most important improvements China (or any country) can make to enhance the legitimacy of its antitrust enforcement activities.

More broadly, the U.S. antitrust agencies' dialogue with China's antimonopoly enforcers and others stretches back to before the AML was passed, when we consulted with officials at China's State Council and National People's Congress regarding the draft law and ways to

http://www.americanbar.org/content/dam/aba/administrative/antitrust_law/at_comments_201407saic.authcheckdam.pdf.

¹⁰ Edith Ramirez, Chairwoman, Fed. Trade Comm'n, *Standard-Essential Patents and Licensing: An Antitrust Enforcement Perspective* 8-9 (Sept. 10, 2014), available at http://www.ftc.gov/system/files/documents/public_statements/582451/140915georgetownlaw.pdf.

make it more consistent with international norms. Since the AML's passage we have conducted a robust program of technical assistance to share with China's new enforcers our best substantive and procedural practices for antitrust enforcement and have frequently submitted comments on draft implementing rules. We also established a regular senior-level dialogue through a memorandum of understanding with China's three AML enforcement agencies. The combination of these engagements we believe has contributed significantly to putting much of China's AML enforcement on the right track, even if concerns continue regarding aspects of that enforcement. For example, our dialogue has helped to move China towards international best practices, including its decision last year to enact fast track rules for simple merger transactions, which in its first several months has greatly reduced the typically lengthy time for merger reviews for a sizable percentage of transactions. Similarly, as I mentioned above, SAIC's draft IP and AML rules have moved in many respects towards approaches consistent with those used in the U.S., likely a result of comments we, along with our colleagues in other agencies of the U.S. government, have provided to SAIC.

Second, shining a light on discrepancies or biases in Chinese enforcement or competition policies also can be effective. In response to the Chamber report, the Chinese antitrust agency heads responded with a joint press conference. They argued that their processes are fair, transparent, and follow regulations.¹¹ And, of course, this press conference was followed by the commitments made in December at the JCCT that in many ways reflected the characterizations of Chinese enforcement practices made by the antitrust agency heads. These actions suggest to me that China's enforcers want to be accepted internationally as serious and disciplined. Indeed, their enthusiasm for engaging with the FTC and DOJ, both in China and in the United States, and attentiveness to our experiences in enforcing our antitrust laws suggests a serious commitment to gaining international acceptance. In addition, I know that there are enforcers and other influential voices within China that want to see domestic enforcement that is in line with international norms.

A third, and final, lesson that I can share today is that American enforcers need to be very clear about the reasoning underlying our decisions. We must remember that we have an audience in China that can easily misunderstand, misinterpret, or even misuse our actions when they are unclear. For example, the FTC concluded a couple of matters in late 2012 and early 2013, including with respect to *Google/Motorola Mobility* in which we placed restrictions on the ability of patentees holding SEPs to seek injunctions.¹² My concern with those actions, in part, was that we could send the wrong message to our foreign counterparts that we do not place a very high value on intellectual property rights and that we did not give enough explanation about why those cases are the exception rather than the rule.

During a conference I attended in China, I heard a presentation on the U.S. and Chinese

¹¹ Michael Martina & Xiaoyi Shao, *Update 2-China's Antitrust Regulators Defend Probes; Qualcomm Inquiry Nearly Over* REUTERS (Sept. 11, 2014) available at <http://www.reuters.com/article/2014/09/11/china-antitrust-idUSL3N0RC2MY20140911>.

¹² See *In re Robert Bosch GmbH*, FTC File No. 121-0081, *Decision and Order*, at 13-14 (Nov. 26, 2012) [hereinafter *Bosch D&O*], available at <http://www.ftc.gov/os/caselist/1210081/121126boschdo.pdf>; *In re Motorola Mobility LLC and Google Inc.*, FTC File No. 121-0120, *Decision and Order*, at 6-12 (Jan. 3, 2013), available at <http://ftc.gov/os/caselist/1210120/130103googlemotorolado.pdf>.

antitrust laws and the FTC's decision in *Google/Motorola Mobility* came up. The lecturer argued that the

U.S. has a strong essential facilities doctrine and then drew a line from this supposed precedent, including the FTC's *Google/Motorola Mobility* decision, and similar European decisions, to the Chinese Anti-Monopoly Law and other Chinese laws that prohibit unreasonable refusals to deal as to essential facilities. He argued that the FTC's action meant that an "unreasonable" refusal to grant a license for an essential patent to a competitor should constitute monopolization under the essential facilities doctrine. The remedy, he implied, should be compulsory licensing (presumably on favorable terms to the licensee) because that would be the best way to facilitate competition among the licensees. This presenter did not in my opinion state accurately the law in the United States, but may have read the law as he wanted to see it or through a lens I do not entirely understand. Either way, it drove home the point that enforcers and others within China are likely to advocate a version of antitrust enforcement that suits their own national economic interest and is grounded in their own cultural and legal norms. I think our goal should be to carefully explain our decisions and avoid making decisions that could be perceived as protectionist to prevent the possibility of misunderstanding or misuse.

I look forward to your questions. Thanks.

**OPENING STATEMENT OF MARK A. COHEN
SPECIAL COUNSEL, U.S. PATENT AND TRADEMARK OFFICE**

CHAIRMAN REINSCH: Thank you.

Mr. Cohen.

MR. COHEN: Thank you very much. I'd like to thank the Commission for inviting the U.S. Patent and Trademark Office to testify today.

My name is Mark Cohen. I'm the Senior Counsel on China at the USPTO, and I propose to discuss IP abuse, IP enforcement and licensing, and the role of the USPTO. Due to time limitations, I refer the Commission to my written statement for further information.

Many observers may find China's current political emphasis on IP abuse a bit hard to swallow. Whatever the definition of IP abuse in the Anti-Monopoly Law, another kind of IP abuse that companies face involves difficulties in protecting their IP. In other words, an IP rights holder cannot abuse its IP rights unless the holder can have sufficient IP rights to protect.

In the attachment to my submission are two charts that demonstrate this type of IP abuse. As shown in Chart 1, the average damage award in a patent infringement lawsuit in China is about \$10,000. This is hardly enough to compensate for infringement of a valuable invention. By comparison, in the U.S., we're talking about \$5 million or more average damages; in Europe, a little less than one million, just to give you a sense of the order of magnitude of the difference.

The second issue is the difficulty in licensing to China. Chart 2 shows total payments from China to the U.S. for royalties of various kinds. In 2012, this totaled approximately--U.S. dollars--five billion.

Chart 3 in the appendix shows the total royalty payments from China to the U.S. [sic] for this same period, about \$10 billion.

As these charts suggest, the U.S. receives only 50 percent of the revenue from China on royalties compared to that received from Japan, yet China exports four times more high-tech goods than Japan, which suggests it may be significantly under-licensed in high-tech IP.

Put another way, China's payments of royalties accounted for 3.6 percent of total U.S. royalties for industrial processes and software in 2012 while China accounted for 19.2 percent of global high-tech exports in the same year. This suggests a highly under-licensed environment, and I'd be happy to provide this data to the Commission in the written submission or supplement.

Reflecting these concerns, the U.S. government has repeatedly asked Chinese authorities to increase the legitimate sale of IP-intensive goods and services and to affirm that their antitrust efforts are intended to encourage competition and not protect individual competitors or industries.

The enforcement and licensing of IP rights has also been of long concern in China. Today a disparity is emerging between the damages

awarded in antitrust investigation and the damages awarded in IP matters, which casts doubt on how much China values IP. As noted, average damages from patent litigation in China are about \$10,000 per year, but IP-related antitrust issues in China have caused proposed mergers to fall apart and have resulted in threats of a billion or more dollars in damages, literally thousands of times average damages for patent infringement.

These kinds of disparities can encourage prospective licensees in China to continue to infringe and risk an adverse judicial decision in China while at the same time proactively launch a Chinese Anti-Monopoly Law case for even greater damages in appropriate circumstances.

China's increasingly dominant role as a consumer of technology or, hopefully, a purchaser of technology has made this a critical issue for many of our technology companies. I'd like to read to the Commission one excerpt I found just yesterday from a report from the Chinese Patent Office, the State Intellectual Property Office, which underscores these issues with regard to Qualcomm, which is reportedly under an antitrust investigation.

I quote: "Although in recent years Chinese enterprises have seen substantial growth in patents in the field of communications with the advantages that come from quantity, but in key areas such as mobile phone chips, Qualcomm still has the core intellectual property, and it is providing Chinese telecom equipment and consumer electronics companies technology licenses and patents, and by doing so charging exorbitant licensing fees in China."

This paragraph discusses the frustration over the patent rents China has to pay to manufacture what is over 70 percent of the world's smartphones and the problem it faces of having quantitative but not qualitative achievements in patents, including a concern about China's "patent strength," which is a key concern to the State Intellectual Property Office.

I find the characterization of licensing fees by a patent office as "exorbitant" in advance of any antitrust determination by the relevant antitrust authorities to be an odd role for a patent office. This type of language could lead foreign companies and countries to be concerned about how fairly the Chinese government may be treating them in antitrust or IP matters.

The manner in which the balance is tilted against the foreign licensors has led many, including one Chinese academic, to realize that in its current IP transfer regime, quote, "licensors' interests appear to be insufficiently taken into account."

This is overwhelmingly a licensee-oriented IP antitrust environment. We hope changes can be made in this regime soon.

At the USPTO, we are concerned about policies that make it difficult to license into China as well as onerous legal provisions that are imposed on the foreign licensor.

An example of this is the regulatory provision that requires the foreign licensor to indemnify a Chinese licensee against third-parties who sue for infringement, in effect, turning a foreign licensor into an insurance

company.

I would close now by responding to the Commission's questions about how we cooperate with other agencies. The PTO is perhaps the agency with the longest history in dealing with international IP issues and technology transfer, dating back to 1846 when we helped Samuel F.B. Morse license his telegraphy technology in Austro-Hungary.

Our China Team, which I lead, consists of 21 lawyers and support personnel, many bilingual and bi-cultural, in Washington, D.C. and three cities in China. I also served as the first USPTO IP attaché when I was posted to the embassy in China at the invitation of then Ambassador Randt, and, as noted, I have over 30 years' experience in Chinese law and IP.

While the PTO itself and my team helps develop IP policy, it obviously has no Anti-Monopoly Law enforcement authority. For this reason, we take an active role in exchanging views and coordinating with our sister agencies, like the FTC, and expressing our concerns through the cooperative relationships we have established in China.

The PTO is currently planning a joint program on IP licensing with China's Patent Office where we hope to air many of the concerns I just mentioned.

We also have developed a China Resource Center to support a more data-driven approach to understanding China's IP environment. We're also an active participant in the JCCT and co-chair the IPR Working Group under that body. This past December, the JCCT included an important bilateral outcome, which we just heard about, on Anti-Monopoly Law, but it also included outcomes in related areas such as standards, licensing, intellectual property, legitimate sales of IP-intensive goods and services, abusive IP litigation, and judicial cooperation, all of which can have significant impact on China's AML environment.

Members of the Commission, we strongly support China's effort to develop an antitrust regime consistent with the practices of other market economy countries. We also strongly support efforts to improve the protection of private property rights, including IP rights, in China. However, we are concerned that China's economy, including in its IP regime, may not be fully market driven, which we believe needs to be acknowledged and discussed with our Chinese colleagues.

Thank you, and I welcome your questions.

**PREPARED STATEMENT OF MARK A. COHEN
SPECIAL COUNSEL, U.S. PATENT AND TRADEMARK OFFICE**

Statement of

Mark A. Cohen

Special Counsel

United States Patent and Trademark Office

Before the

The U.S.-China Economic and Security Review Commission

Hearing on the Foreign Investment Climate in China:
Present Challenges and Potential for Reform

January 28, 2015

I would like to thank the Congressional Security Commission for inviting the U.S. Patent & Trademark Office (PTO) to testify today on “The Foreign Investment Climate in China: Present Challenges and Potential for Reform”, particularly in this “Administration Panel: Assessing the Interface Between China’s Competition and Technology Licensing Policies.” My comments will focus on questions four and five raised of this group:

“How do China’s intellectual property (IP) policies impact its AML enforcement? And

How does the U.S. government handle the interface between IP and AML policy and enforcement? How do U.S. agencies monitor the economic impact of China’s IP policies, including the impact of these policies on AML enforcement?”

I will discuss, in particular, the relationship between the anti-monopoly law and the IP system in China generally; application of the anti-monopoly law to address IP abuse; problems in obtaining IP rights in China that may contribute to the anti-monopoly environment; difficulties in IP enforcement and licensing; and the role of the PTO with respect to these issues.

The Anti-Monopoly Law/IP Relationship in China

China’s experience in IP-related issues has deeply, and perhaps uniquely, informed its perspective on antitrust issues generally. There are jurisdictional, personnel and legislative overlaps. For example, China’s specialized IP tribunals and courts handle antitrust litigation. China’s State Administration for Industry and Commerce, which handles non-price-related abuse-of-dominance cases, also has jurisdiction over trademarks, trade secrets, consumer protection and trade-dress cases. MofCOM Director General Shang Ming, who currently handles mergers, was formerly in charge of IP matters when he was the Director General of Law and Treaties at the Ministry of Commerce where he defended China on an IP-related WTO case brought by the United States. Many of China’s antitrust related laws also built upon pre-existing laws, regulations, and rules, which have significant IP components. These laws include

the Anti-Unfair Competition Law, which contains measures to protect trade secrets and trade dress and the Contract Law, which deals with “monopolization of technology.”¹ China is not unique in its building upon its IP experience to address antitrust issues. For example, the only World Trade Organization (WTO) treaty governing IP – the Agreement on Trade-Related Aspects of Intellectual Property Rights or TRIPs Agreement – is also the only WTO treaty that specifically addresses antitrust enforcement, particularly in the case of abusive practices in licensing of intellectual property.²

Like recently-enacted IP legislations, enactment of China’s Anti-Monopoly Law regime was considered a milestone in China’s efforts to develop a market economy. Unfortunately, China also has a rather long legacy of laws designed to “shake up” the economy – among them, the patent law, bankruptcy law, income tax law, property law, and now the Anti-Monopoly Law. Yet, each of these laws is also intended to implement China’s constitutional mandate to develop a “socialist market economy.”³ Many would view this as an oxymoronic concept. I, instead, view it as a restriction on the impact of these laws in having their intended effect, and a necessary instruction regarding how and why we engage China on these laws.

To those of us who have long been involved in IP, many of the concerns that we hear today – for example, involving transparency, representation of counsel at proceedings, and national treatment of foreigners – have a long history in IP-related issues.⁴ What is more important perhaps is that much as IP has informed China’s Anti-Monopoly Law development, it is likely to remain a significant part of China’s Anti-Monopoly Law enforcement activities in the years ahead.

IP Abuse and the Anti-Monopoly Law

Article 55 of China’s Anti-Monopoly Law addresses IP abuse. This article provides as follows:

This Law does not govern the conduct of business operators to exercise their intellectual property rights under laws and relevant administrative regulations on intellectual property rights; however, business operators' conduct to eliminate or restrict market competition by abusing (or misusing) their intellectual property rights are governed by this Law.

This article is puzzling, and has been the subject of considerable debate. For example, does this law provide a safe harbor? What constitutes “IP abuse”? How does this law affect other laws that regulate competition?⁵

Many observers may find China’s current political emphasis on “IP abuse” a bit hard to swallow. Whatever the definition of “IP abuse” in Article 55 of the Anti-Monopoly Law and related regulations and rules, another kind of “IP abuse” in China today that both Chinese and foreign companies face involves the difficulties they face in obtaining, enforcing, and commercializing one’s IP rights in a society with sometimes unpredictable legal norms and with what often appears to be undue political influence. In other words, an IP rights holder cannot abuse its IP rights unless the holder can have IP use. Inability to commercialize license or enforce patents or

¹ Article 329 of Contract Law

² See, e.g., TRIPs Agreement, Articles 8 and 40.

³ Constitution of the PRC, Article 15; See, also, also the relevant Chinese IP laws e.g., Patent Law, Art. 1, Trademark Law Article 1.

⁴ Mark A. Cohen, “How an IP Lawyer Sees China’s Progress in Competition Law”, in *International Antitrust Law & Policy* (2011 Competition Law Institute (pp. 537-555) (Fordham Competition Law Institute, 2012)

⁵ Harris, Wang, Zhang, Cohen and Evrard, Antimonopoly Law and Practice in China, at 216 (Oxford University Press, 2011).

other IP rights is IP abuse in a more fundamental sense. What kind of abuse is \$10,000 worth of infringement damages? We have been encouraging China for 35 years to establish an IP system that is fully compatible with international norms and that protects IP as a private right. That task is unfinished, and the challenges that companies face in protecting their IP rights should necessarily inform China's antimonopoly policy makers.

Let me give you two snapshots of what this type of "IP abuse" means in current terms, and how it might relate to China's Anti-Monopoly Law efforts: (1) the low patent infringement damages and (2) the low royalty payments that the U.S. receives from China.

As shown in Chart 1 in the Appendix, in 2012, the last year for which relatively complete data is available, the average damage award in a patent-infringement law suit in China totaled about RMB ¥52,000 – roughly USD \$10,000. Initial data for 2013 suggests that patent-infringement damages will average around RMB ¥99,000 RMB – about USD \$20,000. The most cases were reported in 2011, with damages at ¥62,160. These are considerably less than average damages in either Europe or the United States. Most importantly, they are likely not enough to compensate an inventor for infringement of a valuable invention in the Chinese market.

This information is drawn from a private database of about 31,000 cases (www.ciela.cn); unfortunately, the Chinese Government does not release any similar data publicly. Higher damages in 2008 and 2009 were likely due in part to certain high-profile cases, and may be considered outliers. Many of the high profile judgments at this time were also against foreigners. The second issue I would like to talk about is the difficulty in achieving legitimate sales of IP rights in China. Chart 2 in the Appendix shows total payments from China to the United States for royalties of various kinds.⁶ In 2012, this totaled approximately USD \$5 billion.

Chart 3 in the Appendix shows total royalty payments from Japan to the United States for the same period: about USD \$10 billion.

As these charts suggest, the U.S. receives only 50% of the revenue from China compared to that received from Japan. However, this is likely to change. The recently released Action Plan for Further Implementation of the National IP Strategy indicates that China has a goal of increasing its revenues from royalties and franchise fees for proprietary rights from 1.36 billion USD in 2013 to 8 billion USD in 2020.

Another data point to consider: According to the latest World Bank data, China exports four times more high-tech goods than Japan.⁷ Indeed, our understanding is that China today produces over 70% of the cell phones used worldwide.⁸ If one assumes that high-tech goods are a useful surrogate to measure a country's "consumption" of IP rights, it is easy to see that China is a severely under-licensed country. Indeed, China's dominance as a purchaser of technology has led at least one Chinese antimonopoly law academic to note that in China's current IP transfer legislative regime "licensor's interests appear to be insufficiently taken into account."⁹

⁶ The licensing royalty data in the charts is based on US International Trade data released by Bureau of Economic Analysis (BEA). Specifically, the licensing royalty data is based on the International Trade of Services in the category of "Charges for the use of intellectual property"

(<http://www.bea.gov/iTable/iTable.cfm?reqid=62&step=1#reqid=62&step=7&isuri=1&6210=4&6200=161&6211=168>). Older licensing royalty data (for the years of 2004 to 2008) is also referred to in the USITC's 2010 report on "China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy" (<http://www.usitc.gov/publications/332/pub4199.pdf>). The USITC's 2010 report, on page 2-11, also noted the low licensing royalty payments that the United States receives from China.

⁷ World Bank data on high-technology exports, <http://data.worldbank.org/indicator/TX.VAL.TECH.CD>

⁸ <http://www.theatlantic.com/china/archive/2013/08/chinas-dominance-in-manufacturing-in-one-chart/278366/>.

⁹ Wang Xiaoye, *Evolution of China's Antimonopoly Law*, at 227 (Edward Elgar Publishing, 2014).

At the PTO, we often hear anecdotally and from surveys that US companies are reluctant to license in China due to its weak IP environment or restrictive licensing conditions. There is some empirical data that also supports this. For example, the US China Business Council recently ranked IP enforcement as its number two business concern facing US business in China.¹⁰ Moreover, survey data shows that foreign companies are reluctant to use Chinese law as a governing law for technology contracts, preferring instead to choose foreign law where possible, perhaps out of a similar concern over enforcement challenges and onerous statutory provisions.¹¹

For many years, industry and government officials have also expressed concerns about the Chinese government being actively engaged in forced technology acquisition, trade secret theft, and/or “indigenous innovation” policies that are intended to support China’s industrial policies. These issues have further compounded U.S. concerns over IP infringement and difficulties in selling IP-intensive goods and services. Today many companies are concerned that they may be unable to manufacture or sell their products on competitive terms due to preferential policies of the Chinese government and/or state owned or supported enterprises that favor domestically innovated products. These concerns over industrial policies may also cause one to question whether foreign enterprises will be treated fairly in China based on market principles in Anti-Monopoly Law matters. Reflecting these concerns, USG has repeatedly asked Chinese authorities, in a variety of fora, to affirm that their antitrust efforts are intended to encourage competition and not protect individual competitors or industries.¹²

Obtaining IP Rights in China

China’s patent office, the State Intellectual Property Office (SIPO), is the largest patent office in the world. In 2013, it received 2,377,061 patent applications. SIPO’s application docket is also about four times the number of applications received by the Patent and Trademark Office. Most of the patents filed in China are of Chinese origin. Historically, China has had a more domestically oriented patent office in terms of origin of applications than the United States. In some areas, such as utility-model and design patents, well over 95% of its patent applications originate from Chinese applicants.

The PTO enjoys a good, cooperative relationship with SIPO. Both agencies share many common challenges such as handling increasingly complex patent applications; attracting and retaining talented examiners; and maintaining high patent quality. China has emerged as a critical stakeholder in the global IP system.¹³ Many foreign companies find that SIPO handles its patent applications expeditiously and fairly. Of course, there are areas where we would like to see improvement. However, in general, except for patent practices in certain areas, such as those in the pharmaceutical sector, China does not show any unusual tendencies in this key IP

¹⁰ See <http://uschina.org/reports/uscbc-2014-china-business-environment-survey-results>

¹¹ See <http://chinaipr.com/2014/06/19/choice-of-law-in-ip-contracts-with-china-a-sleeper-issue/>

¹² See, e.g., Joint Fact Sheet on 25th Joint Commission on Commerce and Trade, competition outcome (<http://www.commerce.gov/news/fact-sheets/2014/12/29/us-china-joint-fact-sheet-25th-joint-commission-commerce-and-trade>), and press release of the Sixth Strategic and Economic Dialogue “In response to concerns of U.S. companies and government officials regarding enforcement of China’s Anti-Monopoly Law, China recognized that the objective of competition policy is to promote consumer welfare and economic efficiency, rather than to promote individual competitors or industries, and that enforcement of its competition law should be fair, objective, transparent, and non-discriminatory.” (<http://www.treasury.gov/press-center/press-releases/Pages/j12563.aspx>).

¹³ See *China as an IP Stakeholder*, David Kappos, Under Secretary of Commerce for Intellectual Property and Director of the USPTO, 2012 (http://www.uspto.gov/blog/director/entry/china_as_an_ip_stakeholder)

“building block”, particularly in the high-technology sectors.

There is one area, however, where policies that support China’s patent system may have contributed to a kind of self-induced frustration on IP and technology-related issues. Unlike other more economically developed countries, China’s IP is perceived to have low commercial value. The Chinese national and local governments have adopted numerous policies to encourage domestic companies to obtain patents in China. These policies include the following: subsidies for patent-application filings; rewards or awards for patent grants; the granting of tenure (to a university professor) based on the number of patent filings; obtaining a valuable municipal residence permit (a *hukou* in Mandarin Chinese) based on patent filings; commutation of prison sentences for prisoners who file patents¹⁴; and promotion of government officials based on achieving numerical patent quotas. The result has been an explosion in patent applications and grants. Many of these patents, such as utility-model and design patents, are likely of low quality because they are not substantively examined. Some of these patents may even involve trade secrets misappropriated from a former employer, or copying of competitors’ designs or technology. These patents may not reflect market-driven innovation, but are responsive to government incentives. The data shows that China is aggressively patenting, but it may not always be innovating. This lack of demonstrable qualitative achievement in its IP system must be frustrating for Chinese leaders, who have failed to see commercial results from their IP policies, and may lead them to pursue policies in order to achieve greater commercial uptake of China’s patents and IP rights.

These kinds of policies can also lead to litigation problems for U.S. companies. While many of these patents are of low quality, they do have litigation value to Chinese patent “cockroaches” (similar to patent “trolls” in the United States) which have been filing abusive litigation lawsuits, often against U.S. companies, based on low-quality and subsidized patents, without concern for compensating victims for anti-competitive activity. Chinese regulators should address this issue by establishing mechanisms to disincentivize abusive patent litigation, if China desires fair IP and antitrust regimes.

IP Enforcement

The enforcement of IP rights is the second critical building block that has long been of concern in China. Damages in patent cases are too low to compensate most innovations. In fact, a remarkable disparity appears to be emerging between the damages awarded in antitrust investigations and the damages awarded in IP matters, which casts further doubt on how much China values IP rights (or how much it may overvalue antitrust). As noted, average damages from patent litigation in China range from USD \$10,000 to \$20,000 per year. But IP-related issues have been significant enough to cause major proposed mergers to fall apart (beverage makers Huiyuan and Coca-Cola), or have resulted in multimillion-dollar antitrust liability (e.g., Huawei/InterDigital, amongst others), and there is speculation that fines against Qualcomm could exceed one billion dollars,¹⁵ or more than 20% of total US technology exports in 2013, and as much as fifty thousand to a hundred thousand times average damages for patent

¹⁴ See <http://www.scmp.com/news/china/article/1681850/how-get-out-jail-early-china-buy-inventors-idea-and-patent-it>

¹⁵ See, e.g., China Reportedly Wrapping Up Qualcomm Investigation; Hefty Fines Expected *San Diego Business Journal*: <http://www.sdbj.com/news/2014/dec/29/china-reportedly-wrapping-qualcomm-investigation-h/> (Dec. 29, 2014)

infringement. This kind of disparity might easily encourage a prospective licensee in China in appropriate circumstances (such as involving a standards essential patent, discussed below) to consider the potential benefits of continuing to infringe and risk an adverse Chinese judicial decision while at the same time pro-actively launch a Chinese anti-monopoly law case for even greater damages than royalties that are being asked of by the prospective licensor.

As with China's Anti-Monopoly Law regime, administrative agencies have conducted most of China's IP enforcement, and they historically have not been transparent. However, significant improvements have been made in recent years.¹⁶ We hope that these experiences, including more comprehensive reporting on cases, compilation of case data, and publishing of model or guiding cases, can take place in the Anti-Monopoly Law context so that these cases can guide litigants. Our experience has also been that the IP tribunals and newly established specialized IP courts, which also have jurisdiction over AML cases, have demonstrated increasing professionalism and expertise in IP-related matters. However, the IP experience has also shown that both the courts and administrative agencies are not yet independent. Interference from Communist Party organs, local government, and the court's own "adjudication committees" have been concerns in IP matters. We hope that reforms recently announced in the Fourth Plenum and by Supreme People's Court President Zhou Qiang will help address some of these concerns. Another key concern in enforcing IP rights in China is the problem of infringers' delays in taking licenses. This is particularly acute during the standards setting process. To explain this concern, let me first very briefly describe what standards are, why they are important, and the voluntary process used to develop standards that we use every day. Standards, and particularly voluntary consensus standards set by standards-developing organizations (SDOs), have come to play an increasingly important role in our economy. In much of the world, the development of a technological standard occurs according to a voluntary, consensus based process, in which participants select a set of technological solutions to a given problem, often including technologies protected by patents, which can be deemed "standards essential patents" when they are necessary to implement the standard. Standard setting participants typically agree in advance to general guidelines governing any obligations of participants to license any essential patents to parties wishing to implement the standard on F/RAND (or fair/reasonable, and non-discriminatory) terms. The main concern many U.S. companies face in China arises when Chinese companies delay in taking a license on FRAND terms, but the licensor has limited enforcement options because it is practically unable to obtain appropriate damages from IP courts in China. In addition there is the possibility that Chinese companies, usually implementers of the standard, delay in taking a license on FRAND terms and claim that the licensor is abusing its rights in violation of the FRAND commitment in high stakes Chinese anti-monopoly law litigation. . In other words, we are concerned that licensee Chinese companies view licensor foreign companies' willingness to license as unilateral – only restricting the terms of the license while not requiring the licensee to enter into timely good faith negotiation. Companies may seek to minimize these risks by bringing litigation outside of China. An example of this is a recent case in India involving a Chinese company, where the licensor took action outside of China, possibly to minimize these risks and that this problem described above.¹⁷

¹⁶ See, e.g., Through A Glass Less Darkly – China's March to Administrative Enforcement Transparency, at <http://chinaipr.com/2013/11/24/through-a-glass-less-darkly-chinas-march-to-administrative-enforcement-transparency/>. /

¹⁷ Xiaomi Face Phone Ban In India Over Erickson Patent Suit, <http://www.networkworld.com/article/2858554/xiaomi-faces-phone-ban-in-india-over-ericsson-patent-suit.html>

This delay is further exacerbated by China's patent law which has a two-year statute of limitations to initiate a patent infringement action. In the United States, we have a six-year period to initiate a patent infringement action. Taiwan, Brazil, Japan, South Korea, and Germany all have longer periods. Unless another exemption applies, a U.S. company seeking to license its technology to China must initiate potentially costly litigation within that two-year period.

We believe that prospective Chinese licensees should negotiate FRAND licensing agreements in good faith. We have engaged our Chinese colleagues on this important issue, and will continue to do so.

Licensing of IP Rights

This brings me to the "licensing" of IP rights, the third building block of China's Anti-Monopoly Law and IP regime. Like the Department of Justice and Federal Trade Commission, China's antitrust regulators have statutory authority to investigate possible anticompetitive conduct, including that involving IP licensing transactions. However, the ability to license technology is an important trade-related concern, and which is of interest to the Department of Commerce, the Office of the U.S. Trade Representative, as well as the numerous U.S. government agencies that have cooperative research and development projects in China.

At the PTO, we encourage our other agency colleagues to support U.S. efforts to monetize technology in China's markets. We are concerned about restrictions on U.S. companies' ability to license their technology. Several of these restrictions already have been mentioned, for example: weak damages for infringement; short statutes of limitations; and excessive government interference in the market. One particular regulation is especially troubling -- China's Technology Import and Export Regulations, which the Ministry of Commerce enforces, requires that a company licensing a foreign technology indemnify a Chinese licensee against third parties who sue for infringement. The specific language is as follows:

*If the use of the technology provided by the licensor by the licensee of a technology import contract in accordance with the contract infringes upon the lawful rights and interests of another person, the responsibility shall be borne by the licensor.*¹⁸

This provision is mandatory. Its violation, arguably, might entail a claim for "monopolization of technology" under Article 329 of the Contract Law. By comparison, licensors of Chinese technology are not subject to any explicit indemnification requirement.¹⁹

Consider this provision in the context of the current cell-phone patent "wars" that are occurring throughout the world. It would be foolish for a technology licensor to offer any kind of indemnity in these circumstances. However, Chinese law requires it for technology import. This provision effectively turns a license agreement into an insurance contract. As another example, consider the explosion of low-quality, unexamined utility-model patents in China. Today, very few companies can afford to undertake comprehensive freedom-to-operate analyses of all patents applied for or granted in China, due to sheer magnitude and thus may be reluctant to license their technology if they need to offer this type of indemnity.

China has other onerous provisions in its licensing regime. For example, it also requires that the licensee own improvements to any technology that is licensed, as part of these same technology-

¹⁸ Article 24(3) of China's Technology Import and Export Regulations.

¹⁹ Agreements regarding the export of Chinese technology are covered by Article 353 of China's Contract Law, which allows parties to negotiate liability for third-party infringement claims.

transfer regulations. There is no similar requirement under U.S. law. In essence, a foreign technology licensor is creating a competitor through this mandatory provision, in the form of a legalized forced technology transfer.

Another critical area involves the relationship between the state's involvement in licensing and IP. U.S. firms, for example, complain that they may be prohibited from participating in core aspects of standards-setting bodies in China. They also complain that certain Chinese State-owned or approved actors have severely decreased the value of their IP, through state-run monopolies that control the import or sale of copyright content, such as motion picture imports or music ring tones.²⁰

I would close now by responding to the Committee's questions about how we cooperate with other agencies.

The Role of the U.S. Patent and Trademark Office on Anti-Monopoly Matters in China

The Patent and Trademark Office (PTO) is very interested in intellectual property issues that involve antitrust, particularly those involving standards, intellectual property abuse and misuse, and licensing. From the authority granted under the American Inventors Protection Act²¹, the Director of the Office advises the President of the United States, through the Secretary of Commerce, on all matters involving intellectual property.

We are perhaps the agency with the longest history dealing with these IP issues. Our involvement with licensing and standards in an international context goes back to 1846 when a U.S. Patent Office representative helped Samuel F. B. Morse license his U.S. patents to the Austro-Hungarian Empire, thereby helping to establish the world standard for telegraphy in Europe.²²

Our "China Team" which I lead, consists of 21 lawyers and support personnel, located in Washington, D.C., and three cities in China: Beijing, Guangzhou, and Shanghai. We have negotiated agreements and Memoranda of Understanding to support cooperative activities with several Chinese agencies with authority over Anti-Monopoly Law-related issues, including the

²⁰ See <http://beijing.usembassy-china.org.cn/ipindustry.html> ("The piracy problem is compounded by market access barriers including: A government monopoly on film importation [:] A theatrical distribution duopoly."); with regard to the ringtone duopoly in music, see <http://www.billboard.com/articles/6398489/chinas-mobile-providers-huge-problem-music-industry-ringtones> ("According to a 2011 report published in the industry journal **Science-Technology & Publication**,...state-owned telecom operators -- including China Mobile, China Telecom and China Unicom -- siphon around 90-94 percent of the profit they make from value-added music subscriptions. ...This disparity in revenue distribution was also highlighted in a **China Daily** feature which reflects these figures: "If a song generates 100 yuan [\$15.70] in revenue, only 2 yuan [\$0.32] goes to music producers in the form of royalties... The rest goes to telecom operators such as China Mobile as well as Internet service providers... Here's the clincher: ..90% of total recorded music industry revenue is derived from these mobile music services.") Regarding discriminatory practices in standards setting, the report of Dan Breznitz and Michael Murphree to the Commission in January 2013 ([The Rise of China in Technology Standards: New Norms in Old Institutions](http://www.uscc.gov/Research/rise-china-technology-standards-new-norms-old-institutions)) (<http://www.uscc.gov/Research/rise-china-technology-standards-new-norms-old-institutions>): ("Technical committees under China's standards bodies such as CESI and CCSA have multiple categories of membership. At the most basic level, there are observing members and voting members. ..Foreign firms are not barred from voting membership. However, while able to vote and contribute technology, foreign enterprises still have no direct voice in the final direction and adoption of the standard or selection of individual technologies to incorporate into specific protocols.")

²¹ Public Law 106-113 and amended by the Intellectual Property and High Technology Technical Amendments Act of 2002 (Public Law 107-273) enacted November 2, 2002.

²² Silverman, *Lightning Man – The Accursed Life of Samuel F. B. Morse*, at 273 (2003).

State Administration for Industry and Commerce, the Ministry of Commerce, and the State Intellectual Property Office.

While the PTO helps to develop IP policy, it has no enforcement authority. For this reason, we take an active role in exchanging views and coordinating with our sister agencies. We engage in many activities to encourage this kind of cross-coordination. For example, each year, we host a comprehensive, one-day training program on IP developments in China – kind of an IP boot camp – that is intended primarily for our diplomats going on to their posts abroad. We frequently invite industry and Hill staffers to this event. We also work with all U.S. IP agencies in organizing and supporting a range of training programs. A few years ago, we hosted the Minister from the State Administration for Industry and Commerce, inviting our antitrust colleagues to participate, as well as U.S.-based trade associations, such as the Licensing Executive Society, the Intellectual Property Owners Association, and the American Intellectual Property Law Association. This year, with funding from the U.S. Trade and Development Agency and support from USTR and others, we expect to host a program on China’s innovation, which will feature a strong Anti-Monopoly Law component. The PTO is also currently planning a joint program on IP licensing with China’s SIPO, where we hope to air some of these concerns. We expect to invite colleagues from the antitrust agencies to participate. Through these and other avenues, we hope that we can make a difference for our companies and for China. Through our China Resource Center, which we have just inaugurated, we collect data on all IP-related matters. The focus of this center is on IP rights, their protection, enforcement, and commercialization; it collaborates closely with the PTO’s Chief Economist to support more empirically-driven analysis of China’s intellectual property environment. As this effort grows, we hope that it can be a resource to the U.S. Government and business community, including our antitrust colleagues.

In Anti-Monopoly Law matters, we monitor the press and other media for signs of policy positions or shifts, and then work with our inter-agency colleagues to present a unified U.S. Government position and approach. We proactively reach out to U.S. companies that are encountering antitrust issues involving IP. A primary concern is to enable our companies to fairly monetize their IP rights with minimum regulatory burdens. When significant antitrust cases arise, we collaborate closely with the Departments of Commerce and Justice, the Office of the U.S. Trade Representative, the Federal Trade Commission, and others to determine the best strategy to pursue.

We also are an active participant in the Joint Commission on Commerce and Trade, and co-chair the IPR Working Group under that body. This past December, the JCCT included several bilateral outcomes on Anti-Monopoly Law, standards, licensing, intellectual property, legitimate sales of IP-intensive goods and services, abusive IP litigation, and judicial cooperation – all of which directly impact China’s Anti-Monopoly Law environment. I refer the Commission to the U.S. Fact Sheet and U.S.-China-Joint Fact Sheet from the JCCT for further information on the many important developments in these areas.²³

I hope that my observations will aid the Commission in understanding how the PTO views some of the building-block issues in China’s antitrust environment. While the antitrust issues are complex, we also believe that we should not lose sight of the significant IP-related “building-block” challenges that remain. We strongly support China’s efforts to develop an antitrust regime consistent with the practices of other market-economy countries. However, we are

²³ <http://www.commerce.gov/news/fact-sheets/2014/12/29/us-china-joint-fact-sheet-25th-joint-commission-commerce-and-trade>

concerned that there are many aspects of China's economy, including in its IP regime, that are different from ours and may not be fully market driven, which need to be acknowledged and discussed.

Thank you for your time and attention.

Appendix: Charts

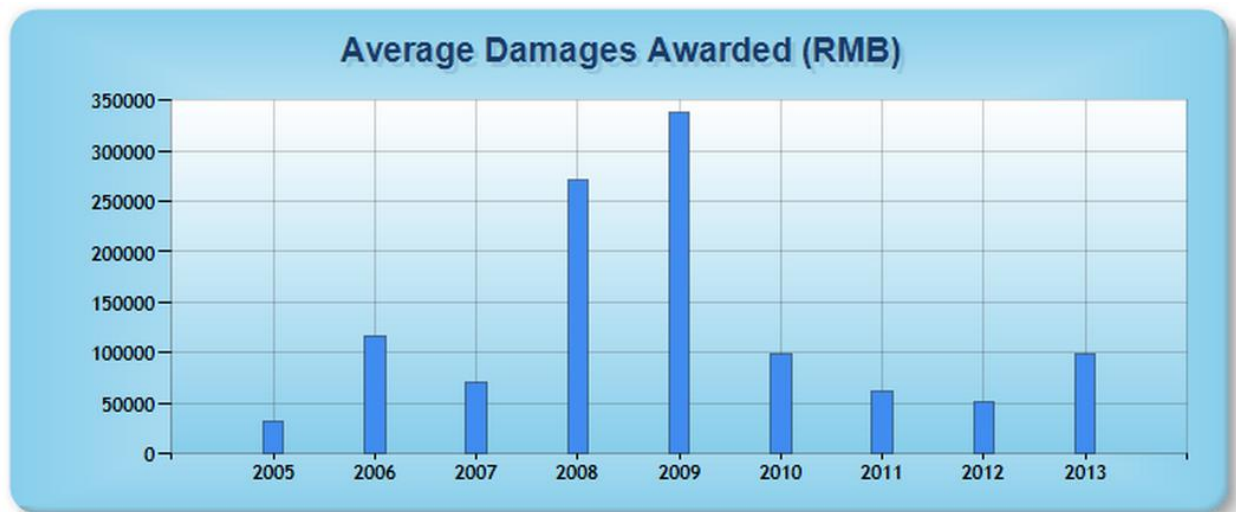


Chart 1:
Average Patent Infringement Damages Awards in China

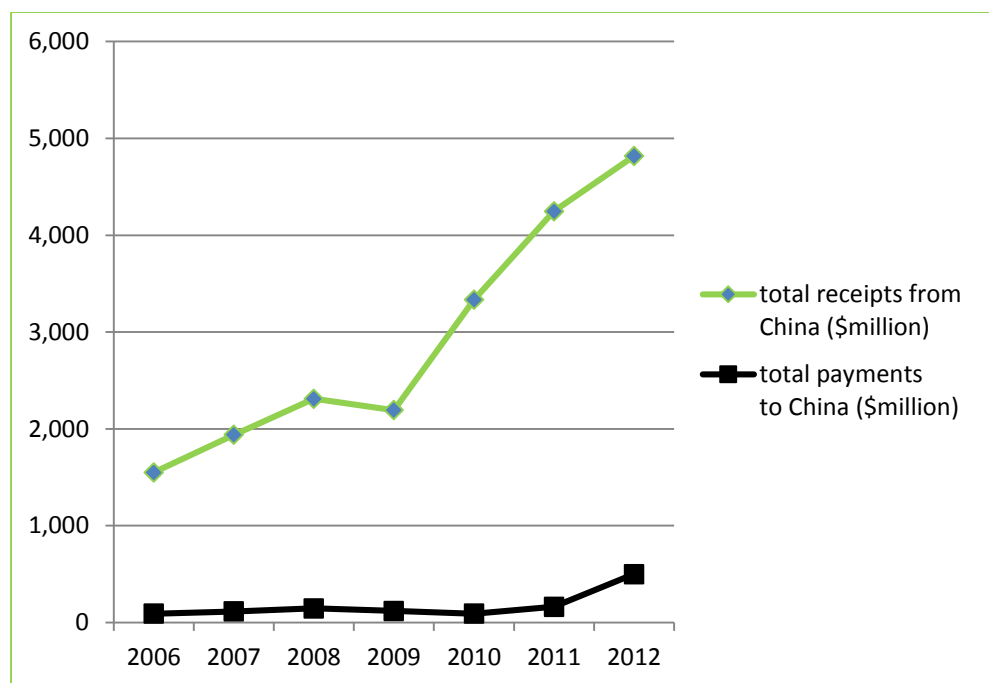


Chart 2:
Total Receipts from and Payments to China for Royalties of Various Kinds

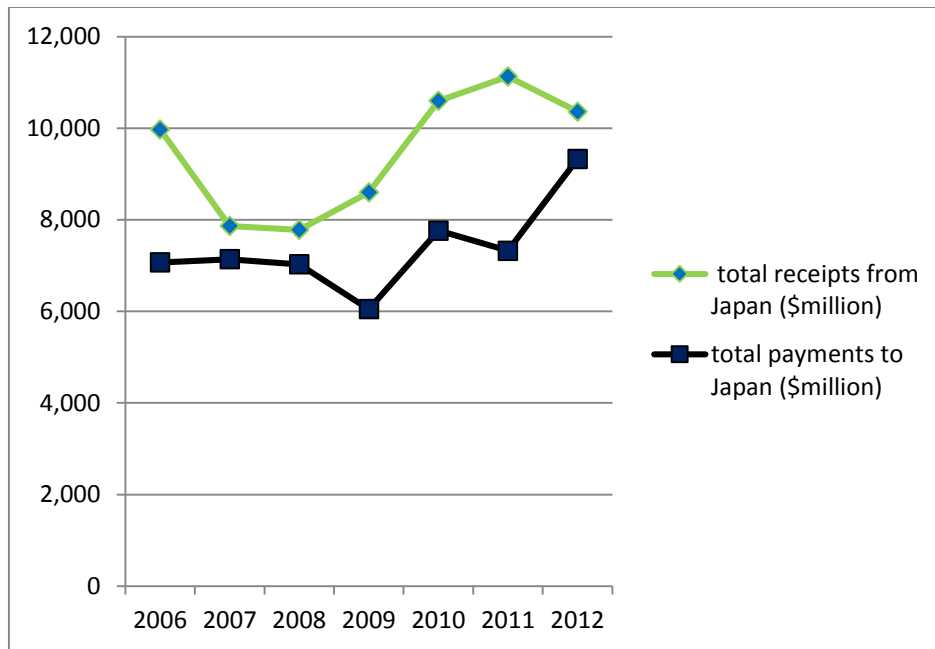


Chart 3:
Total Receipts from and Payments to Japan for Royalties of Various Kinds

ADMINISTRATION PANEL QUESTION AND ANSWER

CHAIRMAN REINSCH: Thank you very much.

First, we'll go to Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you very much for your testimony and thank you for your service with the U.S. government.

Commissioner Ohlhausen, in your written statement and in your oral statement--and you also mentioned this, Mr. Cohen, in your statement-- you called the commitments that the Chinese made at the recent JCCT--the increased ability of counsel to attend meetings, more transparent penalty procedures, competition-based remedies--as "notable advances," and, Mr. Cohen, you called them "outcomes."

These commitments were made in December. Have you seen any follow-up on those commitments that would potentially make them, in my view, real outcomes since that time?

MS. OHLHAUSEN: I think that's always the question. How will the commitments be implemented; how will they be honored? It's a fairly short amount of time between December till now so I can't point to anything in particular that showed steps being taken to honor those commitments. Certainly the fact that they made those commitments, which reflected the highest priority criticisms that the antitrust agencies and others in the U.S. government were raising, I think is a good step, but I think we still need to see what changes will actually be undertaken in China.

VICE CHAIRMAN SHEA: Could I ask you to keep the Commission informed about those commitments and whether they were actually operationalized? And when would you feel that maybe they're not living up to their commitment? I mean when does someone in your position--okay, it happened in December, and nothing has really happened. It's January, late January, okay, it's been six weeks or so, and when do you start questioning whether maybe this commitment was just a commitment and not something that was seriously considered to be undertaken?

MS. OHLHAUSEN: One of the things that would be useful to me is as companies who are undergoing the investigations and the merger reviews and NDRC reviews in China, if they report back whether there have been improvements, whether they are getting more information from the Chinese authorities, whether they're having an easier time having the counsel of their choosing at these meetings. So that's something I'll continue to monitor this year.

VICE CHAIRMAN SHEA: And could you keep us posted? I would really appreciate that.

MS. OHLHAUSEN: Sure.

VICE CHAIRMAN SHEA: I'm going to just editorialize a little bit now. I mean I think the GAO put out a report where the U.S. government doesn't even know what commitments were made in past JCCTs and SEDs or is confused, and some commitments were recommitted at a subsequent JCCT and listed as a positive outcome, and, you know, the Chinese government

has made commitments on government procurement, trade secrets, software and online piracy, indigenous innovation, technology transfer in previous JCCTs and other bilateral fora, and they haven't really--those commitments haven't really come to fruition.

So I'm just editorializing. I think the U.S. government from where I sit places a little bit too much emphasis on commitments rather than actual outcomes.

MR. COHEN: Yeah. Let me just add to that, I think a lot of these JCCT commitments, some of them are of a cooperative nature, some of them are actually concrete commitments, although they're rarely expressed in terms of legal language. They're expressed in diplomatic language.

That doesn't mean they don't have an important effect or they can't be catalytic in nature or they can't actually represent the conclusion of a certain Chinese thought process on an issue, but they really work best in a systemic sense. If you have industry-challenging AML practices, if you have U.S. government advocating for certain fair practices, if you have domestic constituents in China who are also recognizing, as some recently have, that some of the AML practices may be departing from where China needs to go, if you have concerns within China about transparency of administrative agencies, which is another ongoing concern with China, within China, then all these issues could coalesce to drive real change, and the JCCT is one important part of that process, in my personal view.

VICE CHAIRMAN SHEA: Okay. I know my time is up. I have a question for Mr. Cohen, but I'll defer till maybe a second round.

CHAIRMAN REINSCH: Okay. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, to both of you, and, Mr. Cohen, because we share a mutual friend, great to meet you finally, and I hope that our friend on the West Coast is actually watching this if it's being Web cast. That would be a good penalty for--it's six o'clock--that's why I hope he's up watching.

And appreciate all that the two of you do. As Commissioner Shea indicated, public service is a noble calling, and we appreciate what you do everyday.

For many years, as you know, success in the U.S.-China relationship was easily measured by the trade deficit, and next week, we expect to have the final numbers for 2014 come out, and another historic level of trade deficit between our two countries, but increasingly from U.S. businesses, there's a different measure of success in terms of the profitability, the access to the Chinese market, the returns on the investments they've made, both short and long term, and like Commissioner Shea's questions about the JCCT and S&ED and the dialogue that we've engaged in for many years, what I hear from many U.S. companies is that success is actually being penalized.

You raised the Qualcomm case, and here we have a great U.S. company that is succeeding, and the Chinese are basically saying you're succeeding a little too much. We have China developing some of its own standards in

different kinds of technologies, and then you have FRAND and other mechanisms or metrics, I guess, being applied to them.

It's the job of the U.S. government to engage in dialogue, but the American public is getting frustrated, and I think increasingly the business community is getting frustrated.

How much longer should we wait for China to have a global system? Will they ever get there? Commissioner, you mentioned that they have stated time and time again that there will be Chinese characteristics to their system. And if we don't believe they are going to have a compatible system--let's call it that--what should the U.S. response be?

Are there things that the U.S. Congress, as well as the administration, should look at to try and demand or assure proper recompense, proper legal rights, if you will, in terms of how we view the system? Is there some bilateral mechanism? The question, Mr. Cohen, you raised about the royalty rents, et cetera, et cetera. Help us. How long should we be patient? Patience is sort of running thin for a lot of us. And what mechanisms can we look at now basically if there is an interim as to assert U.S. rights?

MS. OHLHAUSEN: Speaking as an antitrust official, one of the things that we have tried to do is to continue to engage in a very serious dialogue with the Chinese on these issues. So we have a memorandum of understanding with the three AML agencies. We've had that since 2011, and we have high-level dialogues based on that memorandum, and we have one coming up this year, and I hope or presume that those issues will continue to be raised.

The other thing is continued engagement. For example, when I was in China last year, I was asked to stay and help train some of their judges who are their IP court judges, who actually also hear their antitrust appeals on these issues. But one of the things we are hearing there, and it does continue to be a problem, is this focus on IP, intellectual property, looking at it as just static efficiencies.

They assert that the way you get more competition is to get more competitors in the marketplace, and you do that by compulsory licensing or applying an essential facilities doctrine to IP rights. So we continue to press them on those issues to try to explain that this is not good internationally, but it's also really ultimately not good for the Chinese economy, and I do think that putting things in a way that explains why it's better for them in the long term will have more of an impact.

There are people behind the scenes in the Chinese agencies who I know are trying to advocate this internally, and our continued dialogue with them I believe gives them the support and the energy that they need to continue to advocate for these positions.

I think that encouraging the Chinese to continue to try to reach international norms, to recognize--for us to have an evenhanded approach that recognizes when they've made improvements but also criticizes when we can see obvious discrepancies or flaws, that's important, and for me my tool box is just the antitrust laws and the international dialogue with that.

But I don't know if Mark has additional ideas.

MR. COHEN: Yes. It's a good question, and I think part of the answer is perhaps to come back with other questions, which is how much do we really understand about how the Chinese system works and why it has the kinds of problems that we've seen manifest itself.

There's so much about the Chinese system that is counterintuitive both in IP and I suspect in antitrust. We now have the largest patent office in the world. It's four times the size of the USPTO and intends to grow another three or four times in the next five years. This is going to be ten times the size of the United States PTO with about six million plus applications per year.

We have the most litigious society for IP in the world, and 97 percent of the litigants are Chinese with a very small foreign element. Foreigners tend to win IP litigation in China. So why are we so frustrated about certain aspects? I'm not saying we don't deserve to be frustrated, but the frustration, some of them seem to be related to systemic problems: lack of rule of law; lack of trust in the judiciary; over-involvement of industrial policy; and state, legacy state planning agencies in IP and in antitrust. These are systemic issues.

The IP environment in China, the biggest flaw in my personal opinion goes back to the preamble to the TRIPS agreement where it says that IP is a "private right." Here you have IP as an element of industrial policy, as an element of state planning with targets on a municipal level, on a provincial level, about how many patents to be filed. You can imagine the problems that evolve when you start having antitrust regulators complaining about foreign licensors, and, at the same time, they're providing subsidies, grants, support, awards for local competitors.

There's an innate inherent conflict of interest that evolves when the state is so actively involved in certain aspects of the market. So I think we have yet to be fully candid in many aspects of this problem. We monitor at the PTO U.S. litigation involving Chinese companies in the U.S., and we try to get a sense about why people litigate in the U.S., why they litigate in China or in other countries, and the answers are sometimes counterintuitive.

I think our system can also be improved in terms of when we exert extraterritorial jurisdiction, what we expect of litigants coming into this country, what kind of cooperation we get with the Chinese courts if we request evidence from the courts, et cetera, and that might be one place to look at some improvements where we can make a difference. It doesn't resolve all the problems, but it could help, and I think trying to get to the point where we really have the kind of candid exchange with some of our Chinese colleagues that this is not the way the system was intended, at least in IP, I think would help in addressing some of these problems.

COMMISSIONER WESSEL: Thank you.

If there's another round, please mark me down.

CHAIRMAN REINSCH: Thank you.

Commissioner Tobin.

COMMISSIONER TOBIN: Great. Thank you, both, for joining us.

Unlike most of my other colleagues, I'm not trained as a lawyer; I'm a social scientist. And I would like to benefit from your extensive experience with the culture and the legal culture. So I have a question for each of you.

Commissioner, you mentioned that you have visited with people extensively, five times since a year-and-a-half ago. When you talk with the Chinese regulators, and I'm sure you convey what some of the issues are in high technology, what do they say? I want you to, in essence, tell us what they are telling you. I'm trying to understand their perspective. It makes no sense to us, but culturally maybe, or just reporting wise, you can inform us on that. So that will be my question for you.

And, Mr. Cohen, you mentioned that it's severely "underlicensed"--under-licensed--this environment. I guess I have a hypothetical. If it were less "underlicensed", under-licensed, therefore more licensed, would it begin to shift the way they do their legal regulatory work?

So, Commissioners, tell us what they are thinking, and are they reporting to anyone? Are they getting mixed messages, both the law and other pressures, and if so, what are they?

MS. OHLHAUSEN: One of the most revealing experiences that I had was when I attended the fifth anniversary of their Anti-Monopoly Law in 2013, and this was a big event that the Chinese antitrust expert body who advises the antitrust agencies put on, and there were very high level ministers, and actually some of the proceedings were broadcast on TV.

And they talked a lot about the value of competition. Competition is so important--and everyone had that message, which was very interesting when you think, coming from a centrally-controlled economy to now being a competition focus. But when you delved in and said, well, what does competition mean to you, that's where the challenges and the difficulties came up.

Some were very clear that it means enhancing consumer welfare, that it is economics based, but others were very clear that, well, competition just means having more competitors. So if we choose an antitrust approach or a licensing approach that has more competitors, that's better and that creates more competition, and that's when they're looking at the outcome today rather than the outcome tomorrow. It's where they're saying we just want to have more people manufacturing these products and that's more competition.

So I think you need a more sophisticated analysis for them, and some of the people in China were advocating this, but there are a variety of voices saying no, we want innovation, and what we don't want is ten people creating today's technology. What we want is incentives for people to create tomorrow's technology.

And so that was one of those difficulties and also questions about, well, if a Chinese business was going to go bankrupt because of licensing, would you intervene? And then, of course, the answer was, well maybe then we would because that could reduce competition rather than saying,

well, that's just the normal course of competition; there are winners and losers.

So the other thing that I found that they always reflect back when there are criticisms is they say we're just doing what you do, and they're very attentive to any indication of positions that the U.S. has taken. For example, I've criticized my own agency's decisions that look like we're devaluing IP rights, that look like in the U.S. we're saying, oh, the right to exclude, that's probably being used anticompetitively, and that it's disfavored, and they're very quick to point that out.

So I think that's the other thing that we need to be careful about, something within our control, is to make sure that we are not doing things that can be portrayed or misconstrued as devaluing the importance of IP rights in the U.S.

COMMISSIONER TOBIN: That's part of what you talked about, be much clearer on our side.

MS. OHLHAUSEN: Yes, absolutely.

COMMISSIONER TOBIN: Thank you.

MR. COHEN: So let me elaborate a little bit what I mean by under-licensing and perhaps what the future holds, but I can't tell you what the amount precisely that China is under-licensed is. I did some rough estimates based on high-tech production and based on Census data on our royalty receipts from China.

It seems to me that high-tech tends to be a patent-dense and technology-dense area so it's a good surrogate that if you manufacture a lot of high tech goods or you produce 70 percent or more of the cellphones in the world, then you probably should be buying the technology to produce that. China is in the unique position of being the world's leading high tech producer of products that for the most part it didn't contribute much in terms of innovation.

So it has the best of both worlds. This is a long debate within China. The glass seems to be half empty to many Chinese officials. Why are we spending so much in royalties? Well, you're spending so much in royalties because you have thousands of workers producing products for export and for domestic consumption for products you did not invent. That's how the IP system is supposed to work. That's the reason you joined the WTO. So I tend to view this as a half-full situation. You're darn lucky. We'd love to have those jobs for products that we helped innovate.

And as you look at it, even \$5 billion is not a huge amount considering the magnitude of the bilateral trade. I suspect there should be several multiples of where it currently is, and I've been trying to work within the Commerce Department and with other agencies about trying to help our companies export technology and to understand what happens in a much more granular way when they try to do deals with their Chinese counterparts. So that's one thing.

The other side of the coin is that China now wants to be a player in this field. The most recent Five Year Plan for intellectual property, the

National IP Strategy, I believe has China increasing its technology exports from one billion a year globally to about eight billion. So they want to be a player, and that's a good thing because I think the future is ultimately not in an I sell/you buy. Particularly with China, because of its rich potential--human resources and technical talent--there will be a lot more collaboration.

But I also caution my colleagues frequently that simply because China wants to be a player doesn't mean the playing field will be level, and those are two different things, and, in fact, the IP experience in China has rather been counterintuitive in this area as well. As China has become an IP stakeholder, it doesn't mean that the IP problems have gone away. It's meant they've gone into other areas, like antitrust, and people talk a little bit less about counterfeiting or piracy, which still exists, and they've gone much more into a high tech kind of frame.

So I don't think that the situation will ease itself necessarily as China develops. It will just change. But I do think there's a lot of potential for increased sales of U.S. technology, which China should pay for, and this is not just true of patents. China is severely under-licensed in software if you speak to any provider of business software to China.

COMMISSIONER TOBIN: Thank you very much. CHAIRMAN REINSCH: Thank you.

Commissioner Fiedler.

COMMISSIONER FIEDLER: Thank you.

I wanted to address your "Chinese characteristics" and our discussions with them about what's in their interest. It seems to me after all these years that it's unquestionable that they know their interests and that they're actually expressing them through the use or misuse of the law, the Anti-Monopoly Law, in this instance, or in previous instances in their failure to enforce IP. So I don't buy at all the sort of notion that they don't understand. I think it's a fairly significant understanding of the system, and they say we don't like it. For us at this point in our history, in our development, it doesn't suit us. It doesn't work for us.

And lots of dialogue just post allows them to go on and proceed with the behavior in the face of a sort of inertia maybe perhaps on our part or maybe it's politically difficult for us to call a halt to some of this stuff because of lots of other political context. I mean there is a political context in China within which these decisions are being made. Right now it's a different political context than ever before, it seems to me, with Xi's consolidation of power being what it is.

So my question to you is when we're formulating our policy, is there an interagency process where you get information from other agencies of government that bear upon the real reasons for the use of certain tactics by the Chinese, i.e., this anti-monopoly push against certain U.S. companies at the moment?

I mean this is not witless on their part, it seems to me, and the fact that they express some understanding to you as a technician doesn't

overcome the politics. I don't think they're in a position to overcome the politics of the dynamic. It's a very ugly dynamic it seems that is developing, and I feel for you to be negotiating within that dynamic, but I don't think the Chinese are unaware of what they want to do. The rule of law doesn't exist right now, and how do you do this without the rule of law. Why do you have any increasing confidence in the rule of law in China right now?

MS. OHLHAUSEN: To answer one of your questions, at FTC and the Department of Justice, we do engage with other agencies on these issues and have discussions about them.

I do think the Chinese understand their interests, and certainly the view that we are mainly a manufacturing economy, we want to have low input costs, and devaluing IP rights is the way to keep input costs down. But there are definitely voices within China who are saying do we want to be stuck at this level of development forever? Or don't we want to transition into a more innovative economy? And I have heard reports of some industries in China starting to say this is hurting us internationally because the fact that as a Chinese business I've created a new process and every other Chinese business can rush in and copy that process because IP protections are weak in China is stopping me from being able to compete on the international stage.

And so there are voices within China who are starting to say this does not serve our long-term interests, and so we are trying to engage with the Chinese personally in a dual-track approach. One is to say you say you're adhering to international norms; here's where you've deviated from them. But the other is to explain why it is in their long-term national interest to start to adhere to those international norms. And I don't mean to be naïve, that I don't understand that there are very strong interests, and they are reflected in the way the AML was drawn, but I do believe that our engagement and our trying to encourage them towards the good things and discourage them from the things that we find disturbing is a useful use of our resources as an antitrust agency.

COMMISSIONER FIEDLER: Mark.

MR. COHEN: I might just add that from my perspective, there is no conflict. In fact, there is a tremendous synergy between intellectual property and rule of law and even human rights in China. IP has been a sandbox that the Chinese government has experimented in on the rule of law issues--transparency of judicial decisions, specialized IP courts, availability of preliminary injunctions, professionalization of the judiciary, including judges increasingly with graduate degrees and technical assistants so that they can focus on legal adjudication, getting the judges a little bit out of--a little bit out of the political dynamic through professionalization.

All of these things have been developing, some of them accelerating more recently. I don't want to be naïve and say that these problems are resolved. They certainly are not, but I think IP has had a very positive effect on improving the specialization of the judiciary, on transparency, and

many other areas which have profound consequences for other areas. And we're talking about IP. We're talking about less than one percent of the civil docket in China with about 3,000 plus IP judges.

This is a tremendous commitment and a tremendous leverage point, if you will, through the commercial system to try to effect change in the Chinese judiciary. All that being said though, I realize that saying that this is helping rule of law doesn't address the problem of a U.S. company that's facing counterfeiting or piracy or whatever else, and for that we have to advocate, we have to encourage them to use the courts because frequently our own companies are shy of using the courts for a variety of reasons, including the perception that there's too much of a government relations cost to adjudication in China or that it will be unfair.

But we have to encourage them, and occasionally we try to exert some political pressure on their behalf, but it still is in the works. It's just I do believe that IP has had a positive effect on some of these legal developments.

COMMISSIONER FIEDLER: Thank you.

CHAIRMAN REINSCH: Okay. Next is Commissioner Slane.

HEARING CO-CHAIR SLANE: Mr. Cohen, thank you for taking the time to come. It's very helpful.

I have had American manufacturers who have developed technology tell me that their attitude is that a patent as far as the Chinese are concerned is a blueprint, and their attitude is to not file patents but to go down the trade secret route, and my question to you is are you seeing some of that attitude from American manufacturers?

MR. COHEN: Well, there has always been a tension between patents and trade secrets. And, in fact, the Uniform Trade Secrets Act, was passed in the late '70s before the federal circuit was established, in part because of the perception in the U.S. at the time that the patent system was too weak. So there's always the sense that when patents get weaker, trade secrets get stronger in any society, and I think it's a quite legitimate business approach if it works because some things you have to patent because otherwise people will copy and you'll have no tool available to you unless you have the patent.

But otherwise a trade secret approach of keeping your crown jewels back in the U.S. or keeping the tools and dies or the secret formula can be a good way of reducing your risk, and I think it is true that many U.S. companies are reluctant to transfer their core technologies because of the perception that they will either be copied or their employees will leave and replicate it or steal it or they'll be the target of industrial policy practices.

But some of these practices, just as a side note to that, are not as clandestine as we might think. I've seen one national policy on the biotech sector that said that China should depend less on acquiring technology and more on employee migration. That doesn't say trade secret theft, but if you're saying that it's easier for me to hire people with the technology, you're obviously running that risk, and so, you know, it's very interesting.

When I meet with companies, and we've done this as an experiment several times, and they come in to talk to us, and they're in a particular field, I will say to them, particularly if it high tech, have you looked to see if there is a national policy in this technology or commodity? They say, well, what do you mean? Well, give us five minutes, we get online, we look that maybe there's a five-year plan for carbon fiber technology or maybe there's a five-year plan for wind turbines by a particular ministry, and he says, well, it says here this looks like this area is one that the Chinese government is very interested in.

It seems to me that if you invest or transfer your technology, it will be warmly welcomed, but you may run a risk that it will be stolen, and that may not be because the Chinese government is mandating its theft. It may be that there are Chinese competitors that have to develop the technology, and the easiest way for them to develop it is by luring away employees, just like they would do in Silicon Valley or anywhere else in the world. It's just a market, and where can you get it at the cheapest cost?

But a lot of our companies are not aware of this planned aspect of technology that they're walking into when they enter the Chinese market, and if they would, they might develop appropriate prophylactic strategies.

I think one of the other interesting consequences of this environment in China is that it's altering the way companies conduct R&D. You know, we have many of our companies, East Coast companies and West Coast companies, pride themselves on kind of having an open R&D environment, cross-fertilization across sectors. And that's exactly the kind of environment that could be highly problematic in China.

If I can download everything from the company onto a USB that I need in any technical area, well, I have a lot of valuable technology on that USB. So it's creating more classified zones of operation and less cross-dissemination, which is a problem, but it also relates to this trade secret risk that's endemic.

CHAIRMAN REINSCH: Commissioner Talent.

COMMISSIONER TALENT: Thank you.

Two questions. One is a follow-on to Mr. Fiedler's. I agree with him. I think the Chinese are going to do what they believe is in their national interest. So the question is--and you, Commissioner, you adverted to this--in your private conversations, discussions where you have a sense that you're getting sincere opinions, how deep do you believe is the commitment and the belief that China is going to have to move for its own interests and its own economic fortunes to assist in where it recognizes the rule of law more in this area?

Do you really sense a commitment or a belief in that as an aspect of Chinese national interest when you talk with your counterparts and people? Do they pull you aside over tea and say, look, we know?

And the second thing is would you all--I mean we have to prepare a report on what's happening on this. Maybe you could give me your top three successes in terms of your activities or your agency activities in terms

of a Chinese response in this area? What would you say are the top three things that you all or that the efforts of your agencies have succeeded in accomplishing?

MS. OHLHAUSEN: To address your first question first, it really depends on who you're talking to within the Chinese agencies, and I wrote an article about how things are sort of happening behind the screen, and sometimes you get glimpses of what's going on, and sometimes it's very opaque. I have found that there are certain officials, certain important academics in China, who are trying to move their system to a more competition focused, IP protective system.

When I was at the event that I mentioned, there was a well-known economics professor, they called him "Market Wu," and he had been persecuted during the Cultural Revolution, and he's been very direct in his criticisms of the Chinese government in these areas.

The other thing that I have found is that, when last September I gave a speech that was rather critical about some of the aspects of Chinese antitrust enforcement, the feedback, the behind-the-scenes feedback that I got was we kind of wish you hadn't said that publicly, but, on the other hand, it was useful. Not just my criticism but the joint attention from my colleagues as well, help to push them towards taking, these criticisms more seriously.

And then the third thing that I'd mention is that I have been in China and given this criticism at events and talked about the problems with their approach to IP, and they have invited me back to continue to say these things. So I do think that that does show openness to the dialogue.

On the top three successes, the FTC and the Department of Justice reached a memorandum of understanding with the three AML, Chinese AML, agencies in 2011. I think that was an important step forward. We do have procedures in place for sharing case information where appropriate, for talking on policy and having technical assistance.

I think the commitments, the current commitments, in the JCCT are an achievement. We'll see if it is--how that is implemented. I think that's important.

And then the other thing that I would say is just the ongoing dialogue that we have with the Chinese officials, for me, it's easy. I feel I can go and I can say what is on my mind. I'm not worried about repercussions from my own government; right? The worst that somebody could say is, you know, we wish you didn't say that. But I think in China, I always have to keep in mind the greater pressures under which even well-meaning officials are operating. So I try to have sensitivity to that. The kind of repercussions they could face if they get out too far in front of what their government wants them to do are very different than the kind of criticism that I may face back here in the U.S.

MR. COHEN: Yeah. Let me just say Cohen's three principles for engaging Chinese officials: principled, informed, and respectful. We need to stick to our principles; we need to be highly informed. China tends to be

extremely informed both about their system and our system, and, of course, no one is going to listen to you unless you show respect. I think that is as true of the government diplomatic level as it is in the private sector.

And it helps me because if I haven't been principled then I feel like I haven't done my job, and if I haven't been informed, then I know I'm not going to make progress.

How has PTO helped make progress on IP and rule of law? I have I think four things where I think we've had a demonstrable impact, and I like to say that China crosses the rule of law river by feeling the IP stones. Let me give you examples of those.

Transparency. You have a huge administrative enforcement apparatus, not only in IP but in a variety of sectors, including antitrust, but that's actually a very small element compared to the numerous areas where there's administrative enforcement, and the Chinese government has committed to make all administrative punishment decisions in IP transparent and available online, and they want to take that more broadly. That's a big plus for IP and for rule of law.

Second of all, specialized IP courts, which I just mentioned, more professional with technical experts that will enable the courts to be detached from the agencies that they rule over and with greater competence in adjudicating cases.

A third one, also judicial related, is increased criminal enforcement, and this really also shows you a little bit about how our engagement works. We brought a case, a WTO case, against China for IP enforcement, including ineffective criminal remedies, and it was a mixed decision from the WTO panel, but a year or two ago, a Chinese judge turned to me, and she said, you know, back when you were attaché and you were complaining about criminal enforcement, no one liked to hear what you said. I said, yeah, I know, it was difficult, and sometimes I wasn't even invited to conferences and programs because no one liked to hear what I said.

And she said, "well, you know what we realize now?" I said "what?" "You were right; we needed to improve our criminal enforcement regime."

So sometimes you're not going to be appreciated. Sometimes you get your picture blown out of the final edition that goes on the front page of the Intellectual Property News, in my case. That's okay as long as you're principled, informed, respectful, and try and make a difference.

And I was very pleased to hear that from a senior judge that she felt that, in fact, I had identified a problem. China was not quite ready to accept it, and frankly I felt like that was my role: bring them a step forward where they might not otherwise be but for that foreign observer saying this is where you need to go.

The last thing I'd mention is PTO has brought China into two communities: the IP5 and the Trademark 5. These are the five largest offices in the world. This was a U.S. initiative where we felt that China as a major patent and trademark office that needed to participate globally in exchanging information and best practices and sharing common challenges,

and I think this has really helped China and the world in understanding China's role as an IP stakeholder.

It's not necessarily the IP stakeholder with the same views we have, but it is the stakeholder in the system, and I think those are important venues for engagement.

CHAIRMAN REINSCH: These are really good questions and really good answers, but they're really long answers. We're running short on time so I'll ask the witnesses if they can condense a little bit as we go forward.

Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thanks very much and thank you to both of our really interesting witnesses. You know, I think that we are all really fortunate that you are willing to dedicate your time and your expertise on all of these issues when you could undoubtedly be making a lot more money not working in the public sector, but thank you very much.

And it's very interesting. I'd like to just globalize this a little bit, though, because every time I hear "international norms," which we've been talking about for 25 years when it comes to China, I just keep wondering is it time for a paradigm shift in our expectations of where China is going because we continue to abide by all of the rules of free market capitalism, and we continue to somehow believe that they are interested in abiding by the rules of free market capitalism when they say what they say and what they do is that they don't intend to become full participants in what we know as free market capitalism, but that they have their own model of what it is they want to do?

And so I just, I get very frustrated, and I think you can hear it among some of the rest of us, that we are continuing to go down this path presuming that the end point is a world that we see and we shape when I believe that the Chinese government has a different end point in mind.

So how do you reconcile that, and is it time for us just to sort of all to accept that free market capitalism is not where the Chinese government is intending to take their economy?

MS. OHLHAUSEN: Very briefly, we have had a fairly good track record internationally of advocating for competition, and I mentioned the ICN. There has been a lot of movement towards other new competition regimes trying to get to these kind of norms.

It's not a perfect track record certainly and not by a long shot, but I am concerned about giving up the engagement with the Chinese because the question then becomes should there be an Asian version of competition law, and is it just China or is it--I've been in Korea. Korea has some interest in this. So I think it's important for us to stay in the business of trying to encourage the Chinese towards these international competition, free market norms.

COMMISSIONER BARTHOLOMEW: But just to clarify, I'm not advocating that we don't engage because I think it's really easy to say that people who are asking questions are saying we don't want to engage. I just wonder whether we have to shift our own thinking about where it is the

Chinese government is intending to take that economy and the impacts on the global economy? You know, when they joined the WTO, there were questions about whether the WTO was going to change China or China was going to change the WTO? And indeed China is changing the WTO.

So, again, I understand you guys are being as successful as you can be in the context in which you're working. It's just the bigger picture of where the policies are going that I worry about.

Mr. Cohen.

MR. COHEN: Yeah, it's a question I've frequently asked myself as well, and I do think that when China joined the WTO, the expectation was that China would have more of a rules-based economy and would conform to those disciplines. I think few people thought about how China would affect the WTO and the global trading system, and I think few people have thought about how China would affect, in my space, the global IP system.

But it's a fair question because this is a reciprocal type of arrangement, and we are seeing changes, and I think we also have to recognize that as China has exerted influence, and it intends openly to exert more influence, and there's no secret here. They advocated for a World Intellectual Property Organization office in Beijing; they got it.

The last major multilateral IP convention was the Beijing convention. We can't be oblivious that China is a major player in the global IP system, and we're not just the ones stuffing China's throat with our views of the world. They're going to come back with their own perspectives.

In those differing paradigms, if you will, it's also important to note that our vocabulary is different. When we talk about IP rights in this audience, we're talking about private ownership, we're talking about a property right, a patent that's described in metes and bounds. It goes back to real property. You can own real property in this country. That's a problem in China.

When we talk about court cases, they are of a completely different order of magnitude. I mean a court case in China is over in six months. A patent case in the U.S. is over in five years. The damages are hugely different, too. The likelihood of an injunction. These things all mean-- they have a different value, a different weight, and they relate differently within their system.

I think in order to make real progress in China, we have to point where this system is really swerving so far off the highway that they're no longer in the mainstream of what we mean by whether it's a court case, a patent, how a patent system works, government involvement in IP, and in some cases they've deviated so far, we're trying to yank them back. We have to engage. We have to deal with a government that is very actively manipulating or adjusting elements, but we also need to engage, recognizing that there is a very large chorus of people within China who also are sympathetic to our views. They want real property. They want intellectual property. They want to be able to reward themselves. They want to develop innovative industries, and they're as frustrated, if not more

so, than we are.

CHAIRMAN REINSCH: Thank you.

We're going to steal a couple of minutes from the next panel if they don't mind to make sure that all commissioners here at least have a chance for one round.

Commissioner Goodwin.

COMMISSIONER GOODWIN: Thank you, Mr. Chairman, and, again, I'd like to extend my appreciation to the panel for the testimony this morning.

Really as a follow-up to what was just said, one of the witnesses on a panel that we'll hear from later this morning actually indicated in a piece he wrote this summer that some of the recent AML enforcement efforts are indicative of what he characterized as a trade war, a long-term fight for leading the global tech industry and one that we will lose if the U.S. does not escalate its response, including by restructuring our interagency trade enforcement process.

I'd like to get the panel's response to that characterization of this being a trade war and thoughts for reorganizing our interagency enforcement process and shifting, as was suggested in this piece, more control to the Trade Representative and the Department of Commerce.

MS. OHLHAUSEN: Given the fact that the AML does allow for noncompetition factors to be included in antitrust reviews, I do think there is this continuing issue and problem that the type of analysis that we would do in the U.S. that would only focus on competition may be being done differently in China, and we need to continue to advocate back to them why that's a bad idea.

Their law allows it, and we have asked them to be more transparent about if they are using these noncompetition factors and then to turn away from them because we don't think that that is consistent with international antitrust law, but also ultimately not good for the Chinese, and it could have long-term impacts on the willingness of companies to invest in China.

So I do think from the antitrust point of view, those are the tools that we can bring to bear. I do think that having some of these due process concerns and competition factor concerns raised in something like the JCCT is an important step forward.

MR. COHEN: Yeah, I'm reluctant to characterize anything as a trade war. I will say that the tech sector in China today, it's a very highly opportunistic, competitive, difficult, government relations-intensive, complex environment that can be extremely difficult to navigate, and that creates unique pressures on our companies, including in competition law, but not only, in tax policy, in patent policy, in the ability to access the courts when you're competing with a local company, in trade secrets where local companies may have better protection through the police compared to a foreign company.

All these things can tilt the balance and make it more difficult. China does, you know, view technology as a key part of its industrial prowess. It

has five-year technology plans, 15-year technology plans, and it has sector-specific plans, some of which I mentioned earlier, and I think there, the degree to which they've made it a key concern of their industrial development is an important call to Americans that we can't sit on our competitive edge.

I mean PTO, we don't enforce anything so I can speak a little bit more freely in that sense, but I think we view our role in the interagency as trying to provide a more informed basis for deciding on policy issues, providing more empirical data to support better decision-making, and being able perhaps a little bit better to anticipate where China is headed. That's not the shock troops of any trade war. That's just trying to help make more informed decisions in helping our companies move forward.

CHAIRMAN REINSCH: Okay. Thank you.

I think in the interest of time since we're over our end point, I'm going to forego my questions, and those of you who wanted a second round, you lose. I'm sorry. But you've been great witnesses. You've provided a lot of food for thought. We may have you back another time, and we'll give you more time. But we appreciate the completeness of your responses and the thought behind them.

So with that, we'll thank you, and we'll move on to the next panel, which Commissioner Slane will introduce.

[Pause.]

PANEL I INTRODUCTION BY COMMISSIONER DANIEL M. SLANE

HEARING CO-CHAIR SLANE: In this panel, three industry experts will detail the most recent and pressing challenges facing foreign firms operating in China. We will hear perspectives from the auto manufacturing and information technology industries, and we'll discuss how Chinese law impacts foreign business there.

Joining us today is Dr. Rob Atkinson. Dr. Atkinson is the President of the Information Technology and Innovation Foundation. Before joining ITIF, Dr. Atkinson was Vice President of the Progressive Policy Institute and Director of PPI's Technology and New Economy Project.

He currently serves as co-chair of the White House Office of Science and Technology Policy's China-U.S. Innovation Policy Experts Group and is a member of other committees at the Departments of State and Commerce.

Next we welcome Dan Harris, who traveled here all the way from Seattle. Mr. Harris is the founding member of Harris Moure, an international law firm that focuses on representing American companies overseas.

Mr. Harris writes and speaks extensively on international law with a focus on protecting foreign businesses in their China operations. He is also a prolific and widely-followed blogger, writing as the coauthor of the award-winning China Law Blog.

Unfortunately, our final witness, Dr. Oded Shenkar, was unable to attend the hearing today. We're sorry to hear that his wife had a medical problem. Dr. Shenkar serves as the Ford Motor Company Chair in Global Business Management at the Ohio State University's Fisher College of Business.

He is also a member of the Center of Chinese Studies and for Near East Studies. Dr. Shenkar has published several books, including his most recent book, *Copcats: How Smart Companies Use Imitation to Gain a Strategic Edge*.

Dr. Shenkar has previously testified before the Commission. His written testimony for this panel can be found on the Commission's Web site.

Gentlemen, thank you very much for being here today. Each of you will have seven minutes to deliver your oral statement. Dr. Atkinson, we'll start with you.

**OPENING STATEMENT OF ROBERT D. ATKINSON, PH.D.
PRESIDENT, INFORMATION TECHNOLOGY AND INNOVATION FOUNDATION**

DR. ATKINSON: Thank you so much. I appreciate the opportunity to appear before the Commission today to talk about these issues.

I'll jump right in and say I think we need to think about where China is on these issues around discrimination against foreign direct investment in the context of a strategic shift that the Chinese government made in the mid-2000s, essentially from a long-term policy from the early '80s of attracting FDI and building their economy up through being friendly to FDI to a fundamentally different strategy, which they call "indigenous innovation," which is all about building up Chinese companies and particularly Chinese companies in technology fields.

I think this was a fundamental strategic shift for how we think about this, at least how our companies think about this. I think, as you all know, in the '80s when we had our trade war with Japan, essentially it was our companies against their companies, and so there was a lot of consensus here in America that we needed to be aggressive going after the Japanese. We don't have that as much with China because essentially our companies benefited significantly from the Chinese policies, and so it was really our workers, if you will, against the Chinese government, the Chinese policies.

Today I think that's changing, and it's becoming a little bit more like the prior Japanese relationship. Essentially, it's now American companies versus Chinese companies, and I think that's an important strategic shift. We're not all the way there yet, but increasingly American companies, particularly in the technology fields, are frustrated with the treatment they're getting.

What's going on here? As the Chinese government adopted indigenous innovation strategy in 2006 they have thrown a lot things at the wall to see what works and what doesn't work. One of the things they threw at the wall was the indigenous innovation product catalog system. Where they weren't able to fully implement that the way they would have liked, now since President Xi Jinping assumed power, they've really taken this whole strategy to a new level "to master its own technologies," as they say.

And that strategy has essentially been using the heavy stick of harassment of U.S. technology companies in a wide variety of forums and means in order to get what they want, which is essentially much more, as Mr. Cohen said, much more favorable terms on IP licensing and, more importantly, more favorable terms on technology partnerships, using this harassment, this stick, this threat, in order to force U.S. high technology companies to partner with Chinese companies as a way to get technology.

And lastly, it's partly a strategy to hobble U.S. companies because weaker U.S. companies make it easier for their domestic champions to thrive in the Chinese market.

This all also ramped up a whole level after the Snowden revelations. Snowden was an incredible gift to the Chinese government because it gave

them an excuse and a justification: well, you do this so we get to do this. And we see that. I'll explain that in just a moment.

So we've seen that obviously in terms of using AML to raid the Microsoft facilities. We've seen it with the Qualcomm and Cisco cases where the NDRC claimed that they were monopolists. We've seen it with they call the "de-IOE Campaign," that is a national campaign to pressure state-owned enterprises to not use IBM, Oracle or EMC products, kind of three core enterprise products that you need in a company, and replace them with Chinese-owned ones.

I even more troubling is what's going on in the last couple of weeks, and this is a new Chinese policy essentially to, quote, "require secure and controllable cyber and ICT products."

And what they mean by that is they're using this excuse to say that they have a legitimate right under the WTO to have exceptions for government procurement and other kinds of policies on the security exemption, and this is largely and clearly an excuse. There is no real viability to the argument, but they're using that argument now very aggressively to say that unless the technology in China is developed in China or controlled by China that essentially they have the right to preclude foreign IT products from their market.

This is very, very troubling, and I think we're going to see that ramp up to an even higher level. So what's behind this shift? As I said, I think what's behind this shift now is that they really feel like some of the other policies they tried to do with indigenous innovation didn't get them what they wanted, and they're ramping this up.

So what should the U.S. government do? I think that there are a number of specific things, but let me talk about three or four high-level things that I think are critical to get right.

First of all we have to realize that this harassment strategy, this heavy stick strategy that the Chinese government is employing, is now a core part of the Chinese strategy, and it's not going to change unless the Chinese government realizes that it has costs, and costs meaning from external players like the United States government.

While I agree with much of what was said on the prior panel, there is learning going on. I experienced that personally. The Chinese government translated our book into Chinese which is very critical of the Chinese government—because there are many people in the Chinese system that want to learn. I don't deny that. But I think fundamentally the people who are engaged in this harassment strategy are the dominant players in the Chinese system now. They know exactly what they want, and they'll keep doing it.

We have to realize what the end game here is. The end game is not just de-IOE. It's de-U.S.A. technology. It's de-Microsoft. It's de-Intel. It's de-Qualcomm. It's essentially replacing all U.S. technology in China with Chinese-owned technologies, then using that to, as the Chinese

government says, "go out" and gain markets globally. Now they're not going to assault our markets initially, but they'll go into third-party markets to gain share and take it away from U.S. companies.

The second step is that the administration, whether it's this administration or the next administration, whatever party that might be, needs to make fighting this high-tech harassment a much higher priority. It needs to be a higher priority frankly than human rights in China. It needs to be a higher priority than North Korea. It needs to be a higher priority than climate change.

We have to act in our own interests on this, and unless we stand up and say we're going to do it, no one is going to do it for us.

A third area is we need to move away from a process-oriented trade regime with China to a results-oriented one. Process-oriented trade regimes work well with countries like those in Europe that aren't trying to manipulate the system, and we can file WTO cases against them. We can negotiate with them. We win some; we lose some.

That really doesn't work with China. They're too sophisticated to get tripped up with the TRIPS regime, to make a pun, or with the WTO, in general, and I think the only real answer is we have to set a set of results we think we want from China. We have to hold them accountable for those results, for making progress on those results.

Fourth, we need to fundamentally change how we think and act about trade enforcement. The incentives are all on the side of market opening for USTR and really for any administration. It's about how many trade agreements can you sign, and, just to be clear, we're very supportive of the Trans-Pacific Partnership. We're very supportive of a trade agreement with Europe.

That's not the issue. The issue is balancing market opening with trade enforcement, and right now I think that's out of balance. So we need to just do much more to step that up. I think Congress has a key role there. USTR is, I think, significantly underfunded when it comes to trade enforcement. They need a Trade Enforcement Officer.

Related to that, I think the interagency process doesn't really work in our interest in this space. The interagency process tends to be dominated by the agencies that would rather make nice than press hard against China. And I've seen that. When I go to the S&ED meetings, I watch that. USTR tends to be pretty aggressive. Commerce tends to be pretty aggressive, but many of the other agencies don't want to rock the boat. They have either other issues that they're interested in pursuing. We saw that, for example, on the Microsoft case where Department of Justice was silent, but could have made a public statement that this was inappropriate use of antitrust law and chose not to.

And lastly--I'm over my time. I apologize. Lastly, the idea we've thrown out as an interesting proposal is to give U.S. companies antitrust exemption for collaboration against government actions like this.

One of the problems is it's a monopsony environment--the big buyer,

multiple sellers, if you will. If U.S. companies could collaborate with each other and with European companies to essentially say we just simply will not invest in China unless you take these actions.

Right now, for example, we see China playing off of Boeing and Airbus against each other for who can give them the most technology transfer because they have the largest and fastest-growing jet airplane market in the world. If we had an antitrust exemption, Boeing and Airbus could collaborate and say we're going to not give technology to the Chinese more than what we would want to normally, and this would give a little bit more of an equal bargaining relationship.

So, in closing, I would say that I don't see this problem going away any time soon. I actually think it's going to be an even higher and worse problem in terms of high-tech harassment from the Chinese government. And I think unless we begin to take more serious action that shows them that we're serious, that they will continue to ramp this up.

Thank you.

**PREPARED STATEMENT OF ROBERT D. ATKINSON, PH.D.
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Testimony before the U.S.-China Economic and Security Review Commission

Hearing on Foreign Investment Climate in China

January 28th, 2015

**Dr. Robert D. Atkinson
President
Information Technology and Innovation Foundation**

Thank you inviting me to testify before the Commission. I appreciate the opportunity to appear before you today to discuss the impact of Chinese government policies on the foreign investment climate in China.

I am President of the Information Technology and Innovation Foundation. ITIF is a nonpartisan research and educational institute whose mission is to formulate and promote public policies to advance technological innovation and productivity. Recognizing the vital role of technology in ensuring American prosperity, ITIF focuses on innovation and productivity issues, including in the context of foreign trade.

The Shift to “China Inc.” Through Indigenous Innovation

From the early 1980s—when Deng Xiaoping made the decision to open China up to international investment—until the mid-2000s, the core economic development strategy for China was the active encouragement of foreign direct investment through a vast array of incentives, including tax incentives, free land, limited regulations and of course, government controls to keep the renminbi undervalued. The goal was to do whatever it took to induce foreign multinational corporations to move production to China. While the consequences of these policies might not have always been good for the U.S. economy, and especially for many U.S. production workers in traded sectors, U.S. multinational corporations benefited from access to a low-cost, global production platform. And Americans in their role as consumers benefited from lower cost goods. And while China occasionally engaged in policies that brought complaints from U.S. industry, by and large U.S. industry was satisfied with the relationship.

In 2006, that began to change. For that was when China made the strategic decision to shift to a “China Inc.” development model focused on helping Chinese firms, often at the expense of foreign firms. Chinese Communist Party leaders decided that attracting commodity-based production facilities from multinational corporations was no longer the goal. The path to prosperity and autonomy was now to be “indigenous innovation” (or in Chinese, *zizhu chuagnxin*) built around Chinese-owned firms.

The seminal document advocating this shift was “*The Guidelines for the Implementation of the*

National Medium- and Long-term Program for Science and Technology Development (2006-2020).” The so-called “MLP” sought to “create an environment for encouraging innovation independently, promote enterprises to become the main body of making technological innovation and strive to build an innovative-type country.”¹ This was much more than a strategy to target some key areas where China had some preexisting capabilities. Rather, the MLP “must be made a national strategy that is implemented in all sectors, industries, and regions so as to drastically enhance the nation’s competitiveness.”² The MLP called on China to “master core technologies” in virtually every area Chinese state planners could imagine. Included were some 402 technologies, from intelligent automobiles to integrated circuits to high performance computers. After the MLP, China began to seek the capability to master virtually all advanced technologies, with the focus on Chinese firms gaining those capabilities through indigenous innovation.

Since 2006, China has shifted more to the Japanese and Korean model of development based on helping its own domestic companies grow by moving up the value chain and gaining global market share. The tactics involve massive government subsidies, theft of foreign know-how, and forced technology transfer in exchange for market access, massive export subsidies, and discriminatory government procurement. This is perhaps why, according to an ITIF study, China ranks as the most mercantilist nation in the world.³ The goal is for Chinese companies to ultimately supplant foreign technology companies both in China and in markets around the world. As such, conflict now exists not just between American and Chinese workers; but between American companies and Chinese companies, just as it did between Japanese companies and American companies in the 1980s and 1990s.

Rising Attacks on Foreign Multi-National Corporations

Since President Xi Jinping assumed power in 2012, China has rapidly accelerated its efforts to promote “indigenous innovation” but not just using the “carrot” to help Chinese firms but also the “stick” to harass foreign producers. Xi has stated that China must “master its own technologies” to not only promote growth, but national security.

And under President Xi the shift to indigenous innovation has taken another turn. Increasingly, foreign firms face outright discrimination by Chinese governments. The American Chamber of Commerce stated in China’s 12th annual “*Business Climate Survey*” that American business owners are increasingly concerned about discriminatory government regulations and other policies that favor domestic companies. The fact that these actions have targeted technology-based sectors such as autos, information technology and life sciences is no accident: these are key technology sectors that China is seeking mastery in.

China discriminates against foreign firms through a number of different means, including tax,

¹ “CPC Central Committee’s Proposal on Formulating the 12th Five-Year Program on National and Social Development,” *Xinhua*, (adopted on 18 October 2010 at the Fifth Plenary Session of the 17th CPC Central Committee, Beijing, October, 2010).

² “National Medium- and Long-Term Program for Science and Technology Development of China (2006-2020): An Outline,” *Wenzhou*, January 2, 2012, http://english.wzj.gov.cn/program/program_detail.aspx?id=1.

³ Michelle Wein, Stephen Ezell, and Robert Atkinson, “The Global Mercantilist Index: A New Approach to Ranking Nations’ Trade Policies”, (Washington, DC: Information Technology and Innovation Foundation, 2014).

transfer pricing, antitrust, visa, and customs laws. For example, as far back as 2009, *Compliance Week* noted, “The [Chinese] government does indeed seem to be giving the local companies a pass. While bureaucrats are raiding foreign-run factories, imposing sizable punishments on multinationals, and making demands on transactions that have little to do with China, enforcement of other domestic regulations come up almost comically short.” The article goes on to note, “While the regulators are going after foreign companies, they appear to be taking it easy on local enterprises... This double standard may indicate that the great enforcement crackdown is as much a matter of industrial policy as it is an effort to raise taxes and prevent economic concentration.”⁴

We saw this initially with how the Chinese government treated Google. Google pulled out of China because of discriminatory treatment. (It is even thought possible that China intentionally slowed down Google search results and disrupted service in other ways.)⁵ As Nick Yang, cofounder of several Chinese technology companies, stated, “The Chinese government itself does not have a positive and supportive view of foreign search engine companies in China.”⁶ Using the rationale of maintaining social control, the Chinese government also blocked U.S. tech companies Facebook and Twitter.

Around two years ago, the Chinese government added a new tactic directly attacking foreign companies. One basis of the attacks is that U.S. technology products were not secure and therefore the government had the right to intervene. One tool of these attacks is a propaganda campaign carried out in the state-controlled media, with multiple articles claiming that U.S. tech company products were not secure, with one government blog threatening “to severely punish the pawns of the villain.”⁷ These attacks happened at the same time Xi took over the reins of a new Communist Party-led committee on cybersecurity. It's hard to underestimate the role of Edward Snowden's NSA revelations in this change of tactic. Before Snowden, the Chinese government was reticent to play this intimidation card. But Snowden gave the cover it needed for the Chinese government to claim the moral high ground and go after U.S. tech companies on trumped-up charges of lack of security.

In 2014, the Chinese central government ruled that government offices were prohibited from running Windows 8 (although many if not most Chinese government offices steal, rather than purchase Windows anyway). Soon after investigators from China's State Administration for Industry and Commerce raided Microsoft facilities in four Chinese cities, claiming it was investigating whether Microsoft violated China's anti-monopoly laws. The Microsoft case was not the first attack on U.S. technology companies. Over the last several years, virtually every leading American IT company has found itself in the Chinese cross hairs. Apple CEO Tim Cook was forced to publicly apologize for purported problems with iPhone warranties. Next up was Qualcomm and Cisco, with the National Development and Reform Commission claiming that both were monopolists. Around the same time, the Chinese government announced their “De-IOE campaign” to pressure Chinese companies to replace their IBM, Oracle and EMC products

⁴ Richard Meyer, “China Whets Its Enforcement Appetite,” *Compliance Week*, January 12, 2009, <http://www.complianceweek.com/china-whets-its-enforcement-appetite/printarticle/186600/>.

⁵ Steven Levy, “Inside Google’s China Misfortune,” *CNN Money*, April 15, 2011, <http://tech.fortune.cnn.com/2011/04/15/googles-ordeal-in-china/>.

⁶ Yinglan Tan, *Chinnovation: How Chinese Innovators are Changing the World* (New York: John Wiley & Sons, 2011), p. 254.

⁷ <http://thediplomat.com/2014/06/china-steps-up-attacks-on-us-tech-firms/>

with Chinese made ones.

The harassment of Microsoft appeared to be a tit-for-tat response to the Justice Department indictment in 2014 of five Chinese military offices for hacking into U.S. companies' computers to steal trade secrets. Indeed, the Chinese government has shown time after time that it doesn't just act to even the score when the U.S. takes action against China; it responds with overwhelming force. But these and other trumped up charges are part of a broader effort by the Chinese government to hobble U.S. technology companies in China, promote China's domestic IT industry, and ultimately replace the U.S. as the world's IT leader. This high-tech harassment will in all likelihood continue until China finally gets what it wants: the complete replacement in China of foreign technology companies with Chinese ones.

It's easy for the Chinese government to use Chinese law as an industrial policy weapon, as there is no real rule of law and their regulations, like their anti-monopoly law, give the government carte blanche ability to go after any foreign company for almost any reason, trumped up or legitimate. Indeed, China's 2007 anti-monopoly law is designed to treat legitimately acquired intellectual property rights as monopolistic abuse, with Article 55 stating, "This Law is not applicable to undertakings' conduct in exercise of intellectual property rights pursuant to provisions of laws and administrative regulations relating to intellectual property rights; but this Law is applicable to undertakings' conduct that eliminates or restricts competition by abusing their intellectual property rights."⁸ And for the Chinese government, abuse means charging market-based IP licensing fees to Chinese companies. This provision has been used to take legal action against companies whose only "crime" is to be innovative and hold patents... Indeed, the Chinese law allows compulsory licensing of IP by a "dominant" company that refuses to license its IP if access to it is "essential for others to effectively compete and innovate."⁹ And with the courts largely rubber-stamping Communist dictates, foreign companies have little choice but to comply. And all too often, complying means changing their terms of business so that they sell to the Chinese for less and/or transfer even more IP and technology to Chinese owned companies. All too often the Chinese government makes foreign technology companies "an offer they can't refuse."

Chinese Indigenous Standards Setting

China has coupled its high-tech harassment with the aggressive development of indigenous technology standards, particularly for information and communications technology (ICT) products. Indeed, indigenous standards setting has become a core component of its industrial development and economic growth strategy. China has done so believing that indigenous technology standards will advantage domestic producers while blocking foreign competitors and reducing royalties Chinese firms pay for foreign technologies.

Most technology and product standards around the globe are developed through international, voluntary, industry-led efforts. Firms meet and agree upon standards that are then used throughout the world. But China has taken a different approach. China's government has sought

⁸ "Anti-Monopoly Law of the People's Republic of China."

⁹ James McGregor, "China's Drive for 'Indigenous Innovation' A Web of Industrial Policies," (working paper, APCO Worldwide), p. 15, www.uschamber.com/sites/default/files/reports/100728chinareport_0.pdf.

to shape technology markets as best it can to afford advantages to Chinese enterprises. Indeed, since at least the 1990s, China's government has funded the pursuit of unique exclusionary standards embodying Chinese proprietary technology as part of that effort. China's institutions of standardization place the state at the center—making China's government the initiator, financier, and leader of most standardization projects.¹⁰ As noted, China's animating goal has been to develop homegrown technology standards both as a way to gain competitive and, hopefully, monopolistic advantage, and to reduce Chinese dependence on foreign technologies and the royalties Chinese enterprises have to pay for those technologies.

As the “Study on the Construction of National Technology Standards System” released by the Standards Administration of China (SAC) in 2004 framed it, China's standards approach sought to: (i) lessen the “control of foreign advanced countries over the PRC [People's Republic of China],” especially “in the area of high and new technology”; and (ii) increase the effectiveness of Chinese technical standards as important protective measures or barriers to “relieve the adverse impact of foreign products on the China market.”¹¹

China's focus on developing technical barriers to trade, such as indigenous technology standards, only grew in importance after China joined the World Trade Organization in 2001, in part because, as China scholar Dieter Ernst notes, “China's accession commitments to the WTO have substantially reduced the use of most other trade restrictions such as tariffs, import quotas, and licensing requirements.”¹² More recently, China's 12th Five-Year Plan (covering the years 2011 to 2015) proposed to “encourage the adoption and promotion of technical standards with indigenous intellectual property rights.”¹³ As one Chinese official explains China's prevailing view of technology standards: “Third tier companies make products; second tier companies make technology; first tier companies make standards.”

This mindset has led China to pursue an aggressive standards development strategy. In fact, by the late 2000s, China was launching well over 10,000 standards development, reform, or implementation projects per year.¹⁴ While most of those standards are comparable or identical to international standards, the reality is that China continues to pursue unique national standards in a number of high technology areas, even where international standards already clearly exist.¹⁵ As a result, China lags significantly behind other nations in developing a pro-innovation standards

¹⁰ Michael Murphree, “Building Markets: The Political Economy of Technology Standards” (PhD diss., Georgia Institute of Technology, May 2014), <https://smartech.gatech.edu/bitstream/handle/1853/51821/MURPHREE-DISSERTATION-2014.pdf>.

¹¹ James McGregor, “China's Drive for ‘Indigenous Innovation’: A Web of Industrial Policies” (U.S. Chamber of Commerce and APCO Worldwide, 2010), 5–6, https://www.uschamber.com/sites/default/files/legacy/reports/100728chinareport_0.pdf.

¹² Dieter Ernst, *Indigenous Innovation and Globalization: The Challenge for China's Standardization Strategy* (IGCC, 2011), 24, <http://igcc.ucsd.edu/assets/001/501951.pdf>.

¹³ Terence P. Stewart et al., *China's Support Programs for High-Technology Industries Under the 12th Five-Year Plan* (Law Offices of Stewart and Stewart, June 2011), 86.

¹⁴ Michael Murphree and Dan Breznitz, “Standardized Confusion? The Political Logic of China's Technology Standards Policy” (working paper, Industry Studies Association Conference, May–June, 2011), 24, <http://www.industrystudies.pitt.edu/pittsburgh11/documents/Papers/PDF%20Papers/5-1%20Murphree.pdf>.

¹⁵ Office of the United States Trade Representative (USTR), “2014 National Trade Estimate Report on Foreign Trade Barriers” (USTR, May 2014), 63.

policy. In fact, according to the WTO, in 2007 only 46.5 percent of Chinese national standards were equivalent to international standards.¹⁶ Moreover, as of 2007, approximately 14.5 percent of national standards, 15 percent of professional standards, and 19 percent of local standards in China were mandatory.¹⁷ (And even voluntary standards can become mandatory if they are referenced as part of mandatory conformity assessment procedures.) Moreover, China does not have a history of allowing foreign participation in its standards-setting process. As noted, China drafts many of these standards without foreign, or even public, input. And in many cases, even if foreign representatives are allowed to participate at all, they can do so only as observers with no voting rights.

But because the Chinese government knows that it has considerable “market power” over foreign companies due to its sheer size, it knows that unless challenged by other governments or the WTO, it has leeway in unilaterally setting technology standards to favor domestic firms or to force foreign firms to pay licensing fees. And in no sector of the economy has the Chinese government been more aggressive in developing indigenous technology standards than with regard to information and communications technologies; it has developed its own standards in wireless networking, mobile television, wireless storage, computer security, terrestrial television, digital satellite television, Internet protocol television, video codecs, digital rights management, the Internet of Things, and many other technologies. (See Figure 1.)

What’s Behind the Shift in Chinese Strategy?

At one level, this shift of Chinese strategy to not just proactively favor its own domestic companies but to actively attack foreign companies seems perplexing. Why alienate the very companies that can provide needed investment in your country? The answer appears to be that the Chinese leadership feels that now is the time for Chinese companies, particularly technology companies, to achieve global leadership positions and that a key way to do this is to step up attacks on foreign technology companies, in part to hobble them, but to also extract concessions from them, particularly on intellectual property licensing terms and on tech transfer conditions, including “requiring” U.S. tech companies to partner with Chinese-owned technology companies as the solution to end their government harassment. With regard to domestic standards setting, in many cases China is trying to strip others’ intellectual property from these standards in order to avoid paying royalties. At the same time, if they are to succeed in their “going out” policy, which seeks to encourage Chinese firms to become multinational with global reach and global brands, they feel that aggressive action against competitors is warranted.

Why This Strategy Hurts the U.S. and Global Economies

These Chinese policies toward U.S. MNCs clearly damage U.S. MNCs. They weaken their competitive position in not just the Chinese market but global markets. They reduce sales. They

¹⁶ Scott Kennedy, Richard P. Suttmeier, and Jun Su, “Standards, stakeholders, and innovation: China’s Evolving Role in the Global Knowledge Economy” (Special Report no. 15, National Bureau of Asian Research, September 2008), 24,

http://www.nbr.org/publications/specialreport/pdf/Preview/SR15_preview.pdf; Breznitz and Murphree, “The Rise of China in Technology Standards,” 36.

¹⁷ World Trade Organization, “Restructuring and further trade liberalization are keys to sustaining growth” (news release, WTO, June 2, 2010), http://www.wto.org/english/tratop_e/tpr_e/tp330_e.htm.

reduce profits, especially related to the ability to monetize investments made in the production of intellectual property.

But some argue that we shouldn't worry if U.S. firms are harassed by the Chinese government. Only they will get hurt and that it serves them right anyway for investing there in the first place. This view ignores the fact that the health of the U.S. economy is still based significantly on the health of U.S. multinationals, even ones that have moved much of their actual production offshore. The rapid decline of U.S. tech companies in China directly threatens the long-term economic prosperity and national security of the United States. If these policies are allowed to continue, we may soon see more U.S. tech companies falling behind, replaced by their Chinese competitors. For example, in 2014, the Chinese State Council released a strategic plan to dominate the global semiconductor supply chain by 2030. And while a company like Baidu is not likely to replace Google in America or Europe, it is intensely fighting for market share in other contested markets like Africa. As a thought experiment, what world would be better for America: a world where U.S. tech companies control 30 to 40 percent of the global market or one where they control 5 to 10 percent? Clearly the latter scenario is one of real decline for U.S. economy and national security.

These Chinese actions also harm the global innovation system—and especially markets for innovative products such as ICTs—in a variety of ways. Their standards policies fragment global markets, reducing scale. This is problematic because most ICT products exhibit high fixed costs (it costs a lot to develop the first product) but lower marginal costs (it costs less to produce subsequent products). Balkanized markets mean higher global costs of production which mean both higher prices and lower profits, the latter of which is important because companies need to earn profits in order to reinvest them in the risky and expensive investments required to produce the next generation of innovative technologies, such as next-generation semiconductors or mobile phones. Chinese IP policies, including harassment designed to force foreign MNCs to license IP at a steep discount also reduces the returns from innovation, making it harder to invest in the next round of innovation. In other words, because innovative industries principally compete not by making existing products cheaper but by inventing next-generation versions of the product (e.g., Intel competes not by making existing semiconductors cheaper and cheaper over time, but by inventing next-generation microprocessors), profits from one generation of innovation are vital to financing investment in the next.

Indigenous technology standards also add unnecessary costs for enterprises developing ICT products, such as by forcing them to develop a variety of versions of mobile phones or tablet computers to accommodate differing wireless network technology or encryption standards in different countries. And because those dollars could have gone into lower prices or investments in innovation and technology development instead of accommodating differing technology standards, countries' requirements for indigenous technology standards lower the global stock of innovation, to the detriment of all consumers globally.

Why Do U.S. Firms Accept Such Abuse?

Few U.S. multinationals are likely happy with how they are being treated in China. Indeed, there appears to have been a marked shift in attitude of U.S. multinationals doing business in China

over the last decade. This has shifted from an attitude of “it’s a nation with problems, but the market is so big and fast growing that we will put up with it” to “this is fundamentally unacceptable behavior.”

But why don’t U.S. companies just pack up and leave when confronted with capricious and detrimental government actions? This kind of discrimination if implemented by a smaller nation would be rejected out of hand by multinational corporations. For example, while the forced technology transfer practices of a nation like Argentina are onerous, their economy is small enough that many companies would rather give up on the Argentinean market than succumb to the strong arm tactics. U.S. multinationals have much less room to maneuver with China since it is the world’s second largest economy. This is why, in a 1999 survey of U.S. executives doing business in China by the U.S. Bureau of Industry and Security, “the majority of industry representatives interviewed for this study clearly stated that technology transfers are required to do business in China.”¹⁸ Foreign companies capitulate because they have little choice; they either give up their technology or lose out to other competitors that are willing to make the essentially Hobson’s choice. Industrial organization economists refer to this type of market as monopsonistic: having one buyer that can set largely whatever terms it wants against competitive sellers.

Conceivably if another large nation, such as India, were to emerge as having a favorable business climate for investment—that is, good infrastructure, low taxes, rule of law, protection of IP, and a welcoming attitude toward FDI—U.S. and other foreign multi-nationals would, at least at the margin, likely shift investment to that nation. But to-date no large nation, including India, appears close to being able or willing to do that. Moreover, virtually no U.S. company is prepared to walk away from the Chinese market, particularly given the pressures from shareholders for short-term returns. Our companies have to make returns this quarter; Chinese firms sometime in the next quarter century. In addition, because of the competitive rivalries between U.S. technology firms, firms often look at aggressive Chinese actions taken against their U.S. counterparts as serving their own strategic interests (at least in the short term).

What Should the U.S. Government Do?

The first step for any long-term response on the part of the U.S. government to this harassment of U.S. companies is to realize that this is now a core part of the Chinese government strategy and it will not change unless the Chinese government realizes that the strategy has costs. This is not principally about us being patient while the Chinese government realizes the error of their ways. It is about making it clear to them that this kind of behavior is unacceptable. This means realizing that America is in a trade war and a long-term fight for leading the global technology industry—a war we could very well lose unless we escalate our response. Fighting back has risks, but so does appeasement: the significant weakening of U.S. competitiveness and lost jobs. The Chinese have shown that they will respond to pressure, but only if it’s serious and done in concert with our allies.

The first key step will be for the administration to make fighting this high-tech harassment a higher foreign affairs priority than issues like climate change, human rights, or North Korea. For

¹⁸ U.S. Bureau of Industry and Security, “Technology Transfer to China,” (overview, U.S. Department of Commerce, Washington, D.C.: 1999), <http://www.bis.doc.gov/defenseindustrialbaseprograms/osies/defmarketresearchrpts/techtransfer2prc.html#techtransferprcpoliciesprocesses>

the Chinese government has learned that it can take these steps largely with impunity, suffering only criticisms from U.S. government officials at forums like the S&ED.

The second step will be changing how the U.S. government fundamentally thinks about and acts on trade enforcement. Congress should pass legislation creating within the Office of the U.S. Trade Representative (USTR) a Chief Trade Enforcement Officer and a Trade Enforcement Working Group, institutionalizing within USTR the function of trade enforcement, making it clear that at least one portion of USTR is expected to play the role of the bad cop. In addition, those agencies devoted to engaging with foreign nations on diplomatic, security, and financial concerns (such as the Departments of State, Judiciary and Treasury) should be relegated to an advisory capacity in the interagency trade process. Too often agencies like the Departments of Treasury, Justice, and State veto strong action against China either out of ignorance of what their real end game is or out a desire to not rock the boat. Enforcement should be left to those agencies that are equipped to do it best and have the largest stake in a strong and globally competitive U.S. economy, in particular, the Department of Commerce and USTR.

Equally important are additional resources for enforcement. In USTR's defense, bringing trade enforcement actions is time consuming and expensive. For the year 2015, the Obama Administration requested \$56 million for USTR, but both the House and Senate proposed underfunding that by between \$1 million and \$2.5 million. Not only is that far below what is needed for trade enforcement, but it reflects the mistaken belief that our economic competitiveness does not need to be protected. In fact, Congress should increase the USTR budget by around \$30 million to fulfill the need for this new Chief Trade Enforcement Officer and an associated Working Group staff of around 50 to 100.

USTR also needs to become more assertive in bringing enforcement cases against China. Companies are often reluctant to initiate complaints because they know that they will face retribution from the Chinese government. The U.S. government should address this conundrum by making it national policy for USTR to bring cases whenever U.S. interests are being hurt, even if U.S. companies don't want them to proceed.

The U.S. government also needs a national trade enforcement strategy that gives guidance to agencies, including the Department of Commerce and USTR, but also others, on what the enforcement priorities should be. Trade enforcement is reactive, treating "potato chips" the same as "computer chips." While there are strong political pressures on USTR to treat agricultural and commodity-based cases the same as high-tech one when it comes to trade enforcement, the reality is that the damage to the U.S. economy from losing tech-based output is significantly larger than losing commodity-based output.

The United States also needs to better empower multinational companies with tools to better resist forced technology transfer. As discussed above, one key part of China's mercantilist strategy is to tie market access to technology transfer. Foreign companies often agree to it because they don't really have a choice; they either give up their technology or their access to the world's fastest growing market, and in the process lose out to competitors who are willing to make the essentially Hobson's choice. Industrial organization economists refer to a market like this as monopsonistic: where one buyer can largely set whatever terms it wants to competitive sellers. To address this, Congress should pass legislation that allows firms to ask the Department of Justice for an exemption to coordinate actions regarding technology transfer and

investment to other nations. For example, if companies in a similar industry can agree that none of them will transfer technology to China in order to gain market access then the Chinese government will have much less leverage over them. The same would be true if companies agreed that they would not invest in China until China improved its intellectual property protections. This could be modeled in part on the 1984 National Cooperative Research Act, which led to an explosion of consortium-based research activity by removing a defect of antitrust law which suggested that collaborative joint research efforts among corporations were potentially collusive. For those who worry that extending this kind of cooperative tool to foreign tech transfer would somehow be anti-consumer, it's important to note that this would not apply to pricing issues, but only to tech transfer issues where companies could point to coercive action in foreign markets.

Congress also needs to ensure any future bilateral trade and investment treaty with China contain strong and enforceable provisions against forced technology and R&D transfer. In 2010, Premier Wen Jiabao announced, "We will ... enable foreign businesses to get national treatment like their Chinese counterparts." Yet, China's system of investment screening is discriminatory, and would constitute a denial of national treatment under U.S. investment treaties and free trade agreements. China bound certain rights of establishment when joining the WTO, namely those for which it scheduled commitments under the General Agreement on Trade in Services (GATS). In the WTO Doha Development Round, a key sticking point has been Chinese unwillingness to expand its GATS commitments. Thus, Chinese statements that it gives non-discriminatory treatment to foreign businesses are not accurate. The Office of the United States Trade Representative is negotiating a Bilateral Investment Treaty (BIT) with China. It is not clear that this treaty will contain the provisions needed to actually end pressured technology transfer. Congress should make it clear to USTR and the administration that no treaty is given preference to a treaty that does not firmly stop this practice. Congress should also make it clear that it will not judge any administration by whether a BIT with China is concluded, but rather by if the United States made a strong effort to conclude a treaty that provided full protection against mercantilist practices like forced transfer of R&D. Without this assurance, administrations will feel pressure to sign agreements just for the sake of signing agreements and being able to "check the box." technology transfer.

Finally, Congress needs to take steps to reform the way in which the national security system collects information. However, the reforms discussed by the Obama administration to date do not go far enough to establish the types of structural reforms needed to protect the economic interests of the United States. Specifically, Congress should clearly and unequivocally state that the policy of the U.S. government is to strengthen, not weaken, cyber security and renounce the practice of having intelligence agencies work to introduce backdoors and other vulnerabilities into commercial products. In addition, the President should work with other countries to establish common rules on when intelligence communities can access foreign data so as to promote zones of free trade in digital goods and services. Such a change in policy will not necessarily change Chinese high-tech harassment in the short term, but it will enable the United States government to more effectively challenge their rationales for it.

In summary, it's not too late to protect global innovation and U.S. from these unfair attacks from China. But absent concerted action soon, we will have to live with the long-term negative consequences on the U.S. economy and national security capabilities.

Technology-Product Category	International Standard(s)	Chinese Standard(s)
Wireless—Home Networking (Local Area Network Encryption)	Wi-Fi (i.e. IEEE 802.11i)	WAPI
Wireless—Metro Area Network	WiMAX	McWill
Mobile Telephony	WCDMA, CDMA2000, LTE	TD-SCDMA, TD-LTE
Mobile TV	DVB-H, T-DMB, MediaFLO	CMNB, T-MMB, CDMB, DMB-T, CMB
Radio Frequency Identification	ISO 18000 and others, EPC/GS1, Uid	NPC
Security—Personal Computers	TPM (Trusted Protocol Manager)	TCM (Trusted Cryptographic Manager)
Consumer Electronics—Terrestrial TV	DVB-T	DTMB (Compulsory)
Consumer Electronics—Satellite DTV	DVB-S	ABS-S
Consumer Electronics—IPTV	Open IPTV	CCSA
Digital Video Players	SVCD, DVD, Blu-Ray, HD-DVD	VCD 3.0, CVD, EVD, HDV, HVD, CBHD
Video Codec	Various MPEG formats	AVS
DRM (Digital Rights Management)	Marlin, OMA DRM, or DTCP-IP	China DRM
Home Networking	DLNA, UPnP, KNX, ECHONET	IGRS, ITopHome
Digital Trunking	TETRA, iDEN	GoTa, GT800
Document Formatting	ODF, OOXML	UOF
Mobile Phone Charging	None	YD/T 1591-2006

Unique Chinese Standards Development Efforts (1993-2010)

Figure 1: Chinese Technology Standards¹⁹

¹⁹ National Science Foundation, Science and Engineering Indicators: 2014 (Appendix Table 6-25: Exports and imports of ICT products, by region/country/economy: selected years, 1997-2012), <http://www.nsf.gov/statistics/seind14/content/appendix/at.pdf>

**OPENING STATEMENT OF DAN HARRIS
FOUNDER/PARTNER, HARRIS MOURE**

MR. HARRIS: Oh, thank you.

I was introduced as an expert, and I'd like to qualify that by saying I do not think of myself as an expert. I am just a private practice lawyer who represents American and Australian companies and some European and Canadian companies as well in China.

I'm going to tell you a little bit about what we do so you can get a little bit better perspective of where I'm coming from on this. The bulk of my clients' firms are small and medium-size businesses, mostly American businesses, but some European and Australian and Canadian businesses as well. Most of them have revenues between 100 million and a billion a year. Our clients are mostly tech companies, manufacturing companies and service businesses.

About 20 percent of our work is for companies in the movie and entertainment industry. We have some clients in highly-regulated industries, like health care, senior care, banking, insurance, finance, telecom and mining, but those companies make up less than ten percent of our client base.

Most of the China work we do for our clients is relatively routine. We help them register as companies in China. We register their trademarks and copyrights in China. We draft their contracts with Chinese companies. We help them with their employment, tax and customs matters. We oversee their litigation in China, and we represent them in arbitrations in China. We help them buy Chinese companies.

For our clients, the big anti-foreign issue is whether they will be allowed to conduct business at all in China as that is certainly not always a given. Certain industries in China are shut off or limited to foreign businesses acting alone. For our clients, publishing and movies are most prominent.

Essentially anything that might allow for nongovernmental communication to or between Chinese citizens is problematic, but it is not clear to me that these limitations are intended to be anti-foreign, as China does not really want any private entities, foreign or Chinese, engaging in these activities without strict governmental oversight.

So do these limits against foreign companies arise from anti-foreign bias or just the Chinese government's belief that it can better control Chinese companies? To our clients, that distinction doesn't matter.

On day-to-day legal matters, our clients are almost invariably treated pursuant to law, and so long as they abide by the law, they seldom have any problems. The problem for our clients isn't so much how the Chinese government treats them; it's how they are treated as compared to their Chinese competitors who are less likely to abide by the laws and more likely to get away with it.

I have no statistics on this. I doubt there are any statistics on this, but

I see it and I hear it all the time. I see it when one of our clients buys a Chinese business that has half of its employees off the grid and has facilities that are not even close to being in compliance with use laws, and I know foreign companies cannot get away with that.

And I hear it from Chinese employees of our clients who insist that there is no need for our clients to follow various laws. They insist there is no need to follow various laws and to do so is stupid. Is this disparity due to anti-foreign bias or is it due to corruption? Again, for our clients, the answer is irrelevant.

Thank you.

**PREPARED STATEMENT OF DAN HARRIS
FOUNDER/PARTNER, HARRIS MOURE**

**January 28, 2015 Dan Harris
Harris and Moure PLLC
Testimony before the US---China Economic and Security Review Commission
Hearing on the Foreign Investment Climate in China**

I. China's Treatment of Foreign---invested Firms¹ in 2014

2014 was a challenging year for foreign business in China. Across many industries, foreign companies reported a rise in legal and administrative investigations, and increased administrative difficulties with normally routine matters such as taxes, visas and customs. For larger companies, a rise in enforcement of China's Anti---monopoly Law ("AML") introduced new elements of risk for local operations and added complications for global M&A. This increase in legal and administrative enforcement actions has led many in the foreign business community to conclude that business in China is becoming more difficult,² with some even suggesting that "multinational companies are under selective and subjective enforcement by Chinese government agencies."³

Given this concern, it is fitting that the Commission has called this hearing to address the overall business environment for foreign firms. It is my hope that our efforts today will contribute to a better understanding of the changing business environment facing foreign firms in China.

Though concerns have been raised about a rise in discriminatory conduct against foreign businesses, my own view is that the dominant trend in 2014 was that of increased enforcement nationwide, equally affecting both domestic and foreign companies. One of the lessons I've learned from handling China legal matters over the last decade is that a good part of my law firm clients' claims of anti---foreign bias often stem from a misunderstanding of China and its laws rather than actual discriminatory action.

In suggesting this trend, I am not turning a blind eye to the reality that foreign firms are not always treated fairly in China, nor am I ignoring the fact that foreign---bias may have played a role in certain investigative decisions, such as AML.⁴ Rather, I suggest we view the current foreign business climate as being shaped by two interrelated factors:

- First, a long---term trend whereby the Chinese government seeks to attract

¹ "Foreign," in this report, refers to any company established in China with any amount of foreign---investment.

² A recent survey by the American Chamber of Commerce in China found that 60% of member companies reported feeling less welcome in China than before ----- a 20% rise over 2013. 49% of companies reported that they felt foreign firms were being singled out unfairly by the Chinese government. See American Chamber of Commerce in China, *Challenges and Opportunities in China's Investment Environment 2014*, available at: <http://www.amchamchina.org/wp---investment2014>.

³ *Id.*

⁴ See Section IV.B.

and condition foreign investment in order to advance its own national economic and industrial policy goals.

- Second, a more recent trend whereby the Chinese government is enacting substantial administrative reforms, one effect of which is an increase in administrative enforcement.

In the remainder of this section, I will address this second, more recent, trend. In Section II, I will cover the first trend, i.e., the mechanisms China uses to condition foreign investment to ensure it contributes to China's own national economic and industrial policy goals.

A. Administrative Enforcement Activity against Foreign Business in 2014

In 2014, the foreign business community in China witnessed a number of government actions seen as negatively affecting the foreign business climate:

- A notable increase in China's enforcement of its AML, including:
 - Combined fines of \$46 million against Volkswagen and Chrysler, and nearly \$200 million in fines against 12 Japanese auto---parts manufactures in separate price---fixing investigations;
 - Numerous investigations into domestic pharmaceutical manufacturers;
 - Blockage of a planned global shipping alliance between Moller---Maersk, CMA CGM, and MSC Mediterranean; and
 - Ongoing investigations into the local business practices of Microsoft and Qualcomm.
- Multiple anti---corruption investigations against foreign pharmaceutical companies, including a \$500 million bribery fine levied against British Pharmaceutical company GlaxoSmithKline.
- Numerous campaigns in China's state---run media targeting, among others, KFC, Apple, and McDonalds for alleged consumer rights violations.
- A domestic backlash against foreign information technology providers and calls for eliminating foreign technology in key sectors by 2020.
- From my law firm's own clients, we have also seen greatly increased enforcement on all sorts of relatively routine business matters such as customs duties, employee layoffs, visa checks, and tax payments.

In several of these cases, we should recognize that there appears to have been concrete evidence of wrongdoing sufficient to justify a government response. But looking at some of the more

borderline cases ----- the more routine administrative difficulties ----- it is difficult to ascertain whether this rise in enforcement has been motivated by anti---foreign bias or driven by some other factor. One effect of China's general lack of legal transparency is an inability to precisely determine the driving factors behind government action. And from the foreign perspective, there is often a tendency to view any adverse action as some form of "bias," when really it just may be how things are done (or being done) in China. In the present case, the recent rise of administrative and legal enforcement actions against domestic companies suggests that more than just simple anti---foreign bias is motivating this recent enforcement.

B. Administrative Enforcement Activity Against Domestic Business in 2014

When viewed in isolation, it seems perfectly reasonable to conclude that some amount of selective enforcement is motivating the increase in administrative and legal enforcement actions against foreign companies. However, looking at the past year for domestic businesses we see many of the same pressures:

- Politically, President Xi Jinping is spearheading a large, possibly unprecedented, anti---corruption campaign targeting Communist Party officials at all levels, including those in the management ranks of state---owned enterprises. Seeking out the "tigers and flies" of official corruption, this campaign has resulted in administrative raids of thousands of domestic businesses suspected of bribery violations involving corrupt officials. Though these investigations have also ensnared some foreign companies, the numbers affected and business disruption caused pale in comparison to domestic firms.
- Although there are important questions to be asked regarding China's application of the AML against foreign companies, we must also recognize that Chinese authorities have not been reluctant to carry out AML investigations against its own domestic companies. According to NDRC statistics, AML enforcement agencies have carried out investigations against 339 companies since the promulgation of the AML in 2008, of which only 33 were foreign companies.⁵ Generally, these investigations fail to garner the type of Western press coverage that follows actions against foreign companies, even though the damage awards are similar. For instance, over the last two years we have seen the following major fines levied against domestic companies for price fixing:⁶

- \$107 million against milk powder manufacturer Wuliangye;
- \$18.6 million against three domestic cement manufacturers;
- \$73.5 million against two Chinese liquor producers; and

⁵ See 中国反垄断法实施6年多查处339家机构外企仅33家[In the 6 Years since China's AML has been implemented, 339 organizations have been investigated, 33 foreign"], China News Web, Dec. 6, 2014, available at: <http://finance.chinanews.com/cj/2014/12--06/6851996.shtml>.

⁶ Industry observers speculate that one of the main motivations behind the recent increase in AML investigations is the possible belief of China's National Reform and Development Commission that AML is the best tool available to reduce prices on citizen's daily goods.

- \$18 million against 23 auto---insurers.
- Chinese tax authorities have also launched twin campaigns to more strictly enforce tax laws relating to personal foreign income and to curb tax evasion by Chinese companies operating abroad.⁷

If the rise in administrative enforcement actions against foreign companies was to enhance domestic competitiveness, as some suggest, then it seems unlikely that China's administrative, party and judicial authorities would carry out equivalent, and perhaps more intrusive, investigations into their own domestic companies. That we've seen a similar increase in administrative enforcement actions against domestic companies suggests that larger elements are at play.

C. Potential Drivers of China's Increased Administrative Enforcement

Though we cannot know with certainty what exactly is behind China's rise in administrative enforcement, it is apparent that this increase coincided with Xi Jinping's rise to power and is due in some part to his ongoing anti---corruption and economic reforms. In particular, two major administrative reforms seem to be supporting this new role for Chinese administrative and judicial authorities.

First, Xi's plans for China's economic reform codified at the Third Plenum in November 2013 included a call for the "market to play a decisive role in allocating resources." As part of this greater market opening, a series of administrative reforms have been promulgated aiming to simplify China's investment approvals process by reducing government oversight at the initial investment approval stage. According to one of our clients, these reforms are requiring regulators to shift their resources away from their traditional role as industry gatekeeper. In a bid to find a new role for these resources, these regulators are now increasing their domestic supervision and enforcement efforts.

A second complementary factor is Xi Jinping's emphasis on governing the country according to the rule of law.⁸ Highlighted in the Third Plenum Communique but made the singular focus of the recent Fourth Plenum, Xi's rule of law reforms are aimed at creating a stronger and more professional judicial corps, while also increasing the transparency of judicial decisions. China's state---run media outlets have further highlighted the "rule of law" as an essential component of Xi's ongoing corruption campaign and as a necessary basis for advancing his economic reforms. As Chinese regulators are often motivated and assessed by their ability to hew to Party dictates, it could be that this increased emphasis on rule of law – in tandem with the administrative reforms described above – may be leading to increased

⁷ See, e.g., *China Starts Enforcing Tax Law for Chinese Citizens Working Abroad*, New York Times, Jan 7, 2015, available at: <http://mobile.nytimes.com/2015/01/08/business/international/china---starts---enforcing---tax---law---for---citizens---working---abroad.html>.

⁸ Some translators have offered the phrase "rule by law." Whichever the case, party documents indicate that the rule of law (or rule by law) should "be advanced under CPC leadership," indicating the continued primacy of the Party in China's administrative hierarchy, and suggesting that rule of law may not provide an independent check on Party power.

enforcement activity by China's administrative and judicial actors.

These two political developments appear to be the main drivers behind this recent trend of increased administrative enforcement activity, and may help explain why foreign companies have seen business conditions deteriorate over the last 12---24 months.

II. Legal and Regulatory Obstacles Facing Foreign Companies in China

As noted in the previous section, the foreign business climate in China is currently being shaped by two interrelated trends: a short---term trend of increased administrative enforcement, equally applied against both foreign and domestic companies, and a longer---term trend of conditioning foreign investment in line with China's national policy goals.

In this section, I will describe the second of these trends, which I view as primarily responsible for many of the legal and regulatory obstacles currently facing foreign companies in China. To do so, I will rely heavily on a recent study prepared by the law firm Covington & Burling for the European Commission Directorate---General for Trade (the "EC Report").⁹ Prepared to help EU and US trade officials prepare to negotiate bilateral investment treaties and other trade agreements with China, the EC Report identifies two mechanisms – legal restraints and extra---legal administrative practices – that may act to "restrain" foreign investors and investment in China.¹⁰

A. Legal Restraints

The EC Report uses the term "Legal restraints" to refer to those *codified* legal measures that have the potential to discriminate against foreign business, either by favoring domestic investors or investments over foreign investors or investments, or by favoring state---owned investors or investments over privately---owned investors or investments.

The report identifies three broad categories of legal restraints affecting foreign business in China:

1. Pre---establishment restraints, such as "discriminatory local partner/equity requirements, market entry restrictions [e.g., minimum---amounts of foreign equity or administrative licensing restrictions], approval process restraints, and technology transfer measures";
2. Post---establishment restraints, such as "differentiated treatment through targeted enforcement, government financial support, and government procurement"; and,

⁹ See Covington and Burling LLP, *Measures and Practices Restraining Foreign Investment in China*, available at: http://trade.ec.europa.eu/doclib/docs/2014/august/tradoc_152739.08.10.pdf.

¹⁰ The study defines "restraint" as any mechanism "that ... can result in more favorable treatment for at least one domestic investor or investment than is available generally for foreign investors or investments."

3. “Broad policy statements that *potentially* result in less favorable treatment for foreign investors and investments during both the pre---establishment and post---establishing stages.”

Historically, legal restraints have been one of the more common mechanisms by which China has sought to shape or direct foreign investment over the last several decades.¹¹ However, because legal restraints are codified in existing laws, they are easily appealable before international trading bodies, making them less effective over time as China becomes more fully immersed in international trading regimes. As a result, the current trend in China is away from the use of black---and---white legal restraints in favor of administrative practices.

B. Administrative Practices

Administrative practices are defined in the EC Report to include “the practices of agencies and officials in all branches and at all levels of government, including those engaged in legislative and judicial as well as executive functions.” The EC Report then uses the term “administrative restraints” to refer to “those administrative practices sometimes used to restrain, condition or otherwise frame foreign investment, including especially those practices that are not explicitly authorized or compelled by published rules.”¹² In some cases, administrative practices may actually conflict with the written law, such as where the government places an additional extra---legal requirement on a foreign investment project. For instance, where a required license is conditioned on the foreign investor entering into a joint venture with a local partner where no such joint venture requirement is found in the law.

Based on extensive research and discussions with industry, the EC report identifies 21 administrative practices falling into four broad categories:

1. Rule---Making (4);
2. Administrative approvals (6);
3. Standards setting (3); and
4. Judicial processes and enforcement (8).

These practices include such matters as verbal instructions (“Oral instructions received by administrative authorities may go beyond what is required in law”) or issues concerning

¹¹ The EC Report notes that legal restraints are primarily used to promote domestic national champions, encourage or protect strategic industries, and promote export or foster indigenous innovation. Local governments may also employ legal restraints to promote their own local industries or to enhance local tax revenues or employment.

¹² The EC Report seems to mainly rely on the term “administrative practice” to refer to both the administrative practice itself as well as the administrative restraint it causes. This usage is followed here.

legislative transparency (“Foreign attorneys have limited access to legal hearings and other proceedings.”). At their heart, they involve systemic processes, omissions or instructions that restrain foreign investment in China, but which are difficult for foreign companies to appeal because they are not formally codified and are often applied by government agencies on an *ad hoc* basis.

According to the EC Report, “foreign investors in China generally believe that **these administrative practices match or even trump published rules as a source of investment restraints**, (emphasis added) because of three characteristics of China’s administrative system:”

1. “Reliance on industrial policies explicitly designed to support the development of domestic industries and creation of domestic champions;
2. The pivotal role of relatively opaque inbound FDI approval processes led by officials explicitly mandated to help China achieve its industrial policy goals; and
3. The lack of effective recourse if aspiring foreign investors believe that the approval authorities have not complied with WTO commitments or China’s own regulations.”
4. These three characteristics demonstrate the core components of China’s long-term trend of conditioning foreign investment in support of national policy goals, and represent some of the core legal and regulatory obstacles facing foreign business in China.

Finally, it should be noted that while we know Chinese officials use administrative practices, we do not know many of the details surrounding their use: how frequently they are applied, what they normally entail, or which industries are most often targeted. As one can imagine, foreign companies are generally reluctant to report the use of administrative practices by Chinese authorities, in part for fear of government backlash from these same authorities. As a result, additional research is needed to quantify their total impact. In Section V, I will propose one such mechanism to achieve this goal.

III. China’s Legal Transparency and Its Affect on Foreign Companies

Although China has made great strides in developing a rule of law over the last thirty years, an ongoing lack of legal transparency continues to create compliance and regulatory obstacles for foreign business in China.

In the EC report, many of the most commonly reported administrative practices relate to legal transparency:

- “Regulatory ambiguity allow[ing] regulators to interpret laws in ways

that advantage local companies or impose special conditions on foreign companies;”

- “Local discretion in deciding whether to enforce PRC laws;”
- “[Limited access of foreign attorneys] to legal hearings and other proceedings;”
- “Legal measures or court decisions not always made public;” and
- “[A] lack of judicial independence.”

Of these issues, “regulatory ambiguity” is far and away the most commonly reported administrative practice. Here, the issue is that many of China’s promulgated laws and regulations contain ambiguous or general language, and often lack definitions for key terms. The resulting lack of precision creates uncertainty for local businesses, whose legal compliance efforts must then be structured around these vague and ambiguous legal requirements.¹³ These difficulties are further exacerbated by the fact that Chinese court decisions are not regularly published, or, if published, often fail to include detailed legal reasoning. This prevents companies from understanding how a particular law or provision within a law has been interpreted or applied in practice.

As a result of this legal ambiguity, Chinese regulators are afforded a great deal of discretion to choose whether or how to interpret a law in response to a given activity. This provides a mechanism for political interests to affect legal interpretation, and contributes to the use of administrative practices discussed in Section II.B.

IV. China’s Treatment of Foreign Companies by Sector

A. Indigenous Innovation and the Strategic Emerging Industries

China’s treatment of foreign companies is determined in large part by the country’s economic and industrial policies goals. To further its economic development, China seeks to attract foreign investment, technology and expertise in the “Strategic Emerging Industries” to further their own development of national champions in these industries.

This Commission is well aware of these programs, having previously addressed them in a 2011 hearing entitled “China’s Five---Year Plan, Indigenous Innovation and Technology Transfers and Outsourcing.”

In that Hearing, the hearing co---chair summarized these industrial policy goals:

¹³ Some have argued that China’s ambiguous legal drafting is a positive feature, providing flexibility for China’s regulators to interpret laws in line with actual circumstances and apply domestic laws fairly across a diverse national environment taking into account specific local conditions.

In its newly---adopted 12th Five---Year Plan China makes clear that it hopes to move up the manufacturing value chain by making explicit mention of Strategic Emerging Industries, which the Chinese government would like to see dominated by Chinese firms. These industries are: New--- generation information technology, high---end equipment manufacturing, advanced materials, alternative---fuel cars, energy conservation and environmental protection, alternative energy, and biotechnology. China's goal is to take the Strategic Emerging Industries from a current combined share of 3% of Chinese GDP to 8% by 2015 and 15% by 2020.

One of the tools the Chinese government will use to grow these Strategic Emerging Industries is indigenous innovation. This policy seeks to help China move up the value---added chain. Indigenous innovation policies have drawn criticism from the U.S. and European business communities and policy makers because China uses this policy to require foreign companies to transfer their higher technologies and know---how as a condition of doing business in China or getting government procurement contracts in China.¹⁴

Given these official policies, foreign companies investing in these industries are likely to attract greater government scrutiny from Chinese officials. This enhanced administrative scrutiny is not always negative. In many cases, China has shown a great willingness to attract foreign investment in identified industries, providing tax breaks, streamlined administrative approvals and other incentives designed to spur investment. Indeed, when Western parties claim discriminatory treatment, one of the standard responses from Chinese media commentators is to point out these incentives and claim that it is, in fact, domestic companies that face the real discrimination, since they do not receive the same incentives provided to foreign companies.

For example, after several industry groups released statements calling attention to China's possible selective targeting of foreign companies in AML investigations, the state---run newspaper Global Times included comments from a Beijing---based economist ----- Wang Jun of the China Center for International Economic Exchange – stating that “recent antitrust investigations have not been targeting foreign businesses” and “in fact, in the last three decades, these overseas firms have actually been giving preferential treatment in areas such as taxation.”¹⁵

Nevertheless, there remains a fear that when targeted industries have reached a certain point of domestic maturity, this formally positive treatment will shift to gradually increasing administrative interference so as to promote the long term growth prospects of Chinese firms. And there are some who feel that China's recent AML investigations may be following this path.

¹⁴ See *Prepared Statement of Commissioner Patrick A. Mulloy Hearing Co---Chair*, available at: <http://origin.www.uscc.gov/sites/default/files/transcripts/6.15.11HearingTranscript.pdf>

¹⁵ See *Foreign Firms Not Being Singled out in Antitrust Campaign: Officials*, Global Times, Dec. 8, 2014 available at: <http://www.globaltimes.cn/content/895645.shtml>.

B. Recent Actions against Foreign Automobile, Pharmaceuticals, and Technology

As noted prior, one of the key factors driving recent AML activity is the newly emboldened NDRC and its apparent belief that the AML is the best tool for reducing prices. This argument is supported by the numerous AML actions affecting both domestic and foreign manufacturers of consumer goods that have occurred over the last two years.

One other potential driver is the belief among certain Western observers that the AML is being applied in areas where industrial policies have failed in China. According to an analysis of recent AML actions by The Conference Board:

“One consistent theme across AML investigations to date – in sectors as diverse as pharmaceuticals, baby formula, IT technology, and automobiles – is that the imposed remedies require both substantial price reductions as well as the abandonment of contractual controls that enable owners of brands and other IP to leverage those assets across their supply chains to maximum full value in the Chinese market. The fact that the investigations disregard market share and market power as the critical transgression makes it clear that this is about curbing the industry---wide power of foreign investors, and not about addressing monopoly abuses per se.”¹⁶

The analysis then suggests that these investigations are focused on disrupting “what the NDRC calls ‘vertical monopolies’ – i.e., the power brand and IP owners have to control costs and pricing across their supply chains and, in doing so, maximize their own margins.”

If substantiated, this type of AML application raises obvious concerns for foreign business. Although my testimony today has largely focused on the trend of increased enforcement, impartially applied, I must also make clear that I believe there are valid questions and concerns to be raised regarding the Chinese government’s use of AML actions against foreign companies. With that in mind, one aspect of China’s recent AML investigations we may wish to keep in mind is that the Chinese companies most at risk of an

AML action based on pricing power will generally be China’s biggest and most powerful companies, and will frequently be state---owned. Because of obvious reasons, these are the same companies the Chinese authorities are likely least willing to confront. This asymmetry between large foreign and Chinese companies could be one reason that foreign companies will be more likely to come under AML scrutiny than Chinese companies.

C. Protecting the Interests of Foreign Companies

At present, foreign investors affected by the use of administrative practices or China’s selective enforcement of its AML have little potential recourse to protect their interests. In a

¹⁶ See The Conference Board. *China Center Quick Note: The AML Background – Looking Behind and Beyond the Current Regulatory Salvo*, available at: <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2880>.

2013 report on China's investment approval process, the US Chamber of Commerce noted four factors that discourage foreign investors from using China's official appeals mechanism:

- “Very broadly defined grounds for denying investment applications and lack of an explicit affirmative duty for approval authorities to approve applications submitted to them if the applications meet clearly specific criteria;
- Difficulty in providing solid evidence of inappropriate conduct, since approval authorities generally rely on oral communications to convey specific conditions of approval, and such communications are often relayed indirectly through a Chinese joint venture partner.
- The fact that decisions of approval authorities and the People's Courts are all subject to Party supervision and are expected to align with the same underlying policies of the Party; and
- The reality that potential investors are extremely reluctant to challenge the decisions of approval authorities, who have considerable power to affect companies' future business prospects in China.”¹⁷

Given these factors discouraging formal appeal, foreign companies must often accept an extralegal administrative practice in exchange for Chinese market access. In light of this reality, one option worth considering is the creation of an online reporting platform allowing foreign companies to aggregate data from their experience in order to better understand, analyze and quantify extralegal behaviors carried out by Chinese officials. Such a tool could permit a company to report the type of administrative practice encountered (e.g., a request for technology transfer in exchange for a license), and record other pertinent data such as the date, location, and identity of the requesting government agency.

The Indian website “I Paid a Bribe” is one example of this type of tool. With “I Paid a Bribe,” the problem faced by Indian citizens was very similar to the one currently facing foreign business in China ---- how to report potentially illegal or corrupt government conduct without incurring government retribution. By harnessing the power of the social web, “I Paid a Bribe” has now accumulated over 35,000 total reports, including not only instances of bribery requests, but also reports of “honest officials” and “bribe fighters.” It has since been replicated in other countries, including Pakistan, Kenya and Bhutan, although sadly, efforts to implement similar systems from within China have run afoul of government censors.¹⁸

¹⁷ See U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Direct Investment: Impact on Market Access, National Treatment, and Transparency* (2013), available at: https://www.uschamber.com/sites/default/files/legacy/reports/020021_China_InvestmentPaper_hires.pdf

¹⁸ See *Web Sites Shine Light on Petty Bribery Worldwide*, New York Times, Mar. 7, 2012, available at: <http://www.nytimes.com/2012/03/07/business/web-sites-shine-light-on-petty-bribery-worldwide.html?pagewanted=all&r=0>

By establishing a similar website overseas, foreign companies would have a mechanism to report extralegal conduct as well as instances of honest officialdom without the potential for government retribution. This dataset would not only help China's efforts to institute a rule of law within China and stamp out corruption, but it would also provide a searchable dataset for foreign companies looking to invest or expand in China, permitting them to choose those localities and provinces that are most receptive to foreign investment.

Of course, design of such a system would need to confront such questions as veracity and access (for instance whether to make the platform closed to qualified individuals within designated companies or open to the public), and additional input from industry participants would be needed to assess their needs. Nevertheless such an approach would bring some degree of light and transparency into what is now a very opaque market environment.

PANEL I QUESTION AND ANSWER

HEARING CO-CHAIR SLANE: Mr. Moure. Mr. Harris. I'm sorry.

HEARING CO-CHAIR SLANE: Thank you.
Commissioner Wessel.

COMMISSIONER WESSEL: Thank you both for being here, and, Rob, congratulations to you and your organization for its recently being noted, I believe, as one of the top think tanks by an August publication. That's something we knew here from our interactions with you, but now has been recognized. So congratulations.

I'm reminded from this panel and the previous panel of an old Peanuts cartoon, which probably was repeated many times, where Lucy is holding the football and trying to convince Charlie Brown to come running at full speed and kick it, and she'll hold it. So we do S&ED. We do JCCT, and we have a discussion. Our officials leave and say, you know, we're on the right path. The path doesn't change: rising trade deficits; U.S. companies that are losing IP, losing opportunities; et cetera, et cetera.

We're now engaged in a BIT negotiation, and I believe we're in the 18th round, as I recall, although not a lot of progress until the negative list comes out shortly this year.

It seems to me that with all that we know and what we've heard today, that a BIT is actually the worst thing we could do right now. By ratifying China's approach, by basically giving a Good Housekeeping Seal of Approval to U.S. companies to expand investment in China, as well as--not that we don't already cover Chinese companies operating here under the rule of law, but a little greater confidence, I think, because their government is worried about politicization with, you know, a number of cases that have come in the past.

It seems to me we shouldn't be pursuing the same approach that we've been pursuing so long. I'm not--and I believe it was said earlier--I'm not saying we shouldn't engage, but we should expect results, and we should stop offering benefits and expecting results different than we have in the past.

Shouldn't we change what we're doing? To both panelists.

DR. ATKINSON: I absolutely agree we should change what we're doing. Simply going to Beijing or having the Chinese government come here and having a couple days of meetings and having some commitments, it's helpful. I mean don't get me wrong. There are certain areas--I've seen that--where if the pressure is sustained enough, broad enough, and focused enough, Chinese will back down. The problem is it's seldom that's the case.

Or when they back down, if they back down, a little bit. We see that, for example, in the HNTE, the High and New Technology Enterprise, R&D credit, which is discriminatory against U.S. enterprises and tries to take their IP along with it, and Chinese are making, I believe, modest, modest adjustments to it but aren't fixing it.

So I think, as I said before, your point about a BIT is a good one. I think ultimately we should have a BIT with China, and it should be incredibly strong, but it does send a message that we essentially are saying to the Chinese, we believe what you're doing is okay right now, and we'll just negotiate with you, and I don't think that's the right message. The message we should say to them is you really are not behaving in an appropriate way as a member of the WTO, and until you start to make real substantive changes that we can document, that have results, we're going to a fundamentally different approach with you.

Now, exactly what that looks like, I don't have the answer to, but I do think one of the first steps--I think a commissioner earlier talked about the trade deficit being an important indicator--I agree with that. But we've got to go beyond that because I could see fundamentally the Chinese getting to a model where they import a lot of our beef and our corn, and the trade deficit goes down, but they're exporting high-tech products and, you know, potato chips, computer chips, they're not the same.

COMMISSIONER WESSEL: I know it needs to be the composition.

DR. ATKINSON: It needs to be the composition.

COMMISSIONER WESSEL: Yes.

DR. ATKINSON: So I go back to this. The U.S. government should have a policy where we identify four or five top things we expect trade performance on. One of them should be the trade deficit. We should see movement down.

I think a second should be IP theft. A third should be fairness in treatment of foreign companies there, and a fourth should be forced, coerced tech transfer, and a fifth should be something around cyber theft and other sorts of direct espionage to steal our intellectual property.

We know how much they're doing, I believe. I think the NSA and other parts of the intel community know that, and I think we just have to say here are the metrics where you are now; this is what we expect. If we don't see progress, we're not going to be negotiating with you the way we have been before.

COMMISSIONER WESSEL: Okay. Mr. Harris.

MR. HARRIS: About a month ago, I attended a big U.S.-China event in Seattle, and at that event one of the speakers was from a very large Chinese Internet company that recently went public, and this company is now doing business in the United States, and it has aspirations to do a lot more business. And this very high-level employee of this company talked about cultural differences and how this Chinese company would have to deal with cultural differences in the United States similar to the cultural differences that tripped up big American Internet companies in China.

And I can't remember whether he named any of the big American companies or not, but that really drove me crazy because the problems that have held back American Internet companies in China, while they may have been in small part cultural, in large part they have been structural and legal. Many of them are basically not allowed to do what they do over here

over there, and what was frustrating to me was how it seemed that virtually nobody in this giant room knew that, and these are people who deal with China all the time.

And many tech companies, particularly the small and mid-size ones, have no clue as to what's going on in China, and it's very popular among them and among the media to criticize companies like Microsoft, Facebook and Google and Amazon and eBay, for not having succeeded wildly in China as though somehow it is due to their own lack of vision or inability to adapt and not due to the fact that it's an extremely difficult legal terrain over there for them, and in a lot of areas it's forbidden.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR SLANE: Commissioner Fiedler.

COMMISSIONER FIEDLER: Mr. Atkinson, I was intrigued by your historical example about Japan and the trade wars and American companies and American workers. Can you give me a single good reason why American workers should care that American companies are getting pummeled in China today in light of everything that has gone on in this country in the last 20 years?

DR. ATKINSON: So let's leave the last years aside and just say--

COMMISSIONER FIEDLER: Okay. Ten.

DR. ATKINSON: No, no. My point is just going forward. So you can argue about the last 20 years, good or bad, but just let's say going forward, are U.S. workers better off or worse off if the Chinese government succeeds in its de-U.S. technology campaign?

And here is why I believe American workers will be better off, significantly better off. U.S. companies actually do employ American workers here partly because they have Chinese markets. Now they may not be front-line production workers, but they're sales workers, they're designers, they're technicians, they're R&D. Those are workers, and if we don't have market access in China, and if the Chinese start to go out and take market access away from us. So I'm not fully of the view that U.S. multinational interests are completely aligned with U.S., but they're not negative. There is--

COMMISSIONER FIEDLER: No, my point is I'm not sure that U.S. workers' interests are necessarily aligned with U.S. company interests. Okay. Number one.

DR. ATKINSON: Yeah. Yeah.

COMMISSIONER FIEDLER: Number two, I mean I'll give you a sort of counterintuitive--people tell me it's counterintuitive. I believe that if the Chinese stop stealing intellectual property, we'll lose more jobs because one of the few things that is keeping U.S. companies from going there up until now was that they were afraid of getting their stuff stolen. If they're not afraid of getting their stuff stolen, then more jobs will leave, and they'll go over and manufacture, in China.

So I don't see the convergence. I would just advise you as a representative of American workers that workers don't see the convergence

of the interests in this country if wages are stagnating, jobs are--yeah, they got a job. They're working three. Okay. So don't be so sanguine politically that we really care that Microsoft who tolerated cheating for the first ten years of its--I mean stealing and theft for the first ten years of its existence in China, that I should now care greatly that they're getting pummeled or Qualcomm is getting squeezed. Okay.

Because they didn't give much of a concern for American workers over the last 15, 20 years. I mean it's just natural sort of reactions of human beings. Okay. Other than compassion on some geopolitical level that Americans are getting bashed by, you know, foreigners, which is mildly xenophobic, I haven't heard a lot of arguments yet why, where, how American workers benefit from all of this. And I haven't heard it for the last 20 years so I'm just continually looking for it.

DR. ATKINSON: So I think that I've heard that argument before from people that you and I both know and very prominent arguments like, you know, let them stew in their juices--let them, you know, sit there and take their own medicine because they've hurt American workers and they're not loyal.

If we do that, it's more divide and conquer result from the Chinese government. I think the only way to respond to the Chinese policies is if we are completely unified and we say that it's important to confront the Chinese on these policies. Now one collateral effect will be to help U.S. companies.

COMMISSIONER FIEDLER: And let me just say, Rob, for your own thing, you sort of overstated yourself when you said that this is more important than human rights, more important than this, more important than that. I mean because I'm not at all certain that it is and that the average person would share that view. I appreciate the advocacy involved in the statement, but I think it's a bit of an overstatement.

DR. ATKINSON: Just to be clear, when I said that, I was referring to getting the overall Chinese economic system right so that it is not mercantilist and having a big trade deficit.

COMMISSIONER FIEDLER: Yeah, but it's not an economic thing. We're talking a base, a political systemic change that is necessary in order to gain the economic change. I think we've had enough demonstrating over the last 20 years--you can disagree with me--that we thought that trade was going to bring democracy; right? We heard that argument. It hasn't even brought a modicum of the rule of law except in a couple of cases--right--where we got 3,000 IP judges now, which is I guess progress of some kind.

But, so you're talking incrementally when the fundamentals are actually, if one does a political analysis and the consolidation of Xi's power, looks like the sort of politics are getting a little uglier and a little less consensual inside China. So I'm not so sure that that is the environment in which economic change that is favorable to what you perceive to be our interest is going to happen.

That's all. I mean it's a tough environment right now politically.

Forget the economics.

DR. ATKINSON: Absolutely. But I think--

COMMISSIONER FIEDLER: This is a political decision that's happening to American companies; it's not an economic decision only.

DR. ATKINSON: The alternative--so there are people who say we should just wait in the long run, and as Keynes said, "In the long run, we're all dead." And I think the long-run argument, frankly, just won't work because--so, yes, eventually, eventually in China, there will not be a Communist Party that controls that China. That is the history of all development. You get to a certain point in development and you become a democracy. That will happen in China. I have no doubt that that will happen.

I don't know when it will happen, but it will happen. The problem, though, if we wait until this nirvana of democracy and market opening comes up, by that time the damage will be so severe that the U.S. will have lost competitive advantage in sector after sector--autos, airplanes, jet engines, all these, semiconductors--at which point we can't get it back.

COMMISSIONER FIEDLER: I agree with that. Okay.

DR. ATKINSON: And the consequences for U.S. workers will be fairly severe, in my view.

COMMISSIONER FIEDLER: Yeah. You've got to be a little more specific in the end than sort of short-term advocacy. It's not--the conditions that exist in the United States now just don't persuade people, but I'll leave it alone. Thank you.

MR. HARRIS: If I could briefly answer that. Let's take something like solar power where China by engaging in competition with Chinese characteristics has managed to dominate that industry worldwide. That has to have reduced American jobs in that industry.

I also think it's a little bit shortsighted to ignore the fact that, what Mr. Atkinson touched on, which is that when American companies do well, oftentimes the American worker does well.

Now you're talking about multinationals, but there's a story I always like to tell. I have a client, who is a consultant, and he came back from China and was on an airport bus talking with someone in Ohio, and that person was telling my client that he was going to have to shut down his business that employed 16 people because--it was a windmill business of all things--and he was going to have to shut it down because he could no longer compete with China.

My client said "I can help you. You should be getting more of your parts from China." My client helped this company, and within a year his company went from 16 employees in the United States to 50. Now, one example, one small example does not an economy make, but I think without a real deep dive analysis across various industries, I don't think we can answer it.

COMMISSIONER FIEDLER: By the way--I'll leave it alone--I wasn't making an economic point. I was making a practical political observation

and discussion, which is American workers have not had pretty decent shake in this whole China relationship. So I don't expect them to wake up one day and join a march to help companies that didn't particularly help them when they were at their worst.

HEARING CO-CHAIR SLANE: Mr. Atkinson, as a follow-up, and we do appreciate you coming here and talking to us, but I and others have been informally told by Chinese government officials usually at the end of a banquet that we have no intention of turning our domestic market over to foreign companies. And do you see that as the long-term end game here?

DR. ATKINSON: Absolutely. The Chinese, and there's a famous, maybe not famous, quote, but Larry Summers once said that economic laws applied on all times and all places. And I think he frankly doesn't understand China because they don't think about economics the way we think about economics. We fundamentally have a consumer-oriented economics view. We look at policies on how well they affect consumers.

We have bought into David Ricardo's views of trade. We specialize in some things. Our trading partners specialize in others. We trade. Everybody is better off. The Chinese fundamentally don't buy into that. Eventually they might, but they don't, in my view.

I think they buy into an autocratic system where if you look at the MLP, for example, in 2006 listed 402 or so technologies. Actually let me put it another way. I can't find a single technology that the Chinese government does not want to be self-sufficient in. I can't.

I think they want to be self-sufficient in every technology. Now maybe they're willing to import, you know, pigs feet or whatever. But when it comes to the really important technologies of the future, the Chinese government, in my view, does not believe in trade. They believe in export. In that sense, the way to get there is to make sure they control the domestic consumer market for their own producers. So I do think that's the end game.

MR. HARRIS: I think China does think about economics the way we think about economics. They just don't prioritize economics the way we prioritize economics. And by that what I mean is that--and I see it with our own clients--they oftentimes say, well, this can't be the case in China, it doesn't make economic sense, and our response is right, and China doesn't really care.

We're always looking to see what they're trying to do economically, and in reality what they're really trying to do, in my opinion, is political. Above all else, the Chinese government is concerned with staying in power, and that is how it runs its economy.

Our movie industry clients, they always say "we feel like the Chinese government hates us," and our response is "yes, and that's because the Chinese government basically hates movies." It's a form of communication, and so I don't disagree at all with what Mr. Atkinson says about what the end result of all this is going to be, but I do think China fully understands the economic issues. It's just that they're absolutely willing to trade

percentages in growth or whatever in favor of maintaining control and security.

HEARING CO-CHAIR SLANE: So it doesn't sound, Mr. Harris, like your clients seem to get it, really where the Chinese are going, and that in many cases, they're just being used?

MR. HARRIS: Well, that sounds like two different questions. I think a lot of them do fail to get it. I think one of the things we're always telling them is that they should read China's Five Year Plan because China does not hide the ball as often as people think that they do, and China in its press talks about exactly what they're doing.

Right before I came here this morning, I got an e-mail from a friend of mine who sent me an article from a Chinese government newspaper talking about how they will never allow American companies into the Internet space and, oh, by the way, that also has the nice effect of helping Chinese companies.

If you read the Chinese press, you can see what China's goals are and where they're heading, and you can see it in the Five-Year Plan as well, and American companies--and this is not necessarily criticism of American companies because it's the case for all companies--they have a natural tendency to assume that the entire world is like the way they are used to doing business, and that the same considerations apply, and they don't in China.

HEARING CO-CHAIR SLANE: Thank you.

Katherine.

COMMISSIONER TOBIN: Thank you, both.

Dr. Atkinson, first, I worked at Hewlett-Packard and IBM, and though I would agree with Commissioner Fiedler that the American workers might not be running in support of the corporations, I think increased jobs will be something that younger workers do find important. So I think I share your viewpoint that we need to see as positive what American companies in high-tech can provide. And when I read your testimony, I loved what you are saying. We've got to concentrate. We've got to be more clear-eyed and disciplined. These are, in a way, our nation's crown jewels.

Years ago, there was a Council for Competitiveness that zeroed in on various trade issues in high-tech. John Young of Hewlett Packard was the leader of that. I've not kept abreast of what we have, but is there any comparable--

COMMISSIONER REINSCH: It still exists.

COMMISSIONER TOBIN: Good, I hear it still exists. And are they acting in any way that you can report on for us?

DR. ATKINSON: Well, first of all, yes, John Young was a--I don't know if Mr. Young is still alive.

COMMISSIONER TOBIN: He is alive.

DR. ATKINSON: He's an amazing American who I have met on a few occasions and have enormous amount of respect for his leadership in the '80s and early '90s in this space.

The Council on Competitiveness still exists. I don't believe that they take exactly the same orientation and approach that they did back then. I think because, in part, as I said earlier, I think that back then it was our businesses versus their businesses.

COMMISSIONER TOBIN: Right.

DR. ATKINSON: And so we had a very clear interest of our CEO community to really push back against what the Japanese were doing because it directly affected their bottom line in the U.S., and that's why I believe you had strong support from the Reagan administration, the Bush administration. It's different now.

It's partly different because globalization is bigger, but, as I said, I do think that the pendulum is going more into that direction. I mean I have had conversations with U.S. technology companies five years ago, including when I was in Shanghai and met with the American Chamber there, and it was very much about how China is this great place and, you know, we're all going to make a lot of money, and it's a fantastic environment for us. And, yeah, there's a few problems, but, you know, those are bumps in the road that we just work around.

I don't hear that today in the same way. I hear much deeper frustration, much more recognition that these are structural problems and much more recognition that they're essentially in survival mode. They understand that they have a target on their head, and they're trying to have--they're at risk of being replaced. So I do think that's different.

Let me make one response that you said about the jobs thing. Let's just take Intel for a moment. You know the Chinese have the new semiconductor plan that they came out with last year, you know, standards manipulation, massive subsidies, a whole set of other things, government procurement, and their goal is to replace Intel. That is their goal.

Now imagine them replacing Intel. Intel has a number of fabs in the U.S. You know, they have R&D in Silicon Valley, but they have fabs in New Mexico.

COMMISSIONER TOBIN: Arizona.

DR. ATKINSON: Arizona, and they certainly have facilities up in Oregon, and those are workers who are blue-collar workers. They're technicians, they're highly skilled, but they are blue-collar workers and who make quite a fair salary. Those jobs are at risk if Intel loses global market share in a significant way, and so I do think, I really do think there's an alignment, and I understand the bitterness of the past. I understand that, and don't get me wrong, but I think this is such an issue that we have to try as best as possible to put emotion aside and look pretty clearly and resolutely at our interests today.

COMMISSIONER TOBIN: So just one thought on that. Besides the negotiation, the governmental approach to gain results, I do think we need, if not the Council, some coming together of the high-technology world concertedly because it did work before, and as you said, it's shifting.

Mr. Harris, assuming you have ten clients out the door, based on the

picture you presented, the clarity of which we all appreciate, do you find that many of your clients decide I'm not going to work there? I'm not going to take our business there, and do they divert anywhere else, or is it so worth it to them? So what's your experience?

MR. HARRIS: They mostly go in. It's just too tempting.

COMMISSIONER TOBIN: Uh-huh.

MR. HARRIS: But what's interesting is most of them do well there, and that was even truer two years ago. There is definitely an increased level of fear and frustration by American companies in China, and that's been growing for years. A lot of it is due to the legal regime, but also a lot of it is due to the fact that the competition there is incredibly intense and costs are rising.

But there is still generally a view that if we are going to be, and by "we" I mean our clients are saying this, if we're going to be an international player, we have to be in China. But a lot of them are more concerned today than they were even two years ago about hedging their bets.

So you've got the huge companies, let's say like Nike, and they've been in--I don't know--20, 30 countries forever. A lot of our clients had all of their eggs in the China basket for, let's say, manufacturing, and they've had problems, and they realize that even though they're not huge companies maybe they should open up a facility in Myanmar, Indonesia, Vietnam. So there definitely is, has been a change in mind-set in the last year or two.

What I think is interesting about China is that, and I'm going to echo a lot of what Mr. Atkinson said, is that there was tremendous optimism by American companies and America, in general, about China, and from my perspective every year in China things got better, and then--and maybe I'm putting too much stock in one small incident--but when a fruit vendor in Tunisia set himself on fire, it seemed like very soon thereafter China got more paranoid, and basically since then the improvements have been few and far between, and there has been more tightening up in various areas.

To a large extent, I think that the frustration stems more from the lack of improvements as opposed to the tightening up.

COMMISSIONER TOBIN: Thank you.

I know my other colleagues have questions.

CHAIRMAN REINSCH: Yes. Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thank you. Gentlemen, really interesting. My questions kept shifting as your comments were being made. Rob, just really a comment more than anything. It's honestly hard to see anything that's treated less important than human rights when it really comes down to it. But I just wanted to make--because you said it needed to be treated as more important than human rights, but that treatment of human rights would actually address a number of the issues that the companies that Mr. Harris represents are facing.

So, for example, if there was freedom of speech, the publishers and the movie houses wouldn't be having the problems. If there was freedom of association, freedom to organize, then workers in the plants where OSHA-

kinds of protections, environmental protections, all of those that are being ignored, would have an opportunity to improve their own working conditions. So I don't think we should separate it out. Just a comment on that.

Mr. Harris, I'm particularly interested because you are working with essentially small and medium caps, those are the kinds of companies that we want to be able to break into the China market, but I confess that I'm baffled that anybody nowadays would say that they don't know what's going on in China. I mean everyday on the front page of the newspaper, any newspaper, there are stories about it.

So when I hear you say also you're sitting in this conference room with these important Chinese Internet companies, which go unnamed, I just wonder whether it's ignorance or whether it's that people (a) believe that they're the ones who are going to be doing things differently and will succeed, or (b) they don't want to raise the difficult questions because they feel that it will somehow disadvantage them?

MR. HARRIS: All of the above. One of the things that I have always found interesting is that I will blog, and I've written on this issue probably once a year over the last six or seven years, about how if you owe someone a debt in China, if you owe someone money in China, or even if they just allege that you owe them money like, for instance--and this happens a lot with our clients--they'll get a bad shipment of product, and they won't pay for the second half of it because it's a bad shipment, and the Chinese company is having all sorts of financial problems, and they will then sue our client in China.

And we tell our clients do not go to China. Do not have anyone from your company go to China. You could get held hostage. And we get five or six calls like that a year. I have a friend who is with a risk advisory company, and just his Shanghai office gets five or six of those calls a month. Yet whenever I write about that, I get all sorts of angry comments saying that I'm making it up. I get e-mails saying I'm making it up, and I'll even get e-mails saying why are you saying that that's going to cause American companies not to do business in China, and it's going to hurt your own business.

There are probably 100,000 China consultants out there who sell their services by claiming that they can achieve various things in China, and there are a lot of Chinese in China who say the same thing. I hinted at it when I talked about the fact that we always have to deal with Chinese employees of our own clients who are telling our clients, look, you don't need to do this, you don't need to do that, this is how it's done, just stick with me, and there are Americans who believe it, there are American companies who actually enjoy that sort of thing. We always fire them as our clients.

And everybody thinks they're special, I mean to quote Garrison Keillor. We get that a lot. Oh, no, this Chinese company would never do that to us; I went to the owner's son's wedding.

COMMISSIONER BARTHOLOMEW: It's amazing. I'll have another round if we go to another round.

DR. ATKINSON: Could I just quickly respond to the human rights question? My point on that--by the way, I would differentiate between worker rights, if you will, and sort of free speech and civil liberty rights. Maybe you don't. I do.

My only point on that is we should advance an agenda with China that is in our interests, and to me the human rights agenda for Chinese citizens, it's in our long-term interests, but you only have so much political capital and so many chits to use when you're negotiating with the Chinese, and if we put human rights at the top ahead of our economic interests for our workers, then I think we're not going to be able to advance those as effectively instead of putting those at the top.

COMMISSIONER BARTHOLOMEW: Well, first, we could debate this for hours so we won't. But I disagree with you that that's sort of not fundamentally in the interest of our workers, and that they are divisible the way that you are talking about because they are certainly connected.

But I also would say that I have in 25 years of working on U.S.-China policy never seen human rights at the top of that list. So--

HEARING CO-CHAIR SLANE: Dennis.

VICE CHAIRMAN SHEA: Well, thank you both for being here. It's been a really fascinating discussion.

Dr. Atkinson, I heard you say--you wrote it in this op-ed called "High Tech Harassment." It woke me up out of my slumber as I was going through the briefing book. It was really pretty charged, but you said today that the Chinese, and correct me if I'm wrong, the Chinese have no intention of allowing Western companies to dominate or have a significant share of their domestic, key domestic markets, including high-tech. Is that fair to say? That's your position?

DR. ATKINSON: High-tech is what I know the best so, yes, in high-tech, I would say that.

VICE CHAIRMAN SHEA: Okay. Now that's sort of a paradigm shift, as Commissioner Bartholomew mentioned yesterday. Do you think the people in the U.S. government understand that? I tend to believe you. I accept your proposition, but do you think the people in the U.S. government who make decisions on our behalf understand that?

DR. ATKINSON: As a group, I do not believe they do. I think they still believe that the Chinese government has bought into the Ricardian trading system that is a core part of our whole economy. I think they believe that the Chinese are more or less like that.

VICE CHAIRMAN SHEA: Okay. Do you, do the high-tech companies, the leadership of the high-tech companies, the U.S. and other Western, understand that, buy into that view?

DR. ATKINSON: Increasingly they do.

VICE CHAIRMAN SHEA: Okay. This is a paradigm shift. Now are they willing to step up and say that, or are they--I think it would be

incredibly powerful if someone like Bill Gates, who I understand is retired from Microsoft, though owns, I understand, quite a bit of shares in the company, but if someone like him were to stand up and say something like that would be very, I think, very powerful.

DR. ATKINSON: It would be powerful, but what U.S. companies have learned in a very bitter way that if they stand up and say anything, they will be the next victim. They will be the next target. They will have Chinese investigators at their door at 7 a.m. in the morning taking their computers away and not giving them a hearing. They know that.

And I think it's incumbent upon U.S. government officials and the top-level officials to come to this realization on their own. It would be nice if U.S. technology--my understanding is U.S. technology companies say these things in private. They explain their situation to U.S. government officials, but I don't believe it has penetrated or permeated in our trade establishment in the U.S.

VICE CHAIRMAN SHEA: Now, the program you outlined in your testimony, sort of recognition of this new paradigm, understanding the problem, creating an office, new office within the USTR, giving them a few extra millions of dollars, bringing more trade cases, which take years in the WTO--I'm just paraphrasing that--antitrust exemption, which by the way the Commission recommended four or five years ago that there should be an antitrust exemption--it doesn't seem, in all respect, and I'm sympathetic, I agree with you, it doesn't seem like it would do the job, it would reverse this situation even over a number of years—but the tools in the tool box don't seem strong enough.

I just would like you to comment on that. It seems like this is the conundrum. What can we really do about it?

DR. ATKINSON: That's the conundrum, and whenever I go to these events and talk to U.S. officials, they always say the same thing: what can we do? And I guess so I don't know the answer to that, but I have two answers. And one answer is if we really believe this is a serious threat, if, for example, this were a military threat, and we didn't have the right weapons, we'd figure out how do we develop the right weapons or how do we use the other weapons in the right way?

This isn't a military threat. I'm not saying that. So I think the first step would be, as we've argued, there needs to be some kind of national commission on mechanisms to deal with the Chinese threat. Bring together some of the leading trade attorneys in Washington, bring together real experts who know every single nuance of U.S. law, international law, all the various tools we could use, whether it's immigration of students, let's put all the possible tools on the table as a tool box because I agree that the tool box is pretty thin right now.

After that, then it's a question of, I think, deciding how far we want to go and which ones we want to do, but I also, I would say, for example, if you look at some of the things where we have succeeded against Chinese what we call "innovation mercantilism"--things like the agreement called

Green Dam; we've succeeded somewhat on indigenous innovation product catalogs; the VAT subsidy on semiconductors--they all had one thing in common, which was that there was a fairly strong unified push.

And in the case of indigenous innovation, it was our business community, our government, the European business community, and their government. And I think fundamentally that's the direction we have to go in. And it just has to be elevated. This is the single biggest trade issue the U.S. government is going to face for the next 20 years. The single biggest one.

And it's Europe's single biggest one, and the problem is Europe is farther behind than we are, I believe, in understanding that. But I think what the next administration has to do is build really strong alliances with Europe, and so at one level I do think that, sort of, basically telling China you are going to be shut out of the global economy in a way, you know, unless you reform what you're doing, and Japan and Europe and America, we all agree with this, I do think there is some leverage there. I agree with you, the tool is a big problem.

VICE CHAIRMAN SHEA: That really takes real leadership, doesn't it, to--

DR. ATKINSON: Yeah.

VICE CHAIRMAN SHEA: --to put that--

DR. ATKINSON: Yes.

VICE CHAIRMAN SHEA: It worked to some degree in the indigenous innovation because-- though I think they are circumventing--

DR. ATKINSON: Yes.

VICE CHAIRMAN SHEA: --the written rules--

DR. ATKINSON: Yes.

VICE CHAIRMAN SHEA: --by--

DR. ATKINSON: Yes.

VICE CHAIRMAN SHEA: Yes. But it really takes leadership.

DR. ATKINSON: Yeah.

VICE CHAIRMAN SHEA: And someone fully committed to achieving this objective.

DR. ATKINSON: I agree with that, but I have to say I do think there is a role Congress can play, which is just, you know--obviously, you play a critical role--but I think the relevant committees in the House and the Senate, having more hearings on this, you know, raising these strategic questions in hearings and getting more testimony on that, I think that can help move the ball and basically set a tone from Congress to whoever is going to be the next president after the election that this is going to be something Congress is going to demand some changes on.

VICE CHAIRMAN SHEA: My time is up, but I'll just say collectively if some of the high-tech leaders working as a group got together in their own voice and made, you know, statements that you're making today I think it would be very powerful, but I'm just throwing that out there.

DR. ATKINSON: I would just add there's a letter I know going out

today that I'd be happy to share with you. You'll probably see it. I'm not sure exactly what time it's going out today, but it's by a number of major U.S. trade associations going specifically at this point of using these security excuses in a way to shut U.S. companies out and how they strongly decry it. So there is some of that going on. I agree with you that more would be better.

VICE CHAIRMAN SHEA: Thank you.

CHAIRMAN REINSCH: It's an excellent letter.

DR. ATKINSON: Have you seen it?

CHAIRMAN REINSCH: We signed it.

[Laughter.]

CHAIRMAN REINSCH: My day job organization signed it.

HEARING CO-CHAIR SLANE: Carte.

COMMISSIONER GOODWIN: Thank you.

Dr. Atkinson, I'm intrigued by your suggestion of the antitrust exemption, but I'd like to play the role of the devil's advocate here just to get the sense as to how both the witnesses think the Chinese might respond to it.

I would think from their perspective, they might find it a bit ironic that in response to what we are characterizing as the selective enforcement of anti-monopoly laws, that we want to selectively enforce our own anti-monopoly laws and allow, through a statutory exemption, agreements restraining trade. So what is your sense as to how such an exemption would be received by the Chinese?

DR. ATKINSON: So, first of all, I would envision any adjustment to our antitrust regime to be, first of all, statutory in basis, I mean congressional legislation modeled after the '84 Cooperative Research and Development Act that Congress put in place, and at the time the Congress said we think it's important that companies are able to cooperate in free competitive R&D, and there is confusion at sort of best in the antitrust laws that prohibit or prevent companies from doing that. So we passed a law to engage in one of these, you have to go to DOJ and you have to have an approved research collaboration, and DOJ approves a number of these every single year.

I would envision a similar agreement, where companies would go to DOJ and get approval. So this would not be extralegal. This would be part of the legal system, and it would just simply say in our antitrust regime, we believe that inter-firm cooperation in certain areas can be welfare maximizing. I think the second point is, and I think we would have to make that quite clear to the Chinese, that this isn't just carte blanche. In my argument you would have to have incredibly strict rules that this cannot include price collusion or other kinds of things that would be anticompetitive. This is really about allowing companies to make the decisions that they want to make with regard to technology transfer.

Lastly, I would just say the Chinese will use anything we do to their own interests. They're very, very good at that. And they follow what we

do quite effectively, but I think we know and they know that it's a talking point for them, I guess. So, yes, maybe they'd have another talking point, but I think we would be better off having that tool in the tool box.

COMMISSIONER GOODWIN: What sort of standards would you anticipate for establishing the nations that would qualify as engaging in, as you put it, coercive action? I mean from my perspective I would think that would be fairly critical. Well, I suppose the Chinese are going to see this as being directed at them in any event, but to have it balanced and have it apply equally across the board to all sorts of countries and jurisdiction.

DR. ATKINSON: Sure.

COMMISSIONER GOODWIN: What sort of standards do you think should be put in place to define what is coercive government action?

DR. ATKINSON: Well, China is not the only government that uses forced localization policies to get coerced tech transfer or coerced investment. Brazil does it. India is trying to do it. So I think a policy like this could have beneficial ramifications in other big markets where U.S. companies face that kind of threat.

Again, I don't think there is anything inherently anti-consumer about companies cooperating and saying we're not going to give technology to our competitors. That's really what this is about. It's about saying we believe we should be able to go into a market and not have to give them our technology. That's a core principle of the WTO.

All this really is saying is that we're leveling the playing field and giving the entrant or the company some little bit more negotiating power. So I don't see it in any way as anti-consumer because it's really, unless you buy into this notion that somehow these countries deserve our technology for free because they're poor, which we fundamentally reject, I don't see it as anti-consumer.

COMMISSIONER GOODWIN: Thank you.

MR. HARRIS: I don't really have anything to add to what Dr. Atkinson said regarding the big policy issues. But what I will say is that--and this is from a practicing lawyer perspective--I know it can be very difficult to determine what is coercion and what isn't.

I remember many years ago Korea had all sorts of rules about buying foreign cars, and they were pressured to relax or strike those rules, and I wouldn't see any more foreign cars on the road in Korea, and I asked a Korean lawyer friend of mine why that was the case, and he said, "well, because everyone knows that if they buy a foreign car, they're going to get audited on their taxes."

So I'm just putting that out there to show how hard it can be to monitor, and even some of our clients get that with China today where let's say they're supplying something to the Chinese banking system or they have an environmental product, there will be nothing in writing, but somebody will tell them, hey, listen, we've been told that there are people who are not happy about us buying your product as opposed to a not nearly as good Chinese product.

So would you do us a favor and instead of selling it to us from the United States, would you form a company in China and sell it to us that way or would you set up a Chinese distributor or Chinese joint venture deal? So my only comment is that these things are oftentimes not very clear-cut.

COMMISSIONER GOODWIN: Thank you.

HEARING CO-CHAIR SLANE: Bill.

CHAIRMAN REINSCH: Well, as Rob knows, we generally agree on these things. I want to pursue a couple comments you made driven by your response to Katherine about that was then/this is now on the Council on Competitiveness.

I think you're right that where we've had success with China, has been when we've been able to multilateralize the message. It's easy for them to dismiss an American message as part of the great American plot to thwart their rise. It's harder to dismiss the international community telling them that they're an outlier, which is a position they don't like to be in. . The Green Dam case you cited is a good example where we had some success. There are a couple of others. It's, you know, two steps forward, one step backward, but a good strategy.

I think along with that persistence, unity of message is also relevant. We have to keep saying the same thing over and over and over again. We have to make sure that every single official who goes there says the same thing over and over and over again.

If we have mixed priorities and mixed signals, then it's easy for them to decide to listen to the one who has put this at the bottom rather than the three that put it at the top.

All that said, let me ask you about a different question related to this. One of the big differences between then and now that you alluded to is the arrival of global value chains and global integration of manufacturing and services, for that matter, which was not characteristic of the '80s.

It seems to me that's an environment of mutual dependence in the manufacturing process. I don't disagree with you about China's goals although I also think that Mr. Harris is right, there are different Chinese that have different goals. Actually China does have a lot of economists, and they're not stupid economists. They are very smart economists and they understand the world the same way that our economists do. They don't make the decisions in China.

But it's not that they're not there. It's just that they're not in charge. I'm inclined to believe the people in charge share the view that you articulated. That said, if their goal is to essentially cut us out of supply chains, if you will, why wouldn't American companies, not unanimously all at once, but why wouldn't American companies coping with that respond by cutting China out of their supply chains and wouldn't that have a fairly significant economic impact on them or are we too far down that road to make that feasible, in which case if it's not feasible for us, how is it feasible for them?

DR. ATKINSON: Well, I think the answer to that, Chairman Reinsch,

is that they, you allude to the fact in these negotiations, in these dialogues, the Chinese always speak with a single voice, and that's been fully my experience. U.S. doesn't speak with a single voice--and that's been my experience as well.

I think the same thing is true with their economy. They are able to enforce discipline and so that their producers follow the line rather than lead the line. We can't and shouldn't enforce discipline in our economy that way. We have a free market economy. Our companies can do and think what they want.

Our companies can't ever and won't ever fully come to a sort of coordinated action agreement to shut the Chinese out. I mean that's what it would take, and for no other reason that our companies are much more dependent upon quarterly returns and performing well for Wall Street. You follow that strategy, and you're going to see diminished returns for five years. You might in the long run, your net present value might be up, but your returns in the short run.

So I just don't think U.S. companies have the ability to coordinate or the long-term ability to take the long-term interest approach that they might need to do.

CHAIRMAN REINSCH: I'm more persuaded by the second part than the first part. I don't think they need to coordinate. What they need to do is act in their interests, and you're making a good case about why they would perceive their interests differently by focusing on long term rather than short term.

Mr. Harris, do you want to comment on this or not?

MR. HARRIS: Yes. When you talk about supply chains, that could mean anything from clothing and shoes on up to super high-technology products, and when it comes to things like clothing and shoes, I don't think that's even really on the program here today because I don't think that the issues that we've talked about are really terribly relevant to industries like that.

CHAIRMAN REINSCH: I think we're talking mostly about high-tech sector.

MR. HARRIS: Okay.

CHAIRMAN REINSCH: Reflecting Mr. Atkinson's expertise.

MR. HARRIS: Okay. Yeah. Okay.

CHAIRMAN REINSCH: I'm out of time.

HEARING CO-CHAIR SLANE: Thank you.

Mike.

COMMISSIONER WESSEL: Thank you, gentlemen.

I would argue, and listen carefully here, Dennis--

VICE CHAIRMAN SHEA: Okay.

COMMISSIONER WESSEL: Probably the single best president on trade was Ronald Reagan in the sense of making clear to the Japanese at that time that whether it was keiretsu or any of the other systemic governmental business approaches that they were engaged in that enough is

enough. America is going to stand up and is going to have a unified voice.

When I look at our enforcement strategies here in the government, here in our own government, and certainly this administration has done more on a broad range of issues than any prior to it other than Reagan and the way he stood up, but it's far from enough, and we talked earlier about, for example, the indictment against five PLA hackers last year, and I have this vision that those hackers despite the fact that they're not going to be able to travel to the U.S. because they'll be brought to justice aren't terribly unhappy for the esteem they're probably held in by their compatriots for what a great job they did at taking U.S. secrets. And there's been no follow-up action.

Yet when Sony is hacked, the President raises, you know, this is a national threat to our core interests, and whether it's the U.S. or others who took action against the North Koreans, that this was a serious issue.

You know, three years ago, the U.S. began a case on auto parts and activities of the Chinese. Three years later, we're still waiting to go to the consultation phase, and in our Annual Report last year, there was a chart of the enforcement actions that began against China but that are still waiting resolution years later.

The Chinese are winning. I mean if you measure it from an economic sense or industrial policy or almost any other sense, human rights sense, they're winning. We're not taking them to courts. The activities of many of our leaders years ago of bringing a letter each year and saying, these people need to be let out of prison, which achieved results, that's largely stopped.

We don't do the trade cases. We say engagement, dialogue is what we should do. Isn't it time to say that this isn't working, and we have to-- again, I raised the BIT earlier--say no new agreements until we get the results we expected from the previous ones, as well as a broad range of enforcement actions, to take that catalog which they publish every year, the National Trade Estimates report, clean the catalog out and say now we can start?

DR. ATKINSON: I think, as you know, a report that we did a few years ago on China with the title "Enough is Enough," and I agree with you, it just doesn't look like we've seen systemic progress.

What we see is a little bit of progress when we push hard, and then it's a little bit like whack-a-mole or pushing down on a water balloon. You push down here and something else comes up here.

I think your point on the Sony case is exactly the point I was making. I think it's an important point. We made the Sony response, which, look, at the end of the day I mean it wasn't good and all that. But it was a nuisance. It was bad. It was embarrassment. It wasn't legal. It wasn't right, but it fundamentally was a nuisance as far as I could tell. I don't know. Maybe there's other things going on. They didn't steal core crown jewels of the U.S. technology economy.

And yet we had a coherent top-level response from the administration, argued on the basis of it violated our core principle, which was freedom of

speech.

I don't think that was--in my view, the core principle should be our long-term economic viability as the global-leading innovation economy, and so I think that just sends a message to the Chinese that we'll put all men on deck, all things on deck if you violate freedom of speech in the U.S., but if you violate freedom of property, which the Chinese have done over and over and over again, there's no response.

So I fully agree with you that we need to have a fundamentally new strategic approach that we don't have, and I think part of the problem frankly is that many of the leading trade think tanks in Washington don't believe that, and they're much more oriented to the view that we should subjugate our economic interests in China for global national security interests, and, secondly, that China is eventually going to move in our direction, and it's just a question of convincing them and talking a little bit more and a little bit louder.

How long are we going to do that before we realize that just isn't working? I mean maybe it will work. Maybe I'm wrong, but I just don't see any evidence of that so I would agree with you.

COMMISSIONER WESSEL: I really do appreciate your comments, and I noted when you first started or when I first commented about the organization you lead, you are a global thought leader. You're looked to by many. So your comments today are helpful. You know, it was individual companies in the 1980s. Today it's really the industry trade associations that lead because of fear of retaliation by individuals.

So thank you for what you're doing. Keep it up. Convince some of your colleague trade associations that there needs to be a unified voice, and maybe we can have a unified policy response as a result.

DR. ATKINSON: Thank you.

HEARING CO-CHAIR SLANE: Jeff.

COMMISSIONER FIEDLER: A quick question on state enterprises--this is something I don't understand--as a sort of retaliatory or leverage point here. So the Chinese are essentially, among other things, trying to protect their national champions, which are state enterprises. And we're like free market capitalists. Maybe I'm not exactly, but--

[Laughter.]

COMMISSIONER FIEDLER: --Americans are. Okay. Yet we are in this sort of deadly embrace with, Chinese state enterprises, and every time a person like me says why do we let state enterprises come to the United States and operate, no cost of capital, this, that, and the other thing, and we're capitalists. I'm really not--or let them go to the New York Stock Exchange, raise \$3 billion so we enable it a little more, and then the Chinese protect it, and they bang our companies. I'm missing something about how to leverage power and things that are important to the Chinese.

Any comment about reciprocity here? And state enterprises generally? And retaliating against them?

DR. ATKINSON: Yeah, and I think--I'm sure you've seen this

evidence, at least when we looked at it, I think it was the Unirule Foundation or institute in China that showed that the average ROI, rate of return--excuse me--for Chinese state-owned enterprises was negative five percent.

COMMISSIONER FIEDLER: Yeah, which means we can bury them. I mean the existence of them is not because they want to make money.

DR. ATKINSON: No, my point is if we were competing against any other country--

COMMISSIONER FIEDLER: Yeah.

DR. ATKINSON: --any other company in the world, and our enterprises didn't have to make 15 or 20--

COMMISSIONER FIEDLER: Right.

DR. ATKINSON: --they could sell at negative five--

COMMISSIONER FIEDLER: Right.

DR. ATKINSON: --so you're now talking about a 20, 25 percent--

COMMISSIONER FIEDLER: Right.

DR. ATKINSON: --price discount there.

COMMISSIONER FIEDLER: Right. Right.

DR. ATKINSON: That's a huge subsidy. I think I would generally agree that we should have a different orientation for SOE investment in the U.S. than we do for non-SOE investment. I do think there are legitimate Chinese companies that are non-SOEs that we have to try to bring into the fold, if you will, because eventually, I think actually now, but increasingly they can be an important counterforce against the Chinese policies, particularly around SOEs, because I think that's one dynamic that, if I'm hopeful of any dynamic in China, it's that the independent companies are, you know, when we visited an independent company a few years ago there, when it was part of the Innovation Dialogue, this company was really, really mad, really mad.

I mean it was angry at state-owned enterprises because they had been hurting them as an independent Chinese company, and I think this Chinese company was in the auto parts sector, and they were a real company, they had an owner, they had capital, they were trying to do and win. So I think I agree with you in general. I just think we shouldn't be in a blanket all Chinese investment is bad. I think we need to be thinking about--

COMMISSIONER FIEDLER: I didn't say so. I didn't say so. That's not what I was proposing. So what would you do to the SOEs?

DR. ATKINSON: I hate to sound like I'm copping out on this.

[Laughter.]

DR. ATKINSON: It's just not an area I have studied enough to know exactly what the right response is. One area we have written on, though, and I know that people in the intelligence community or at least the defense community are thinking about this, I think we need to rethink CFIUS seriously because the CFIUS regime is oriented to sort of one at a time.

Chinese acquisitions are not oriented to one at a time. They're oriented systemically. So I do think that's an area where we should see real

reform, and understand in the CFIUS process this is a broader strategy to acquire technology for military and national security purposes. So that's an area I would argue. On the SOE and what do you do, I'm afraid I just don't know.

MR. HARRIS: I don't know either, but I'll play lawyer again and point out that it's oftentimes very difficult to know what an SOE is, meaning some people say SOE to describe a company that's let's say 49 percent owned by the mayor of a town, and you get a lot of that in China, where there will be a private business that is owned by let's say the province 49 percent. So I think the technical definition is owned by Beijing.

COMMISSIONER FIEDLER: No. But I don't think that you have to be so lawyerly about it. Okay. You can be arbitrary about it on some level, which is U.S. controlling interests in a company, in a publicly traded company, is five percent. That's a ridiculously low amount on some level. All right.

But, so, if you say that accumulation of more than 50 percent of a company is SOE-owned, okay, that's fine. I mean there's plenty of targets is my point. Don't diminish the targets.

MR. HARRIS: Well, I'm not so sure there are.

COMMISSIONER FIEDLER: His problem--no, no. What I'm more concerned about is that Rob, as influential as he is, hasn't thought about it, which means to me that the government and people around in the community, I mean in the business community, have maybe already rejected the notion of retaliating against SOEs. I mean that's what's important to the Chinese--SOEs. I mean I know how to pick targets.

MR. HARRIS: Well, there actually is some case law on this that was established by one of the lawyers in my firm. A long time ago when China Ocean Shipping tried to come in, first tried to come into the United States, they had their assets seized by people who--I may be getting some of the facts wrong. I believe seized by companies who had had their assets seized--

COMMISSIONER FIEDLER: By Ocean Shipping.

MR. HARRIS: --China and the courts held that even state-owned enterprises if they're operating like a private business are not really the government. So I think--

COMMISSIONER FIEDLER: Unless we pass different laws dealing with SOEs.

MR. HARRIS: Well, I don't know. I think that's a very complicated path, and I'm not sure there's much return because I'm not sure what SOEs there are in the United States. I mean what you have are the SOEs tend to be the big shipping companies or oil companies, tank companies, mining companies. It's not the dynamic Chinese companies that people talk about, and then you've got other companies that might, we might be suspicious that they're in line with the government, but they're not necessarily owned by the government.

COMMISSIONER FIEDLER: Thank you.

HEARING CO-CHAIR SLANE: Well, we've gone over our time. Dr. Atkinson and Mr. Harris, thank you so much. You guys were terrific, very, very helpful, and we'll get ready for our next panel.

PANEL II INTRODUCTION BY CHAIRMAN WILLIAM A. REINSCH

CHAIRMAN REINSCH: I think we're almost ready to get started. Do we have our witnesses here? Good. I'll start the introductions. We're running a little bit behind.

This next panel will focus on China's Anti-Monopoly Law. Three legal experts will discuss the structure and history of the law, assess the factors affecting China's implementation and enforcement of its Anti-Monopoly Law, and put China's competition policies into global context.

Our first witness is Tad Lipsky, and Mr. Lipsky, we appreciate your filling in late in the day. Mr. Lipsky is a partner in the Washington, D.C. office of Latham & Watkins, where he focuses on U.S. and international antitrust and competition policy matters. Having served as chief antitrust lawyer for the Coca-Cola Company from 1992 to 2002, Mr. Lipsky has antitrust experience in the U.S., EU, Canada, Japan, and other established antitrust law regimes, as well as in new and emerging antitrust law regimes.

From 1981 to 1983, Mr. Lipsky served as Deputy Assistant Attorney General under William F. Baxter, where he supervised Supreme Court litigation in a series of groundbreaking antitrust cases.

In 2010, Mr. Lipsky testified on the impact of China's antitrust law and other competition policies on U.S. companies before the Subcommittee on Courts and Competition Policy of the House Judiciary Committee.

Our next witness is Dr. Elizabeth Xiao-Ru Wang. Dr. Wang is a principal at Charles River Associates in Boston. Dr. Wang has extensive experience working on antitrust matters with Chinese regulators.

She has submitted reports and presented economic analysis in front of the Chinese agencies. In addition, she has advised clients on merger reviews, antitrust investigations and private litigation in China.

Dr. Wang has published and spoken on various topics related to Chinese AML enforcement, especially on the competitive and economic analysis frameworks employed in China's merger reviews.

Our final witness on this panel is William Kovacic. Professor Kovacic is the Global Competition Professor of Law and Policy and the Director of the Competition Law Center at George Washington University Law School--the longest title on the panel today.

Before joining the GW Law School, he served as the Federal Trade Commission's General Counsel from 2001 to 2004 and was a member of the Commission from 2006 to 2011.

From 2008 to 2009, Professor Kovacic was the Chairman of the FTC, and in 2011, he received the Commission's Miles W. Kirkpatrick Award for Lifetime Achievement.

Before we start, I would also like to point out that the Commission received an additional written statement for this panel from Gil Kaplan, who is a partner at King & Spalding, on potential U.S. legislative responses to China's misuse of its Anti-Monopoly Law. Mr. Kaplan's submission can be found on the Commission's web site.

Thank you all for being here. As we've advised the other panelists, please do your best to keep your oral statement within seven minutes and also, given our experience with the last two panels, please do your best to keep your answers to questions brief so that we can stay within our five-minute limit for each commissioner and not run over time as we have on every panel so far.

So with that, we'll start. We'll go in the order in which I introduced you beginning with Mr. Lipsky.

**OPENING STATEMENT OF ABBOT (TAD) LIPSKY, JR.
PARTNER, LATHAM & WATKINS**

MR. LIPSKY: Thank you, Mr. Chairman.

When Lauren sent me this list of 13 questions that I might cover as part of the subject matter, I was kind of flabbergasted.

CHAIRMAN REINSCH: All in seven minutes.

MR. LIPSKY: You could write a book about each of them so in an effort to be brief, in summary, I'll just say the following:

China was a late arrival to the antitrust party. The United States was pretty much the only serious operator up through the 1970s, and then because of the forces of European cohesion and the collapse of the Soviet Union in 1991, the idea of market economics became quite popular all over the world, and so we had this incredible surge in the enactment of new antitrust laws and the enforcement of old ones.

That occurred roughly between 1985 and let's say the year 2000, by which time there were maybe a hundred jurisdictions with actively enforced competition laws.

The Chinese law was under debate for about 15 years and finally went operational in 2008. The substance of the law itself is modeled loosely on the majority of other competition laws around the world. It has the three major features: prohibitions on restrictive agreements; anticompetitive mergers; and abusive unilateral conduct by dominant firms.

But in its enforcement mechanisms, it has some very unique elements. It has three enforcement agencies: one limited to mergers; one limited to price-related anticompetitive conduct; and the other limited to non-price-related anticompetitive conduct, something unique in all the world. And, of course, the enforcement occurs in a legal environment that has only distant analogies in jurisdictions that we would regard as within our own tradition.

So there are a lot of antitrust laws around the world. And you can find them anywhere. You can find them not only in the developed jurisdictions like the European Union, France, Germany, Canada, Mexico, and in the "off-Broadway" jurisdictions like Pakistan, India, Costa Rica and Brazil, but then there are even the "off-off-Broadway" jurisdictions like the Isle of Jersey and Sri Lanka. These are all places that now have fully-enforceable systems of antitrust laws.

The diversity in the mechanisms by which these laws are administered and enforced is just staggering, and the list is growing. The Philippines right now are considering a piece of legislation that would give them a more full-fledged antitrust law.

So the problems that have arisen in the Chinese context are not necessarily radically different from the problems that occur in other jurisdictions that are new to antitrust law and that do not have a kind of a strict and highly-developed legal culture the way, for example, the United States and the United Kingdom do.

But they've got more of these problems, I think, because of the

distinctions and the lack of local familiarity with not only the antitrust traditions but the traditions of economic analysis and the legal traditions that prevail elsewhere are absent in China.

So if I could just very quickly identify some of the main criticisms of the way that the Chinese antitrust regime has developed, top of the list would be absence of what we would recognize as procedural rights in other systems of law, the right to counsel, the right to learn of the evidence and arguments that are being posed against the target of an antitrust proceeding, and indeed the right to present a defense without fear of retaliation from government agencies.

Particular concerns have arisen with regard to the application of Anti-Monopoly Law in the field of intellectual property. There have been concerns that the Anti-Monopoly Law is being applied in ways that are less grounded on sound economic principles and sound implementation of competition policy to promote innovation and more of the nature of favoring whatever Chinese party happens to be in play in terms of access to foreign sources of technology and intellectual property and so on.

There are also some articulated concerns about the use by the Chinese of industrial policy and other non-competition factors in the application of their Anti-Monopoly Law, all of which I think, reduced to their essentials, have more than a grain of validity. It's a long list of grievances, but I think I can be most useful by trying to put this in a broader context.

I'm referring to the fact that antitrust law wherever it occurs has this annoying tendency to continuously grow and it needs weeding and pruning from time to time. In the United States, when I entered law school in 1973, almost everything was per se illegal under U.S. antitrust law: joint ventures; horizontal mergers; actions by monopoly firms, even if they tended to increase competition and innovation. All vertical restraints were per se illegal. It was a very harsh environment.

Over the course of the ten years, say from about 1973 to 1983, that was fortunately reversed. Now how did that happen? It happened through a combination of very good scholarship being published, it happened through innovations in our courts, who are the ultimate arbiters of the meaning of our antitrust laws, and ultimately it happened when the antitrust agencies were populated with officials who recognized that antitrust is best based on sound competition analysis and cannot be approached in a legalistic way.

But it took an epochal change in the antitrust principles of the United States to bring about that change. If you look at almost any other jurisdiction around the world, and I would include still our own jurisdiction in this, but if you look at Europe or Japan or Korea or Canada or virtually any other, there is a kind of a problem that there are no self-correcting mechanisms in the antitrust enforcement environment, and one of the reasons that progress in these various areas has been so slow is that most of the dialogue occurs within the purview of the government antitrust enforcement agencies, which are not in the business of criticizing each other for the extent of the powers that they can exercise and the remedies

that they can impose for antitrust violations.

It's just not part of the community. As we think about how we can reform these aspects of the Chinese enforcement regime that affect the United States and American companies and world commerce, in general, we should try to think of it as one instance of a broader problem with all of these new antitrust regimes that have emerged around the world and to some extent that still apply to our own antitrust laws.

I better stop there. Thank you.

**OPENING STATEMENT OF ELIZABETH XIAO-RU WANG, PH.D.
PRINCIPAL, CHARLES RIVER ASSOCIATES**

DR. WANG: Mr. Chairman and members of the Commission, thank you for inviting me to participate in this hearing.

My name is Elizabeth Wang. I am a competition economist at Charles River Associates, a global consulting firm specializing in litigation, regulatory, and financial consulting. My testimony today reflects my knowledge of China's antitrust enforcement from my experience as an economic consultant.

I'll start my remarks with a brief background on China's Anti-Monopoly Law to provide a general context to help understand some characteristics of the China AML enforcement.

First, China is in the process of transitioning from a planned economy to the market economy. While economic reform and privatization have changed the economic landscape, it has taken some time for the policymakers and even business people to adopt a full market economy mind-set or for price signals to allocate resources.

Second, China is at an early stage in implementing the AML. Antitrust law is complex, evolving, and constantly presents new challenges. China's AML enforcement teams are resource constrained and are in the process of developing institutional knowledge and gaining case experience.

Next, I will provide an overview of China's AML enforcement. China has three agencies enforcing different areas of AML. They were all established six years ago around the time when AML went into effect in August 2008.

The Anti-Monopoly Bureau within the Ministry of Commerce, known as MOFCOM, handles merger review. From August of 2008 through the end of 2014, MOFCOM reviewed 1,006 proposed mergers and acquisitions.

The agency approved 980 transactions without conditions. That is 97.4 percent of all the cases reviewed. Rejected two transactions outright and approved 24 with conditions. Studies indicate that a large majority of the transactions reviewed by MOFCOM involved foreign companies. MOFCOM has recognized the issue of underreported transactions and has taken steps to punish companies who fail to notify.

Two agencies in China handle administrative investigations into alleged AML violations related to monopolistic conduct. The Price Supervision and Anti-Monopoly Bureau within the National Development and Reform Commission, the NDRC, is responsible for enforcement against price-related monopolistic conduct while the Anti-Monopoly and Anti-Unfair Competition Bureau within the State Administration for Industry and Commerce, the SAIC, is responsible for the enforcement against non-price-related monopolistic conduct.

To date, the administrative investigations have focused on cartels, vertical agreements, and abuse of dominance matters. Investigations initiated by the NDRC account for a majority of those actions. Based on

the statistics provided by the two agencies, ten percent of the entities investigated by the NDRC and five percent of the cases investigated by the SAIC involved foreign firms.

These figures by themselves do not suggest a conclusion that there has been a systematic targeting of foreign companies in AML investigations. However, more data and more complete analyses are needed before any definitive conclusion can be drawn whether foreign firms pay systematically different fines than Chinese firms while controlling for other relevant economic factors.

In principle, the AML allows the state and the AML enforcement agencies to take into account factors beyond the traditional antitrust considerations. However, it is unclear at this stage whether non-traditional competition factors have actually affected AML enforcement decisions, and, if so, exactly which factors played a role and in which cases, to what extent such non-traditional competition factors influenced the case outcome, and whether China applies a different standard in considering those factors when analyzing pure domestic conduct versus conduct involving foreign firms.

One key challenge to understanding this effect is the lack of sufficient transparency in reasoning and fact-finding behind some enforcement decisions.

In conclusion, China's AML regime features new agencies carrying a heavy caseload involving complex antitrust issues within a changing economic and legal framework. This is due to, at least in part, China's large, diversified and dynamic economy.

These factors combined magnify the difficulties and challenges the AML enforcers face. News coverage has provided anecdotes of foreign companies frustrated with China's AML enforcement. My understanding is that a good amount of the frustration is due to growing pains associated with the early stage of a developing antitrust regime in China's transitioning economy.

I would recommend the following efforts: first, engaging detailed dialogue on China's AML agencies' decision-making; second, encouraging more transparency through disclosure of economic analysis and fact-finding; last, helping AML regulators focus on competition analysis.

Thank you.

**PREPARED STATEMENT OF ELIZABETH XIAO-RU WANG, PH.D.
PRINCIPAL, CHARLES RIVER ASSOCIATES**

**Testimony before the United States China Economic and Security Review Commission
Hearing on: “The Foreign Investment Climate in China”**

by

Elizabeth Xiao-Ru Wang, PhD¹

Principal, Charles River Associates

**Regarding the Legal and Regulatory Context for China’s Antitrust Enforcement
January 28, 2015**

Mr. Chairman and members of the Commission, thank you for inviting me to participate in this hearing. My name is Elizabeth Wang. I am a competition economist based in Boston at Charles River Associates, a global consulting firm specializing in litigation, regulatory, and financial consulting. I am a Co-Chair of the China Committee and a Vice Chair of the International Antitrust Committee of the International Law Section of the American Bar Association. I am also a Senior Research Fellow and Economist at the Competition Law Centre, University of International Business and Economics, in Beijing, China. I was born and raised in China, and I received my PhD in economics from the University of Chicago. I have 15 years of experience consulting on antitrust matters both in the US and in China. With regard to my work related to China, I advise clients on merger reviews, antitrust investigations, and private litigation. I also frequently meet with Chinese regulators and economists at conferences and through my case work. My testimony today reflects my knowledge of China’s antitrust enforcement from my experience as an economic consultant.

Background on China’s Anti-Monopoly Law and its Enforcement Agencies

I will start my remarks with a brief background on China’s Anti-Monopoly Law (AML) and its enforcement agencies to provide a general context to help understand some of the characteristics of China’s enforcement of the AML.

General Context

First, China is in the process of transitioning from a planned economy to a market economy. It does not yet have the same type of open and mature market economy as that in the US, Europe, Japan, and many other developed countries. Many companies are state owned. Certain others, while private, lack the full autonomy to make key business decisions such as setting prices, developing new product lines, and selecting the company’s management.² While economic reform and privatization have changed the economic landscape, it is taking some time for policy makers and even business people to adopt a full market economy mind-set, or for market price signals to allocate resources. These are key steps to developing a free and open marketplace. Second, China is still at an early stage in implementing the AML. Antitrust law is complex,

¹ The views expressed herein are the views and opinions of my own and do not necessarily reflect or represent the views of Charles River Associates, or any of the organizations with which I am affiliated.

² For more discussion about China’s transition from a planned to market economy, see Greg C. Chow, “Development of a more market-oriented economy in China,” *Science*, vol. 235, January 16, 1987, pp. 295-299.

evolving, and constantly presents new challenges. Antitrust law has 125 years of history in the United States. Experience has taught antitrust practitioners that competition analysis often requires a fact-intensive, case-by-case assessment, guided by economic principles and backed by empirical analysis. Since China's AML went into effect six years ago, the agencies in charge of enforcing the AML have made efforts to raise the awareness of the AML with key stakeholders, such as consumers, government administrative bodies, courts, and business communities in China and abroad. Nonetheless, China's AML enforcement teams are resource constrained, and they are still in the process of developing institutional knowledge and gaining practical case experience working with, and applying, economic models of competition and empirical techniques. The AML agencies are new and have been operating with a relatively small group of regulators and antitrust practitioners. It is my understanding that the three AML agencies combined have fewer than a dozen PhD economists. By comparison, the Antitrust Division of the US Department of Justice (DOJ) and the Federal Trade Commission (FTC) together employ well over 100 PhD economists.

AML Enforcement Agencies – Resources and Roles

China has three agencies charged with the responsibility of enforcing different areas of the AML. The AML bureaus were established around the time when the AML became effective in August 2008.

- The Anti-Monopoly Bureau is within the Ministry of Commerce (MOFCOM). MOFCOM is a large ministry whose primary responsibility is to grow China's international trade and foreign investment. The Anti-Monopoly Bureau is responsible for antitrust review of proposed mergers and acquisitions. It is one of 31 bureaus in MOFCOM. Currently, the Anti-Monopoly Bureau has 30 to 40 staff members, roughly half of whom are involved in case handling. Only three of its staff members have PhDs in economics.³
- The Price Supervision and Anti-Monopoly Bureau is part of the National Development and Reform Commission (NDRC). The NDRC's primary responsibility is to develop plans for China's economic and social development, such as energy policy, the balance of economic activity across China's geographic regions, and pricing regulations. The Price Supervision and Anti-Monopoly Bureau is one of 33 bureaus within the NDRC. It is responsible for the enforcement of prohibitions against price-related monopolistic conduct under the AML. The Bureau's antitrust enforcement team currently has over 40 staff members, five or six of whom have PhDs in economics.
- The Anti-Monopoly and Anti-Unfair Competition Bureau is part of the State Administration for Industry and Commerce (SAIC). The SAIC has the primary responsibility for market supervision and regulation including consumer protection, trademark registration, and enterprise registration. The Anti-Monopoly and Anti-Unfair Competition Bureau is one of 15 bureaus within the SAIC. It is responsible for the enforcement of prohibitions against non-price-related monopolistic conduct under

³ There is no publicly available information on staffing levels at the three AML agencies. The information provided here is based on personal observation.

the AML. The Bureau's antitrust enforcement team currently has approximately 15 to 20 staff members, one or two of whom has a PhD in economics.

The NDRC and SAIC also have regional offices involved in AML investigations. However, high profile cases are handled by the central office which provides guidance and direction for local enforcement.

Enforcement of AML

There have been many AML enforcement actions since 2008. I will provide an overview of these merger reviews and administrative enforcement actions, with a particular focus on foreign firms in the context of case selection and outcome.

Merger Review

Like US antitrust law, the AML requires that *all* mergers and acquisitions meeting certain thresholds obtain antitrust clearance with MOFCOM before a transaction can be consummated.⁴ From August 2008 through the end of 2014, MOFCOM reviewed 1,006 proposed mergers and acquisitions. The agency approved 980 transactions (97.4% of total reviewed) without conditions, rejected two proposed transactions outright, and approved 24 transactions with conditions.⁵

Two publicly available studies indicate that a large majority of transactions reviewed by MOFCOM involve foreign companies. One study shows that from August 2008 to June 2013, 82% of acquisitions and 90% of non-acquisitions (mostly joint ventures) reviewed by MOFCOM involved at least one foreign company.⁶ The other study shows that from August 2008 through the first quarter of 2014, 92.4% of transactions reviewed by MOFCOM involved at least one foreign company.⁷

These statistics do not include all the transactions that should be filed for the AML review. MOFCOM has recognized the issue of under-reported (particularly domestic) transactions⁸ and has taken steps to punish companies who fail to notify the agency of transactions meeting reporting thresholds. On December 2, 2014, MOFCOM imposed its first fine of RMB 300,000 (approximately USD 48,000) on Tsinghua Unigroup for failure to notify its acquisition of RDA Microelectronics in 2013, an acquisition involving two Chinese companies.⁹

As previously noted, 97.4% of the transactions reviewed by MOFCOM have been cleared without conditions. This is comparable to similar statistics in the US and EU. In the 26 cases

⁴ These thresholds are: each of at least two business operators must have sales in China in excess of RMB 400 million (USD 65 million), and the combined sales of all the business operators must exceed (i) RMB 10 billion (USD 1.6 billion) on a worldwide basis; or (ii) RMB 2 billion (USD 325 million) in China. These thresholds are lower than those required in the EU. The US Hart-Scott-Rodino filing uses a different approach so it is difficult to make an apples-to-apples comparison.

⁵ MOFCOM statistics about transactions cleared without conditions and MOFCOM's announcements about transactions with intervention are available on the MOFCOM website. The information is in Chinese.

⁶ Fei Deng and Cunzhen Huang, "A Five Year Review of Merger Enforcement in China," *The Antitrust Source*, chart 3, October 2013.

⁷ Lester Ross and Kenneth Zhou, "MOFCOM to Publicize Administrative Penalties for Illegal Implementation of Concentrations," WilmerHale, April 21, 2014.

⁸ MOFCOM press release, January 10, 2012 (in Chinese). MOFCOM's press conference regarding draft regulations on the investigation and treatment of failure to report concentration.

⁹ MOFCOM Administrative Penalty Announcement No. [2014] 788, December 8, 2014 (in Chinese).

where MOFCOM intervened, none were purely domestic transactions (that is, involving two Chinese companies) though five involved at least one Chinese party, and the remaining 21 involved solely foreign firms. MOFCOM reports its economic findings and competition concerns for each of the transactions in which it intervenes. These announcements over time have provided increasing detail and evidence of growing sophistication. The business and antitrust communities could further benefit from announcements that provide more detailed reasoning and fuller descriptions of the supporting evidence behind MOFCOM's decisions.

Administrative Investigations of Monopolistic Conduct

To date, investigations initiated by the NDRC account for a majority of China's administrative investigations into alleged AML violations related to monopolistic conduct. The investigations have focused on price fixing agreements, retail price maintenance agreements, and abuse of dominance matters alleging excessive prices. While excessive pricing is not an antitrust concern under US law, it is included as a concern in the AML. Based on the statistics provided by the Director General of the Price Supervision and Anti-Monopoly Bureau of NDRC, between August 2008 and the summer of 2014, the NDRC and its local branches investigated 339 entities. Of these entities, 33 (10%) were foreign or foreign-controlled companies. The rest (90%) were state-owned enterprises, private domestic firms, and industry associations.¹⁰

The NDRC has not disclosed information on all of the penalties it has imposed as a result of AML violations. While the NDRC often imposes multiple types of penalties for a given violation,¹¹ fines expressed as a percentage of an entity's yearly revenue in China is a measure that may be used to compare the size of penalties across different companies. The NDRC website reports that information for 70 entities (including 50 Chinese entities and 20 foreign entities) in a number of industries such as insurance, travel agencies, auto parts, and retail. These data indicate that the average fine percentage imposed was roughly 2.2% of annual revenues for Chinese entities, and 4.0% for foreign entities.¹² More data and more complete analyses are needed before any definitive conclusions can be drawn as to whether foreign firms pay systematically different fines than Chinese firms, while controlling for other relevant economic factors. From August 2008 to the end of 2014, the SAIC and its local branches investigated 43 cases of alleged AML violations, concluded 19 investigations, and suspended one investigation. Two investigations (5%) involved foreign-invested companies, while the remaining 41 cases involved Chinese firms or industry associations.¹³ To date, SAIC investigations have focused on cartel agreements (e.g. market division) and abuse of dominance conduct (e.g. bundling). The SAIC imposed fines totaling RMB 19.7 million in 2013 and 2014 combined, all of which were on

¹⁰ "Foreign companies are a minority among targets of Chinese antitrust regulators, senior official says," *MLex*, December 8, 2014.

¹¹ For example, in NDRC's investigation of LCD price fixing, the penalties imposed on the six LCD suppliers include restitution in the amount of their illegitimate profit from the sale of LCDs in China, and commitment to abide by China's laws, engage in fair competition and extend the warranties on LCD products, in addition to paying fines based on their revenues.

¹² NDRC penalty information collected from penalty announcements on NDRC website (in Chinese). I supplemented NDRC's announcements with general internet searches for information about several high profile investigations and about specific fine amounts.

¹³ "China's SAIC, local agencies initiated 13 new antitrust investigations in 2014, official says," *MLex*, December 8, 2014.

Chinese firms.¹⁴ Both of the SAIC investigations involving foreign companies are ongoing as of this testimony.

Based on the statistics provided by the two agencies, 10% of the entities investigated by the NDRC and 5% of the cases investigated by the SAIC involved foreign firms. These figures by themselves do not suggest a conclusion that there has been a systematic targeting of foreign firms in administrative AML investigations. However, there is insufficient data to allow us to conclude whether fines imposed on foreign firms are systematically different than those imposed on Chinese firms when fines are imposed, after controlling for other relevant factors.

Non-traditional Considerations in AML Enforcement

In principle, the AML allows the state and the AML enforcement agencies to take into account factors beyond traditional antitrust considerations in AML enforcement. Article 27.5 of the AML states that “the development of [China’s] national economy” shall be considered as one of the factors in China’s merger review. A broad reading of Article 4 (“The State will formulate and implement competition rules compatible with the socialist market economy, perfect macroeconomic control and develop a sound uniform, open, competitive and orderly market system.”) could allow the NDRC and the SAIC to take into account factors beyond traditional competition issues in their AML investigations.

In addition, the institutional context of the three AML enforcement agencies might allow their respective “supervising” ministries, which have a wide range of administrative functions, to influence AML enforcement. The personnel of each AML enforcement bureau are appointed by their respective ministry. In principle, the ministry leadership approves the final decision in major AML cases. Therefore, ministry goals beyond AML goals could possibly influence AML enforcement through various means.

It is unclear at this stage whether non-traditional competition factors have actually affected AML enforcement decisions; and if so, exactly which factors played a role in which cases, to what extent such non-traditional competition factors influenced the case outcome, and whether China applies a different standard in considering those factors when analyzing purely domestic conduct versus conduct involving foreign firms. One key challenge to understanding this effect is the lack of sufficient transparency in reasoning and fact finding behind some enforcement decisions. Information on AML agencies’ decisions is scarce. When the information is made available, it is often brief and offers limited insight into the agencies’ thinking process, especially for complex antitrust matters not involving cartels.

The agencies often have access to information (sometimes confidential information) that they cannot and do not make available to the parties involved or to the general public. For example, MOFCOM often seeks and receives information from stakeholders such as trade associations and customers. As a result, it is difficult to unravel the boundaries of competition concerns and to refute suspicion that non-traditional competition factors might affect AML enforcement decisions. Regular dialogue with the case teams and parties involved, with an emphasis on fact finding and economic analysis of the information provided, could lead to a greater understanding of how non-traditional competition factors, if any, are considered in AML enforcement.

¹⁴ “Comment: SAIC ends 2014 with record fines of 14.5 million yuan, seen active in 2015,” *MLex*, January 7, 2015.

Conclusion

China's AML regime features new agencies carrying a heavy case load involving complex antitrust issues within a changing economic and legal framework, due to, at least in part, China's large, diversified, and dynamic economy. These factors combined magnify the difficulties and challenges the AML enforcers face. News coverage has provided anecdotes of foreign companies frustrated with China's AML enforcement. My understanding is that a good amount of the frustration is due to growing pains associated with the early stages of a developing antitrust regime in China's transitioning economy. Working with Chinese AML agencies to help them move along the learning curve expeditiously will be useful in overcoming these effects. Future efforts could include engaging in detailed dialogue on the agencies' decision-making, encouraging more transparency through disclosure of economic analysis and fact finding, and helping regulators focus on competition analysis.

**OPENING STATEMENT OF WILLIAM KOVACIC
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MR. KOVACIC: Thank you, Mr. Chairman, and I express my gratitude to the Commission and to the professional staff for the opportunity to appear before you today and discuss the development of competition policy in China.

Like Tad, I'd like to provide some context in which to understand the development of China's institutions and to examine China by reference to other nations that have developed competition systems.

In a university, typically you grade students on a curve so a relevant question is compared to whom is China doing a good job or not? As Tad mentioned, a striking feature of policymaking in the modern world has been the emergence of many competition systems. In 1990, there were fewer than 15. Over 125 jurisdictions today have competition law systems.

We've learned a number of things from this experience. First, nobody gets it right on the first day, and that goes back to the late 19th century with the first experiment in Canada in 1889 and certainly in the United States in 1890. If you had measured the performance of the U.S. system ten years into that performance, you would have graded it very badly. It was not an immediate success. Arguably it took a full half-century for the system to be set on a sound foundation and, as Tad said, a much longer evolution to develop doctrines that we regard now as being sensible competition policy.

The second general observation is that good systems over time need upgrades. That is, it is somewhat less important where precisely you start. It is vital how often you go back to your system and evaluate performance in light of past experience. And China, as Elizabeth said, is in the various earliest stages of its life cycle, but six years into the development of a system is a very good time for China to look back and say how are we doing and are there areas in which we could get improvements?

None of us use the word-processing package that was designed in the mid-1990s. Nobody in competition law should be content with a system that is not upgraded routinely.

I'd say there are three basic focal points for reconsideration for China going ahead, and in my own work in China, I sense a willingness to revisit the framework and operation of the system in these three dimensions.

First, structural simplifications. Tad has described for you the extraordinary degree to which at the national level China has decentralized the decision to prosecute. It is perhaps odd enough that the United States stands out as the only Western jurisdiction with two federal competition agencies with overlapping authority. As Tad said, China has three.

I think there is a broad and growing understanding that three is a crowd, that three greatly complicates efforts to develop policy coherence.

One thing I would predict in the coming years is a reconsideration of that basic framework and a debate within China about how to achieve greater coherence from going from three to one.

Moreover, one could take the competition authorities out of their existing framework and to set them in a new institution that would be a stand-alone agency. As you know, the three Chinese agencies have competition units that are tiny offices in broad, sprawling policy conglomerates -- small units on the organization chart that are dwarfed by much larger institutions.

A point for debate that I would anticipate in the future is whether to take those institutions as part of the simplification out of their existing homes and situate them in a stand-alone competition agency. This will have the effect (if it takes place) of giving them greater autonomy. The life cycle we have observed with many other institutions is that in the earliest stages, the government, especially in a transition environment that has featured central planning and heavy reliance on the state as the owner of business enterprises, a trend we've seen that in the early stage, the government does not trust this new institution so it tends to situate it in a place that's closer to, more responsive to the preferences of political leadership.

The evolution we see over time in many countries is to move those institutions farther away from political control of this kind, to give them more autonomy to take decisions in the manner that both Elizabeth and Tad were suggesting are part of the evolution of competition systems.

So one thing we might anticipate on structure is simplification of the system, reducing the number of national participants but also a repositioning of the institutions and perhaps a stand-alone body that only does competition law.

Second, procedural change. Tad has identified a number of concerns that have arisen with process in China, and here I would anticipate, to underscore a point that Elizabeth made, a greater emphasis over time on more disclosure.

New competition agencies do not naturally take to the idea of disclosing more information about what they do, and when you're operating in a national environment in which there is no history of broad disclosure, no history or custom for administrative bodies to say a great deal about what they do, the introduction of the Anti-Monopoly Law in China, which has a mandate for certain forms of disclosure, is a real novelty in public administration.

I think we have seen, for example, in the work of the merger control unit in MOFCOM much greater disclosure over time simply in six years from saying very little at the beginning to saying much more now.

I was a junior case handler at the FTC when the FTC's mandatory merger notification Regime went live in 1979, and I remember quite keenly that the response of the agency to questions about the inevitable ambiguities in the regulatory mechanism was to say "Read the regulation

again.” Companies would say “Can you give us more guidance than this?,” and the answer was “Read it again.” The companies said “We've read it several times.”

It was not until many years later that there was a habit of giving advice over the telephone, issuing frequently asked questions, giving speeches at which officials would routinely appear. This is a slow growth, and I would anticipate we would see more of the healthy disclosure that both Tad and Elizabeth have referred to over time.

Last point, human resources. Elizabeth referred to this, and I underscore it. China's anti-monopoly regime gave tiny offices massive responsibilities. There was a severe understaffing that has had the following effects: delays in processing information; less attention to transparency. You spend less time explaining what you're doing if you're trying to fight the next fire that's coming your way. And last, less good process. If you have too few people to do proper investigations, to do a thorough examination, to engage in a fuller discussion with outside parties, you're inclined to take shortcuts to get things done quickly.

I think a major need for the Chinese agencies, realized in China, is to develop fuller resourcing, better staffing in order to address these concerns.

I look forward to your questions.

CHAIRMAN REINSCH: Thank you. Thanks to all of you for pretty much staying within the time limits.

Commissioner Wessel.

**PREPARED STATEMENT OF WILLIAM KOVACIC
GLOBAL COMPETITION PROFESSOR OF LAW AND POLICY
DIRECTOR, COMPETITION LAW CENTER, GEORGE WASHINGTON
UNIVERSITY LAW SCHOOL**

Hearing on the Foreign Investment Climate in China: Present Challenges and Potential for Reform

Testimony of William E. Kovacic¹

U.S.-China Economic and Security Review Commission

Washington, D.C.

January 28, 2015

Introduction: China's Antitrust Experience in Context

In any country, the introduction of a system of competition law is a difficult, time-consuming endeavor. No nation gets it right in the first year, or even the first decade. In the United States, for example, it took roughly a half-century (from 1890 to 1940) for the country to settle upon competition as the core principle for economic organization and to give antitrust enforcement a central role in making markets work for consumers.² Modern U.S. antitrust experience has featured important changes in the legislative framework, doctrine, and enforcement policy. The process of building an effective competition law system is an ongoing process of experimentation, assessment, and refinement.³

The challenge of creating an effective competition law system is still greater in countries, such as China, which have adopted competition laws to facilitate the transition from reliance on central planning and state ownership toward a market-based economic regime in which the private sector assumes greater responsibility for the production of goods and services.⁴ Three basic obstacles have confronted the implementation of China's Antimonopoly Law (AML), which took effect in August 2008. The first is to build awareness of the competition law and to gain acceptance for market-based competition as the foundation for good economic performance. This is an especially daunting task where powerful interests within and outside the government regard competition with suspicion and desire to protect economic structures established during the era of planning and comprehensive state ownership.

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² This history is recounted in William E. Kovacic & Carl Shapiro, Antitrust Policy: A Century of Economic and Legal Thinking, 14 *Journal of Economic Perspectives* 43 (2000).

³ This cycle is analyzed in William E. Kovacic, Achieving Better Practices in the Design of Competition Policy Institutions, 20 *Antitrust Bulletin* 511 (Fall 2005).

⁴ The difficulties of creating a competition policy system in formerly planned economies are examined in William E. Kovacic, Institutional Foundations for Economic Legal Reform: The Case of Competition Policy and Antitrust Enforcement, 77 *Chicago-Kent Law Review* 265 (2001).

Competition creates considerable benefits for society, but it also disrupts. Competition can dramatically alter the fortunes of individual firms and the communities in which they reside. A competition agency in any country must persuade government policy makers and the larger society of the benefits of the continuous process of competition-driven industry transformation, and it must discourage reliance on economic policies that would freeze in place an existing configuration of products and services and the firms that supply them.

A second formidable endeavor is to establish effective institutions to implement the law.⁵ Among other measures, this requires the formation of new entities to enforce the competition law and the establishment of capacity within existing bodies (e.g., the courts) to carry out duties related to the new law. Good performance by these bodies, in turn, requires the development of a strong supporting intellectual infrastructure – including the establishment of university departments that teach courses in economics, business, law, and public administration relevant to competition policy. No jurisdiction can succeed in implementing a competition law without the contributions of these and other collateral institutions.

A third necessary measure is to establish a culture of public administration that emphasizes informative disclosure of decisions taken by the competition agency and the reasons for the agency's actions. This is not a natural or welcome step within a bureaucratic tradition that has no custom of explaining administrative decisions or making public officials available for routine discussions of agency policy in settings such as conferences convened by professional societies. Approximately 125 jurisdictions have created systems of competition law. Some of these systems (e.g., Canada and the United States) were formed in the late 19th century. Most systems are relatively new. All but roughly twenty of the existing competition law systems have been formed since 1990. No two of the jurisdictions to enact competition laws are identical. Variations in cultural, economic, historical, legal, and political circumstances abound. Despite these differences, it is possible to derive at least two generally applicable principles from experience with competition law.

First, the construction of an effective competition law system takes considerable time. Accomplishment of the tasks identified above can be, and often is, a long journey. It can easily require decades to set the foundations of the implementing institutions soundly in place and to establish the capacity of the new enforcement agencies to apply the law in an effective manner. It is important to keep in mind that China is still in the earliest stages of developing its competition law system.

China has made considerable progress in a relatively short time to implement its law, yet considerable work remains to be done.

The second proposition is that successful competition systems require periodic upgrades. The starting point for a new system, in terms of the design of the law and its implementing institutions, is perhaps less important than the care with which a jurisdiction takes stock of its

⁵ On the institutional design choices associated with the creation of a competition policy regime, see David A. Hyman & William E. Kovacic, *Competition Agency Design: What's on the Menu?*, 8 *European Competition Journal* 527 (2012).

experience and makes improvements over time. Good practice consists of a commitment to assess the existing framework on a regular basis and to make refinements. Experience in other jurisdictions suggests that an ideal time for a new regime to assess its progress and consider refinements is between five and ten years out from the creation of the system. Thus, a reexamination of China's antimonopoly system, six years since its establishment, is timely and desirable.

Compared to other relatively new competition systems, China has accumulated substantial experience in the implementation of the AML in a very short period of time. Given the difficulty of creating a new legal regime in any country and the specific difficulties of establishing a competition regime as part of a fundamental economic transition, this record is a major accomplishment. Thus, from a comparative perspective, China has progressed relatively rapidly down the learning curve.

No legal reform of this magnitude is frictionless. All nations that have adopted competition laws have learned that the emergence of an effective new regime is a slow growth. From careful reflection upon international experience, it is possible for a newer system to mitigate implementation difficulties, if only by anticipating problems that appear universally, regardless of the distinctive circumstances of each jurisdiction. Even with astute examination of foreign experience, some difficulties in the reform process are unavoidable. Even when a driver is equipped with excellent maps and guidebooks, the experience of driving an automobile for the first time in a large, unfamiliar city is a voyage of discovery. The only way to discover the best way around town is to drive the car through it.

Experience with the implementation of competition laws in over 125 jurisdictions with competition law systems indicates the benefits to any nation (including China) of periodic upgrades. That is why there is special value to a new system from undertaking a basic assessment of possible reforms from five to ten years after the enactment of the competition law. This provides sufficient experience to understand the strengths and weaknesses of the initial design.

China's Antimonopoly System: Possible Focal Points for Refinement

As established in 2008, China's antimonopoly law contains the basic portfolio of commands that one would observe in many of the world's competition systems. After carefully examining experience in other jurisdictions, China devised what in many respects is a state of the art law that addressed the core areas of competition law: horizontal restraints, vertical constraints, mergers, and abuse of dominance. Presented below are some possible focal points for examination as China considers the path ahead.

Competition Law in Multi-function Agencies

China assigned enforcement responsibility to three agencies: the Ministry of Commerce (MOFCOM, which performs merger control; the National Development and Reform Commission (NDRC), which has jurisdiction over price-related offenses; and the State Administration for Industry and Commerce (SAIC), which has jurisdiction over non-price

related offenses. NDRC and SAIC, have preexisting mandates that are related to the AML and continue to bear upon the implementation of the AML. NDRC has competence to enforce China's pricing law, which supplies a separate mandate to set limits on some pricing decisions. The NDRC unit that enforces the AML also is responsible for enforcing the pricing law, and there have been NDRC investigations whose foundations – pricing law or AML – have not been clearly specified. In addition to its AML duties, SAIC has competence to enforce China's law prohibiting unfair competition, a command that applies, among other matters, to misleading advertising and marketing practices. The SAIC unit responsible for AML enforcement also is entrusted the implementation of the unfair competition law.

China is not alone in giving the competition authority other law enforcement duties.⁶ A number of other jurisdictions have given the competition agency a mandate to enforce prohibitions on unfair competition. The question of which agency should do what depends heavily on the analytical connection across the different functions. Where there are strong conceptual complementarities across the functions, it can make sense to combine them in a single agency. Where the functions are intellectual substitutes, it is ordinarily best to locate the functions in separate bodies. The possibility for conflict between functions would be greater between NDRC's residual price control authority and its duties under the AML.

Even when the functions are complementary, the unification of discrete tasks in one body can blur the “brand” of the institution and reduce the clarity of its mission. A single-function agency has the advantage of being able to define its aims clearly and to resist confusion about its aims and priorities.

The Structure of Public Enforcement Institutions

For a variety of understandable reasons, China distributed public enforcement authority across three agencies. For the future, China might revisit this decision and consider a rationalization that would unify the AML functions of the three existing antimonopoly bureaus in a single institution. The historical trend in many other jurisdictions (though not all nations) has been to move antitrust-related functions to a stand-alone entity. Were China to take this path, non-AML functions would remain with their existing host institutions. Thus, NDRC would continue to enforce the price law, and SAIC would continue to enforce the law on unfair competition – perhaps as part of a larger mandate that would make SAIC China's principal consumer protection agency.

In all three of these agencies, the antimonopoly bureau is a small unit within a large, diverse bureaucracy. In each case, the new antimonopoly bureau has confronted the task of establishing a presence within an institution with well-ingrained customs and power centers. To a considerable extent, the competition policy mandate of the antimonopoly bureau coexists with other duties that are in tension with or inconsistent with pro-competition economic policy.

⁶ See David A. Hyman & William E. Kovacic, Why Who Does What Matters: Governmental Design and Agency Performance, 82 George Washington University Law Review 1446 (2014).

The subdivision of policymaking authority across various government bodies also can undermine the coherence of the competition policy regime. The foremost concerns in this respect arise in the relationship between NDRC and SAIC. As noted above, NDRC is responsible for price-related non-merger matters, and SAIC oversees price-related conduct. This is an inherently murky delineation of policy tasks. One could argue that many (if not most) business practices ultimately affect the prices a firm charges. By this reckoning, NDRC could assert that its mandate covers non-price arrangements (e.g., a tying agreement or an exclusive dealing contract) nominally assigned to SAIC. In addition, there are a number of instances in which a firm adopts a strategy that employs a combination of practices – some price-related, some “non-price.” A consumer goods producer, for example, might use a resale price maintenance and exclusive territories to distribute its goods. Is such a case properly assigned to NDRC, SAIC, or to both?

Such questions of allocating enforcement tasks inevitably will arise between NDRC and SAIC in the implementation of the AML. Not only is this a source of possible tension and a coordination burden between NDRC and SAIC, but it also is a source of uncertainty for firms which are attempting to discern which Chinese agency has authority to review specific episodes of business conduct.

Nor is it safe to assume that merger control has no connection to non-merger areas of competition law. The scrutiny of cartels and the evaluation of coordinated effects theories of merger control share a common analytical core.⁷ In the course of enforcing prohibitions against cartels, an agency can learn a great deal that is useful in predicting when firms might succeed in engaging in tacit coordination following a merger. It is possible for separate cartel (NDRC) and merger (MOFCOM) agencies to share relevant information and analytical perspectives through interagency cooperation, but the joining up of relevant information might take place more readily and completely if carried out within the same institution.

For any jurisdiction, multi-agency configurations raise the costs of coordination not only at home but in foreign relations. Such complications arise when China’s antimonopoly system interacts with other competition systems internationally. Having three institutions increases the effort that must be taken to define and articulate the Chinese view about antimonopoly issues to individual foreign agencies or before larger international organizations.

Experience in other jurisdictions would suggest that at some point China will revisit the design of its public enforcement mechanism. A reassessment of the existing framework might consider whether to undertake a restructuring that would combine the functions of all three existing antimonopoly units into a single body, and whether to establish the unified institution as a stand-alone body. In other jurisdictions, these types of adjustment have sought to accomplish two ends. The first is to give the antimonopoly function greater coherence and visibility by removing the enforcement function from diversified policy conglomerates (in China’s case, MOFCOM, NDRC, and SAIC) in which the competition mandates run a risk of being submerged or subordinated to other policy interests. The second is to unify policy responsibility to overcome the uncertainties associated with determining

⁷ These connections are explored in William E. Kovacic, Robert C. Marshall, Leslie M. Marx & Steven P. Schulenberg, Quantitative Analysis of Coordinated Effects, 76 Antitrust Law Journal 397 (2009).

jurisdictional boundaries across agencies (e.g., the price/nonprice delineation of power between NDRC and SAIC) and to avoid the costs associated with coordinating activity among different institutions.

Restructuring measures along the lines sketched above would align China's system with trends globally in competition law. Within the past ten years, several jurisdictions (including Brazil, France, Portugal, Spain, and the United Kingdom) have combined two or more competition policy entities into a single public body. A number of relatively new systems (including Mexico and Morocco) have moved the competition enforcement function from a bureau within a larger ministry to give the antimonopoly function to a separate, stand-alone institution.

Not all jurisdictions have undertaken the simplification and integration measures outline above. Perhaps most notably, the United States continues to allocate enforcement responsibility between two public agencies (the Antitrust Division of the Department of Justice and the Federal Trade Commission). I have worked within the U.S. system for the past 35 years and has studied its operation carefully. I raise the possibility of simplification with an awareness of the costs that the United States regime incurs by sustaining its dual-agency enforcement mechanism.⁸ I also acknowledge the tremendous forces of inertia that can impede, as they have in the United States, structural reforms.

It is important to note that public enforcement is not the only means for the implementation of competition law in China. An important design feature of the AML is the creation of private rights of action. As observed in experience with other competition law systems, the establishment of a private enforcement mechanism has two important implications. The first is that it divests the public institutions of their capacity to be the sole gatekeeper to determine the content and sequencing of enforcement matters. Private rights enable private parties – individual firms or consumers – to bring cases that the public authorities, for various reasons, have chosen not to prosecute and to accelerate the prosecution of matters that the public agency might have preferred to bring at another time.

Private rights provide a potentially powerful engine for doctrinal development and policy implementation beyond the control of government enforcement agencies. In only a few years, private rights of action have played an important part in the enforcement of the AML. Private cases have yielded important judicial decisions concerning abuse of dominance and resale price maintenance. The People's Supreme Court has issued guidelines to facilitate discovery and the presentation of evidence in private cases.

Agency Autonomy

It is a common precept of international experience with competition law that competition agencies should be “independent.” Definitions of this concept vary, but the core idea is that

⁸ The costs of the federal dual enforcement mechanism in the United States are reviewed in William E. Kovacic, Antitrust in High-Tech Industries: Improving the Federal Antitrust Joint Venture, 19 George Mason Law Review 1097 (2012).

the competition agency should have autonomy from political branches of government in exercising its authority to initiate or resolve cases. At the same time, there is general agreement that a competition agency should be accountable to the political process for its policy choices – for example, by being required to disclose the basis for its decisions, by issuing statements of its priorities and enforcement guidelines, and appearing before political officials from time to time to discuss their enforcement programs. There also is a general awareness that a competition agency must have some connection with the political process if it is to function effectively as an advocate for competition before other government bodies.

China has no experience with “independent” regulatory bodies as the concept is defined immediately above. China’s antimonopoly agencies confront at least two conditions related to their capacity to apply their enforcement powers with a necessary level of autonomy. As noted above, the antimonopoly bureaus of MOFCOM, NDRC, and SAIC are small subunits of large, diversified policy conglomerates. Within its host institution, each unit coexists with well-established bureaus with economic interests and policy views in tension with the competition law.

China’s antimonopoly bureaus also face countervailing policy views and economic interests from government bodies located outside their own institutions.

Examples include other ministries that oversee specific sectors or individual state-owned enterprises or government administrations at the provincial or municipal level. As in many other countries, these external bodies sometimes press the antimonopoly units to resolve individual matters in ways that favor the interests represented by the external bodies.

Procedure

To speak of good procedure for a competition system, I have three things in mind: quality control in the sense of a rigorous testing of evidence that leads to an accurate diagnosis of observed behavior, legitimacy that comes from the use of processes that give affected parties and the general public confidence in the soundness of the agency’s methods and substantive conclusions, and the minimization of delay.

From international experience, it is evident that several characteristics of competition agency practice tend to promote the attainment of these ends. One essential foundation, is meaningful disclosure, or transparency. Competition agencies (or all government agencies, for that matter) do not always willingly embrace norms that promote fuller, meaningful revelation of information about their operations and decisions. I have noticed that this tendency is more pronounced in newer systems. The reluctance of newer competition agencies to disclose more information has many sources, including the fear of being bound in a rigid manner by past decisions, or the uncertainty that comes from limited experience with a field of law.

These misgivings are understandable, yet fuller disclosure serves to accelerate an agency’s progress by strengthening internal decision processes and educating external audiences more effectively. For example, a leniency program is unlikely to succeed unless the competition agency is clear about the terms on which leniency will be available and about the conditions that firms must satisfy to qualify. Meaningful disclosure also can stimulate a healthy debate

about what the agency has done and assist the agency to identify possible improvements in its analysis and procedures. Thus, as a source of better guidance to affected parties and as a symbol of good governance, broader disclosure serves the interests of a new competition agency.

Over time, China's antimonopoly agencies have taken progressively greater steps to explain how they intend to apply the AML. In developing enforcement guidelines, China has followed the internationally accepted practice of issuing draft documents and soliciting comments from external groups. This is a valuable means for achieving a necessary degree of transparency – the meaningful disclosure of information about substantive decisions taken, the agency's priorities, and the analytical approach it uses to do its work.

As suggested above, agencies in the first phase of their institutional life tend to function more effectively as they disclose more about how they do business. This consideration presses in the direction of expanding existing initiatives to provide further guidance about enforcement intentions and analytical methodologies.

Expansion of existing MOFCOM, NDRC, and SAIC efforts to provide guidance about agency enforcement intentions and analytical methods likely would serve to improve the implementation of China's AML. Means to this end include the issuance of additional formal guidelines (e.g., the pending SAIC guidelines on competition law and intellectual property rights), public speeches and appearances at conferences, and the publication of answers to "frequently asked questions" about the content and application of the AML. These and related measures can increase the effectiveness of China's enforcement regime by improving the transparency of its operations.

A second necessary element of good process is to provide the subjects of agency inquiries a meaningful opportunity to discuss the agency's theory of harm and to provide its own view of the theories and evidence the agency intends to apply. In widely accepted international practice, this approach involves allowing representatives of the company and its external advisors (e.g., its law firms and economic consultancies) to meet with the agency to discuss pending inquiries and proposed enforcement measures. The agency also should be responsive to the requests of affected parties about the status of existing agency inquiries and about the expected path of deliberations going ahead.

A third foundation for good process is judicial review of agency action. Recourse to effective judicial review provides an important safeguard against serious agency error and impels the agency to maintain high levels of internal quality control.

Perhaps the single area in which the urgency to increase the speed of agency decision making is merger review. Inordinate delays raise the uncertainty associated with carrying out routine transactions and complicate the completion of mergers involving firms active in dozens of jurisdictions. MOFCOM has taken major steps to introduce a simplified merger review procedure for matters that appear to pose no competitive hazards.

A further element of good process is a commitment to examine past experience as a way to improve future performance. A fundamental question concerning the enforcement of a

competition law in any jurisdiction is effectiveness: How do we know that an enforcement program is accomplishing its intended aims – to cure existing competitive harms, to compensate victims, to deter future offenses? In many areas of competition law, enforcement has an inherent element of experimentation. Over time, a competition agency tests a number of approaches to solve specific competition problems, curing the effects of past anticompetitive behavior, and obtaining deterrence. An important component of the selection of remedies is the development of even rudimentary means to assess whether they are working as intended.⁹ Among other means, this can be achieved by performing even a rough comparison between the agency's expectations about future commercial developments and what actually transpired.

Human Resources

No single factor is more vital the success of a competition agency than the quality of its human capital. Through adequate resourcing and by building a high quality professional and administrative staff, an agency improves its ability to analyze accurately the competitive significance of business conduct and increases the speed with which it performs its work. Competition law systems with serious deficiencies in human capital often encounter a crippling mismatch between the commitments embodied in the competition law and the capacity of public institutions to fulfill their duties properly.

From the first days of the AML's implementation, China has given the three antimonopoly agencies too few resources to carry out their responsibilities. All three agencies have recruited some highly capable professionals and administrators, but the level of staffing falls well below the numbers that competition agencies in other jurisdictions have found necessary to operate effectively.

Understaffing can create at least five distortions in a competition law system. First, the agencies have too few resources to conduct in-depth inquiries in matters that warrant careful fact-gathering and analysis. Pursuant to the commands of the AML, the three antimonopoly agencies have undertaken ambitious agendas, including the examination of behavior involving considerable analytical and factual complexity.

Second, the lack of resources creates tremendous pressure upon the competition agency to obtain settlements to resolve apparent violations of the law. In some cases, agencies may press parties to make concessions early in the life cycle of a matter, in lieu of a more deliberate process of evidence-gathering and analysis. Proper resourcing relaxes the pressure to use settlement short-cuts to address complex commercial phenomena that deserve closer study and fuller deliberation.

Third, inadequate resourcing tends to extend the duration of matters for which the agencies have chosen to undertake a more elaborate investigation. This is particularly true where an agency is running two or more complex inquiries at one time.

⁹ On the importance of this type of assessment, see William E. Kovacic, Using Ex Post Evaluation to Improve the Performance of Competition Policy Authorities, 31 Journal of Corporate Law 503 (2006).

Fourth, weak resourcing can deny an agency the means it requires to monitor fulfillment of obligations imposed on firms through decisions taken by the antimonopoly agencies (by settlement or otherwise). The credibility of undertakings provided by companies depends heavily upon the expectation of business operators that the competition authority will oversee compliance with their terms. As a related point, an agency with too few resources is likely to invest too little effort to determine whether specific remedies achieved their intended effects. This form of evaluation provides valuable insights to the competition about how to design resources in future cases.

Fifth, under-resourcing impedes an agency's engagement in valuable work beyond the investigation and prosecution of cases. Relevant tasks beyond investigation and prosecution include the preparation of guidelines or other policy instruments that inform businesses about the agency's priorities and its intentions about the application of the law. These non-litigation activities can play a useful role in gaining compliance with the law, but the demands of law enforcement matters can tend to divert resources away from these initiatives. A weakly resourced competition agency will be especially prone to invest too little effort to use non-enforcement instruments to improve the performance of the competition system.

The Role of the Courts

The development of China's antimonopoly system has been accompanied by major enhancements in the country's judiciary, especially within the chamber of the Supreme People's Court responsible for intellectual property issues. This chamber has played a crucial role in the evolution of private rights of action and in providing a forum for the resolution of cases brought by the government agencies. In many countries, judicial decisions have provided valuable interpretations of competition laws and have raised the quality of competition policy analysis within the jurisdiction. In effect, the courts engage in a long-running conversation with the enforcement agencies, academics, and the business community.

The reported decisions in the Qihoo/Tencent and Johnson & Johnson cases are examples of instances in which China's courts can raise the quality of discourse about competition law. The judges of the intellectual property chamber have participated in a wide array of judicial education programs related to competition law, and their work in dealing with competition law disputes reveals an impressive sophistication in this field.

International experience suggests that effective judicial review is a valuable means to improve the quality of decisions by administrative agencies and to increase the perceived legitimacy of a competition system. A major question for the future development of China's competition law system is the availability of judicial review to oversee decisions taken by the three public antimonopoly bureaus. In theory, recourse to judicial review is available to challenge agency action. In practice, I am aware of no instance in which a party has used the existing machinery of judicial oversight to challenge agency action.

PANEL II QUESTION AND ANSWER

COMMISSIONER WESSEL: Thank you, all, for being here on what is a critical issue, a very complex one.

I want to try and understand how the relationship between the institutions, the procedural and the other issues, and the standards, and, Ms. Wang, you said that China is on this march, is on this path to being a market economy. I want to question that because the standards that one applies depends on how one views the role of your competition laws. We have a market economy statusmind-set. Does China really have that mind-set? Is that really what the purpose of their competition laws are when one looks at the upcoming 13th Five-Year Plan?

I agree with all the transparency and all the other issues, and they're still in their infancy, but can one really disengage or detangle the standards from the procedural issues you're talking about? Each of the witnesses, please.

DR. WANG: Thank you for the question, Commissioner.

I am an economist so I will just try to answer your question from an economic point of view. What I see when I say lack of full economic market mind-set, I'm thinking and talking about the business and government body, whether they allow or have the environment for the business operator to have full autonomy to make business decisions.

What I see right now is that they have varying degrees of that. Some companies, even though they're private, they still do not have the full autonomy of making some very important business decisions such as naming new management or setting price sometimes. So I think this is one area that is not there yet.

MR. LIPSKY: I agree with Dr. Wang. Every jurisdiction, even ones that have a fairly heavy commitment to a market economy, as the United States does, as the UK and other European nations do, will impinge, will have government action that impinges upon that economic activity to some significant extent. I think it's probably to a greater extent in China than it is in a lot of other jurisdictions, but in the United States, for example, in the 1970s, we had very heavy intervention and regulation of some fundamental industries--electricity generation and distribution, domestic airlines, domestic freight transportation.

And very much to the good, I think, all of those forms of regulation were very significantly cut back, and some of them entirely overthrown. The Civil Aeronautics Board and the Interstate Commerce Commission no longer exist. The energy industry relies much more heavily on competition now than it did 30 years ago.

This evolution, it seems to me, has progressed to a much more limited degree in China, and anything we can do to accelerate it I think will be to the good.

MR. KOVACIC: I would add that one of the interesting features in the AML is that there is a specific mandate for the agencies to be engaged in

dealing with overreaching by state-owned enterprises and by municipal or other government authorities that seek to put a thumb on the scale with respect to who enters the market and who participates.

That is in a sense an underdeveloped element of the Chinese scheme. I think we've observed slowly over time more attention to that. I think a promising aspect of the AML is that the anti-monopoly authorities are some of the only institutions in China which have a mandate to specifically address those imbalances, and, in the brief history that Tad described, it was the Department of Justice principally that played a major role as an advocate, sometimes as a litigant, in changing perceptions about the appropriate scope of state ownership and regulatory control in the United States. Something that could happen in China is we'll see a similar progression there, too.

COMMISSIONER WESSEL: Thank you.

CHAIRMAN REINSCH: Okay. Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you all for being here. I appreciate your testimony.

Now, Mr. Lipsky, you were at Coca-Cola? You were the antitrust counsel?

MR. LIPSKY: Yes, correct.

VICE CHAIRMAN SHEA: You left though in 2002; is that correct?

MR. LIPSKY: Yes, before the fun started in China.

VICE CHAIRMAN SHEA: Right. Now, I'm sure if you were sitting in that chair, what happened in 2009 would not have happened; right? And I'm referring to Coke's acquisition of Huiyuan--how do you pronounce--juice company.

MR. LIPSKY: Huawei, I think--not Huawei. It's Huiyuan, Huiyuan.

VICE CHAIRMAN SHEA: Right. And are you familiar with that? That seemed, to my understanding, that was sort of the first big Western acquisition attempt under this new law, new regime, and people were sort of shaking their heads, how could--it's a juice maker. It's not some sort of national security asset that's being purchased, and it was rejected.

Do you know what--could you enlighten us about what the circumstances were, and if there are lessons learned six years later here in 2015, have things changed?

MR. LIPSKY: Well, let me hasten to point out I was not involved in any way in the handling of that matter, and so--

VICE CHAIRMAN SHEA: But if you were, it would have come out in a better way?

MR. LIPSKY: Well, undoubtedly.

VICE CHAIRMAN SHEA: Right.

[Laughter.]

MR. LIPSKY: So what I'm going to say is just based on--

VICE CHAIRMAN SHEA: Sure.

MR. LIPSKY: --careful newspaper reading. First of all, based on experience with very many new and old antitrust regimes around the world

on behalf of Coca-Cola, you'd be surprised how touchy some countries are about their beverage businesses.

You may recall that the French rejected an effort by the Coca-Cola Company to acquire the Orangina brand back in the 1990s. So it's not a--

VICE CHAIRMAN SHEA: I missed that one.

MR. LIPSKY: It's not an entirely unknown phenomenon in various jurisdictions, but what struck me about the decision there is that immediately after that decision was made, the comment, usually I suppose intended as a criticism, was that the Chinese, what the Chinese had actually done in that decision was to protect an important indigenous locally-owned brand. It was a juice brand, but it was an important brand nevertheless.

And one could have debated based on the fairly extensive defense of its decision that MOFCOM published, one could have debated to what extent that played a role. MOFCOM, of course, tried to put it entirely on competition law grounds.

But in my personal view, I think they made a Freudian slip a few months later that revealed their true stripes. As you may be aware, one of China's most serious administrative problems in their merger review was that they're extremely slow relative to other jurisdictions. For complicated mergers that pose significant issues, it's not so apparent. But the Chinese have had particular trouble promptly reviewing and clearing transactions that self-evidently have no competitive implication and therefore there has been a lot of focus on that.

The Chinese have acknowledged that problem, and they issued a proposed regulation announcing that they would try to adopt criteria for the identification of transactions that would require a more lengthy review, which suggested that transactions that did not meet those criteria would be promptly reviewed.

Well, I think there were six criteria, and one of the criteria was that the target company owns a famous Chinese brand. So somehow this made it through the diplomatic screens at MOFCOM, and so I took that as a signal that, in fact, the involvement of an important indigenous brand is an important consideration in their merger analysis, perhaps independently of the competitive implication, and of course that's an issue when you're talking about deviation from strictly competition-based criteria in your merger analysis.

VICE CHAIRMAN SHEA: And that's still in place today?

MR. LIPSKY: Well, that particular feature was not present in the final regulations. The simplified procedure was adopted, and its early implementation seems to be, seems to contain a lot of promise although there are still a lot of so-called "no-brainer" transactions that require several months to clear.

VICE CHAIRMAN SHEA: Okay. Thank you.

CHAIRMAN REINSCH: Okay. Commissioner Fiedler.

COMMISSIONER FIEDLER: Just a quick question. Clearly American business feels that it's being targeted for undue attention, let's just

characterize it. Are they?

MR. KOVACIC: I find it extremely difficult, Commissioner, to come up with a baseline for deciding how much compared to where else. Like you, I see the concerns, and I read about them a great deal, but I find it difficult to develop a sense of how to measure the amount.

COMMISSIONER FIEDLER: So you don't know?

MR. KOVACIC: I don't know.

COMMISSIONER FIEDLER: Elizabeth?

DR. WANG: I think the data out there is not enough to say right now. We see, we see a few cases. For mergers, let's remind ourselves 97.4 percent are cleared without problem. A lot of them are foreign companies. And for administrative investigations, again, the number shows the large majority are domestic companies so I think in order to fully understand the issue, we need a lot more and more datapoints.

COMMISSIONER FIEDLER: Okay. So you don't know either?

DR. WANG: No.

COMMISSIONER FIEDLER: Okay. You don't have a comment on it?

MR. LIPSKY: I guess my comment would be that in any system where your antitrust enforcement is not avowedly devoted to sound competitive and economic analysis, your criteria are going to come into question, and because of all the other issues in the U.S.-China economic relationship, I think the Chinese antitrust review is uniquely susceptible to this criticism because they incorporate in their law this idea of protecting of--I forget the precise phrase--the national--it's the national socialist economy or something.

And so they almost invite this type of speculation, and because they are limited in their transparency, there really is no effective way to rebut it.

COMMISSIONER FIEDLER: Well, there's limited transparency on every level. Let me have a follow-up question that I perceive to be simple. I thought the last one was simple, yes or no, but is the enforcement of the anti-monopoly system more political or more legal? In the majority? I mean, okay, I mean, look, antitrust in the United States is partially political, I would argue. People make decisions in the Justice Department to go after companies and not others. So there's a political element in it.

I'd say maybe 20 percent. I mean this off the top of my head, and 80 percent straightforward legal, or if I can make the case I'm going to win.

What about China? Is it 80 percent political? Or is it 20 percent? Or is it--what's the--now, in order to ease your calculation, just give me a majority. Is it more political or more legal right now?

MR. KOVACIC: Who knows?

DR. WANG: I have no--

COMMISSIONER FIEDLER: Well, by the way, the answer is if it's not--I mean your answer of "who knows" is that it's more political because legal answer would be clear.

MR. KOVACIC: Commissioner, I don't know how I would measure that for the United States. 20 percent, 80 percent--

COMMISSIONER FIEDLER: No, I was--

MR. KOVACIC: I can't tell the--

COMMISSIONER FIEDLER: It's less political than it is legal; is that correct? In the United States?

MR. KOVACIC: I would say so, but all of the legal decisions are taken in a context of intense political interests, especially for mergers.

COMMISSIONER FIEDLER: What do we read this morning? That Qualcomm is being threatened with a billion dollar fine. Does anybody in this room believe that some, one of the two or I mean one of the three newly established embryonic not-fully-aware agencies handling AML could get away with that without the Politburo knowing that this billion dollar fine was on the table? Is that the way the Chinese decision-making system works?

People at the bottom of the central government or somewhere near the middle make decisions that the top is unaware of on that kind--on that level of consequence?

MR. KOVACIC: I would just ask is there a competition agency in the world that would take a decision like that without being aware of the preferences of elected officials?

COMMISSIONER FIEDLER: Hey, look, I'm not really going after the Chinese. I'm just making an observation of whether--I think the evidence that we're picking up anecdotally is it's a political process at this point in history. Dangerous for American companies. They feel aggrieved. They feel they're being targeted. You know, while I'm not particularly sympathetic to them, I do understand that they probably have a pretty good read on that they're being targeted. That's why I'm a little hesitant to say why you guys are resisting this notion that they're being targeted.

MR. KOVACIC: I'm resisting because I find in many ways the concept is so amorphous and the request for a yes or no answer for where it depends so much is hard to say. I would say that in the scheme of agencies early on, and I'd say China is consistent with many other agencies, is the agency in its early stage more responsive to the demands of a political system than it is later in its experience, I'd say yes, unmistakably.

And in that sense, China's agency in the spectrum of all agencies because younger, because tied to the specific system of political control, more attentive to and interested in what political leadership has to say.

COMMISSIONER FIEDLER: Thank you.

MR. KOVACIC: So generally speaking, yes.

COMMISSIONER FIEDLER: Thank you.

CHAIRMAN REINSCH: Okay. Commissioner Slane.

HEARING CO-CHAIR SLANE: I hate to kick a dead horse here, guys, but when I read the comments of the National People's Congress members debating the MLA, the lack of transparency, the lack of due process, selective enforcement, it seems to me the law was enacted in large part to curb the influence of foreign companies to protect their domestic industries, a perverted use of the law driven by political policy and not for competitive

reasons.

Am I missing something or do you guys agree or disagree?

MR. LIPSKY: I'm not an expert on the legislative history. I suppose it's entirely plausible that the merits of having a competition law would be sold in part on the rationale that these laws could be made available for such a purpose.

There is precedent in other jurisdictions. You know, Japan received the blessing of an antitrust law through General MacArthur and the Allied powers, and initially had a very aggressive law designed by an American-educated Marxist economist, which underwent very radical revision as soon as the Japanese got the degree of legislative independence necessary to change that law.

And one can observe in the course of Japanese anti-monopoly enforcement over the period from post-war to say roughly the Washington Consensus era of the early 1990s that they were engaging in uses of the law that were criticized on bases that echo this criticism of the Chinese Anti-Monopoly Law. So there could well be an element of that.

MR. KOVACIC: I'd say there were many purposes. That was one of them. It coexisted with others. There were those who saw the mechanism as a way to push back against the state in some instances. There were those who saw it as a necessary mainstream element of good economic policymaking, but in China and elsewhere, as Tad said, I think you do see an impulse to use the law reflected in the statute to deal with these larger industrial policy concerns.

It's unmistakably there. Is it the dominant impulse? I'm not sure I can measure. I would say that many jurisdictions begin their law with such a feature in it. There is a tendency over time to back away from it, but of the 125 today, I'd say roughly half would have a provision that is similar to that, and, in the early stages, it tends to receive more attention, have more effect.

The tendency over time is it becomes less significant. I'd say it's unmistakably there. Whether I'd call it the dominant impulse I'm more uncertain about that. It coexisted with other purposes, but it is there, as Tad said. It shows up in many laws. My experience is it becomes somewhat more attenuated over time as a controlling influence in what the agencies do.

HEARING CO-CHAIR SLANE: I guess that's where, you know, where I take issue with you. You know, they're using it for price control. They're using it to prevent mergers. They're using it to extract IP and other concessions when they do approve the mergers, and I think that for us to hope that this is going to evolve in a competitive or economic-based law over time is, is not the way things are done in China.

And, you know, they're not interested in playing with the global rules. They have their own set of rules. I mean that's how I--I don't see it ever--I think if I'm hearing you right, I think what you're saying is that other jurisdictions have started out this way and then evolved into a competitive

basis on their law. I just don't believe China will ever get there.

MR. KOVACIC: What prediction would you have made about the direction of Chinese economic policy 30 years ago?

HEARING CO-CHAIR SLANE: I think that we gave the store away on the basis that China was going to become a democracy because we were going to allow them to be prosperous on the backs of our economy, and that didn't work out, and I think that had we realized that going in, we might have taken a different course of action.

MR. KOVACIC: I'm just suggesting that if the mechanisms you describe were immutable, so resistant to change, I'd suggest that the past 30 years couldn't have happened, that the Chinese economy could not have taken the path that it did, and I would have a bit more confidence that this type of evolution can take place, though I acknowledge that when you have suggested changes that so unsettle entrenched interests, those kinds of changes are very difficult.

But, again, those of us at my age would not have predicted the Chinese system would have emerged as it did 30 years ago if there was an immutability about the system and an imperviousness to change.

CHAIRMAN REINSCH: Okay. Okay. Commissioner Goodwin.

COMMISSIONER GOODWIN: Thank you.

Let me ask a question befitting a panel of legal experts. Is the AML law legal under international law and is it being applied in a manner consistent with China's treaty obligations? We have in our briefing materials a paper written I believe late last fall by the U.S. Chamber which suggests that it could be in violation of those standards with the expected lawyerly caveats, but if the AML is indeed discriminatory, and if it's being applied in a discriminatory manner, this paper makes the case that that, in turn, could arguably violate the WTO obligation.

So my question to the panel is, as drafted, taking into account the noncompetitive factors that the law includes, does it run afoul of the WTO obligations of China? And second, is it being applied in a manner, a discriminatory manner, that also violates those principles?

MR. LIPSKY: I'm not sure I've got the right expertise to address that question, and I'm not going to offer you a legal opinion, but I certainly understand how the Chamber arrives at this line of reasoning. There are some, you know, basic principles that underlie WTO obligations.

It tends to be a commonly expressed point of view, or it did tend to be 15 or 20 years ago, that one of the reasons the Chinese adopted an Anti-Monopoly Law was that it was in some sense a requirement of full WTO accession, and I suppose that is based on something.

Now, the United States has had some experience in trying to approach this question of government implementation of competition law in ways that violate trade obligations. You may recall there was a so-called "Special 301" of our Trade Act, which gave a trade remedy if the Japanese government, if a foreign government--the Japanese turned out to be the only ones, I think, that were ever subject to this provision--it provided some

means of trade retaliation if the government acquiesced in anticompetitive conduct and failed to enforce its antitrust law in a way that discriminated against trade with Japan from the United States, and it led to this huge long complicated dispute between Kodak and Fuji, but I don't think it ever actually led to any international remedy.

I think whatever problems existed were worked out by consent and agreement to the extent they were ever worked out. So I'm sorry that I can't answer the question legally, but I guess what I'd like to suggest is that the long way back to the barn is through trade remedies.

The Europeans very aggressively pushed a WTO competition discipline as a part of the Singapore Round. I like to think that I was instrumental in persuading the USTR to oppose that approach because the American Bar Association Antitrust Section and other similarly minded groups share the view that trade institutions are peculiarly unsuitable to address this kind of problem with competition laws, but I certainly wish, have all good wishes for the U.S. Chamber and their ambitions in this area. So we'll see where that debate goes.

MR. KOVACIC: I'd like to add I'm not a WTO expert and don't have the technical footing to give a confident answer. My impression on the drafting of the statute itself, as Tad suggested, is that it fits within a mainstream of acceptable practice.

My sense is from talking to my trade colleagues at school is that there's quite a bit of given the Joint's about whether the application of individual national laws rises to the level of being so idiosyncratic that they can be said to be discriminatory in their application. My impression, as Tad's was, is that it would be fairly difficult to establish given the indistinctness of the standards that the application of the law itself was a WTO violation, but that doesn't deny the importance of discussing the application on its own terms and having a full debate about whether those standards are suitable.

My sense would be the answer to the questions would be no and no, but in answering that way, I wouldn't suggest that the discussion and examination of the points that have caused so much friction is not worth a lot of attention.

CHAIRMAN REINSCH: Thank you.

I recall the Kodak case. I'm not sure that's entirely relevant to the question, but it was litigated at the WTO. There was a decision. It wasn't worked out. Kodak lost. I'm not sure what that means for antitrust laws. It didn't mean anything very good for Kodak.

COMMISSIONER WESSEL: That was nullification and impairment done on--

CHAIRMAN REINSCH: It wasn't on this--

MR. KOVACIC: Correct.

CHAIRMAN REINSCH: Yes. Exactly. All right. We still have time, and we still have some other commissioners to go. Commission Tobin is next.

COMMISSIONER TOBIN: Great. Thank you.

All three of you have spoken almost harmoniously about the fact that around the world it takes a while for any country, including our own, to establish an effective anti-monopoly system, and you also convey that it has to be updated. We don't have the data, as you said, Ms. Wang, to be able to see if we're being targeted so we don't know, and maybe it will evolve to provide better visibility on data.

But I want you to put on another hat, beyond your lawyer and your economist hats. Many of our companies, many multinational companies do feel they are being unfairly focused on and punished. What would you recommend we as a Commission suggest companies might do or what might Congress do or what an executive might do for those companies to have a more level playing field while there's this transition?

So, if you would, put on a different hat for a few minutes here and help us see what can be done action-wise while there is this slow process?

MR. LIPSKY: Well, let me take a stab at that. I agree with Bill that one of the things that we should do is be patient and await this natural evolution that he describes, and I think things will evolve in a good way in China and in other jurisdictions.

But as I tried to suggest in my opening remarks, U.S. antitrust ran into a ditch all on its own in the '60s and '70s, and it took a tremendous amount of effort to put things right, to get it out and put it on the path of rational competitive and economic analysis.

COMMISSIONER TOBIN: I understand that, but what can be done for our companies who are experiencing this and have a different perception?

MR. LIPSKY: Well, what I am suggesting is that in the U.S., this problem was not remedied, quote-unquote, "from within" except to the extent that Justice Powell wrote the Sylvania decision and some very eminent scholars, like Robert Bork, wrote these withering critiques of this faulty U.S. antitrust tendency, and then Ronald Reagan was elected, and all of that got put more or less right, and that consensus persisted more or less until a few years ago.

If you look at other jurisdictions--let's take the European Commission as an example--competition decisions in the European Commission are made by the Commission. Now, in practice, they are delegated to a great extent to the specialized DG Competition, but over the years, and I've had very direct experience with this, there have been some very pointed complaints about procedural fairness in the European procedures.

There is no opportunity to present evidence to a decision-maker. The decision-maker is the Commission, but you present evidence to the staff. There are a lot of biases in the system that allow the Commission to do pretty much what it wants. There are long judicial delays. There is no particular tradition of economic analysis in the judiciary.

Now, the point I want to make is the European Commission has been very, you know, has been criticized aggressively on this point, and yet the progress has been extremely limited. So I wouldn't rely on natural

evolution in the European case. I wouldn't rely on it in the American case. I wouldn't rely on it in the Chinese case.

But you're asking a very profound and meaningful question. Well, what do we rely on? Maybe we need something of the nature of a new or different institution. I mentioned that most of the discussion about reforms along these lines, they take place in the enforcement community. I don't think we can look to the enforcement community to say let's have less enforcement. Let's limit our powers in the name of due process, in the name of economic analysis, or any other worthy goal. It's just not in their nature.

When you get enforcers together, they talk about how to get more enforcement and how to improve enforcement, and--

COMMISSIONER TOBIN: So just so I make certain I get a chance to hear from the others.

MR. LIPSKY: Yes. I'm sorry to be so long-winded.

COMMISSIONER TOBIN: So basically wait for this to get better, let the enforcers remedy it themselves? What would you say to the companies, Dr. Wang. Or beyond that, what recommendations would you make?

DR. WANG: I feel that how we communicate and which channel we use to communicate is very important. The message needs to come across from as many different venues as possible. People in China, business people, or government people, regulators, and Western companies and lawyers, they all have different mind-sets.

I feel like cultural business and difference is very different sometimes. What worked for me in my own experience was that we start from detailed specific facts, and then we build from there. And, of course, multiple prongs of efforts, abstract, policy, directional, that's helpful. But what's really, really effective is during these case-specific discussions have more specific fact-finding and analytical dialogue. And ask what exactly do you mean by you're finding this specific anticompetitive harm? How can we help you to look at this specific fact? How about the others? And I think that's probably easier to come across.

COMMISSIONER TOBIN: Thank you.

And Professor.

MR. KOVACIC: I would do many of the things that I think they're doing now and sustain that effort. What are they doing now? They're trying to engage as much as they can with public officials in the United States and in China to make their views known.

I think that had some influence in the adjustments that were made as a result of the December conversations between the United States and China. The formal statement that certain procedural norms would be followed, I think that's a direct result of that kind of engagement.

There's a continuing participation in the work of legal societies, universities and the way in which they teach competition law, work through trade associations, the companies, they're active in those areas, sometimes more subtly, sometimes in a more visible way. I think that continued effort

is going to be fruitful over time. I could never urge the panel that that's going to yield results that are immediate and visible, but I think in many ways they are doing these things now, and they would be well-advised to continue.

It's also very helpful to the enforcement community where they can provide a specific account of their experiences because the conversation that the enforcers have with each other on some of these points over time where trust is developed provides a mechanism for providing additional observations.

The technical features that I would press for, again, I would press for better resourcing for the agencies. I think, to go to Tad's example on merger review, why are things so slow? MOFCOM started with 20 people. Ten of those were professionals. They're up to about 30 now. The agency probably needs to be three times that size.

When you're so small, the assembly line just can't move as quickly as it should be. So as a technical matter I'd say why not resource this vital function in a more substantial way.

COMMISSIONER TOBIN: That's what China needs to do?

MR. KOVACIC: Yeah, yes. And I would say, I would say the continued effort to say explain more about why you're doing and what you're doing creates greater pressure internally to come up with coherent explanations for decisions taken. It provides the basis for a debate over time.

Again, I think the companies have been involved in doing this. So I would say in many respects, they already have a list of measures that pursued over time has promise.

COMMISSIONER TOBIN: Thank you.

CHAIRMAN REINSCH: Commissioner Talent.

COMMISSIONER TALENT: Thank you.

I really regret missing your testimony. One question I wanted to ask the three of you--there are noncompetitive issues or factors built into the actual law, the Anti-Monopoly Law. And what I wondered was is there a body of law or precedent that's fairly understandable and reliable growing up to define what those terms mean?

I mean if a client or somebody consults you and says, okay, I want to do this merger or I want to do this thing in China, would you or other experts feel reasonably comfortable saying, okay, well, here it's going to be Problem A, B and C, and A, given how they've decided this and this, it's probably going to come out this way; and B is--you see what I'm saying? The normal process. I'm a lawyer myself. The normal process you'd go through based on precedents, fairly understandable and predictable administrative rules or determination, or would you just have to say, you know, to this point they're still evolving, it's been pretty arbitrary, you know, I really can't tell you?

MR. LIPSKY: I don't think I would dignify the sources as precedent or a definable area of law. I think there is some degree of regularity in the

way that the Chinese agencies behave that can provide some sense of prediction, but it is very difficult to predict even relative to other jurisdictions because they have in their law this protection of the national socialist economy.

It's difficult to predict how that will be interpreted, and because given the structure of enforcement and the way things are run, sometimes the best guidance you can give for any proposed acquisition or proposed business strategy is to ask the client what Chinese firm or agency would this hurt? How can that be ameliorated or eliminated? And that often leads to a prediction of how things are likely to go in the legal process.

MR. KOVACIC: Yeah, I like Tad's description. There isn't a clear specification in the text of the law about what these terms mean. There aren't formal precedents in the way that a lawyer would look to them, but you learn from previous decisions. You look at what they've actually done, and I think there is a growing ability of outside advisers to take these different data points and to come up with this type of analysis.

You have a better idea of what the agencies have done before as a guide for what they'll want now. You have a better idea of who will complain, to whom? Who will raise objections? How you get to them early? How you make counterarguments to them?

In effect, you have the development of the science that is well developed in this city, which is of lobbyists, lawyers, advisors, Kremlinologists on the outside looking at the buildings to see what's going on, and you have an idea of what they're going to want and how to negotiate going in. I think that skill is much more heavily developed now than say it was even three years ago.

So that you start coming up with the charts and the profiles that again are well-known to those of us who live in this city about how the regulators are behaving, what they do in different circumstances. In China, it's not as well-developed an art as it is in other countries, but I'd say people are catching up, catching up somewhat rapidly, going down the learning curve to figuring out what's expected, what would be wanted, and how to go about making the best case.

COMMISSIONER TALENT: I love your use of the term criminologists with reference to people who try and understand Washington.

[Laughter.]

COMMISSIONER TALENT: As a former member, I'm not sure I like it.

COMMISSIONER BARTHOLOMEW: Kremlinologists.

COMMISSIONER TALENT: Oh, Kremlinologists.

MR. KOVACIC: But you wouldn't say it's wrong.

COMMISSIONER TALENT: Well, I just said criminologists.

COMMISSIONER FIEDLER: Actually criminologists is just reducing it down to its--

COMMISSIONER TALENT: I was going to say I understand the reference. Ma'am, did you have any?

DR. WANG: I echo what Tad and Bill just said, and I also want to add that having a good competition story is absolutely necessary. In addition to that, we need more. We need to add. We need to find out who are the stakeholders. In addition to who this transaction might hurt, we also want to bring out a story who this transaction may help so we will have a good story and to counter or balance whatever is out there. So it is more, more than just a competition story.

MR. KOVACIC: I'd just add that in the U.S., by comparison, most merger review and concerns of merger review are resolved by settlement, not by litigation. Litigation is exceedingly rare. Maybe three, four cases a year go into the courts. Everything else takes place through negotiation where there's a tremendous amount of discretion to achieve different outcomes.

Outside counsel and other advisors become proficient in collecting those data points to see what they did the last time as a way of going in to negotiate and to make predictions about what you're probably going to have to give up the next time. Again, that mosaic of past experience, much more limited in China than it is here, but a similar process, I think, is beginning to take place that provides, if not what we would call predictability, at least less uncertainty.

COMMISSIONER TALENT: Well, just because it's--you're describing a political process. Just because that's what it is doesn't mean it's arbitrary. I mean there are understandings that--and I get that. I guess my time is up, and I was late anyway. So thank you.

CHAIRMAN REINSCH: Several of you have referred in your testimony to the fact that there are three enforcement entities and not one, and I think Mr. Lipsky had some recommendations about that.

Can any of you comment on the way the three interact with each other? Do they cooperate? Is one clearly superior to the other two? Can you tell us anything about sort of the internal, not internal inside--the interagency dynamic, if you will, of how this is administered?

MR. KOVACIC: They do cooperate. I would say the discussions among them are routine, but I'd suggest a universal theory, theorem about political science, which is that when you take two or more public agencies and put them in the same policy domain, they don't always get along very well. I would offer the United States as a good example of that.

CHAIRMAN REINSCH: I was getting to that. But go ahead.

MR. KOVACIC: And indeed when the suggestion is made to them about simplification, a response delivered very politely to Americans by the Chinese is when you rationalize your system of two federal agencies and the delegation of authority to all 50 state governments, and you sort that out, please do come back to us, and we'll be right behind you.

CHAIRMAN REINSCH: Do either of the others want to make a comment?

MR. LIPSKY: Well, you probably should take note of this unique structure that the law established because I remember seeing in the law this

phrase, "they're creating an anti-monopoly commission under the State Council." Now that technically is the entity that actually adopts these regulations and enforces these laws, narrowly speaking.

And I've been told that that phrase "under the State Council" is a way of giving the agencies a very heavy dotted line back to the center. You know, the State Council is the senior day-to-day administrative agency of the national government in China. It's a very powerful unit, and it suggests to me that the Commission is always guiding the agencies, looking over its shoulder at the State Council, much the way the DG Competition must look at the Commission that actually renders their decisions.

Moreover, this same splintering, local splintering of authority that-- you know, Bill referred to the fact that we have state antitrust laws. Well, the Anti-Monopoly Law explicitly provides for delegation of the authority of those three main agencies down to the provinces and the autonomous municipalities, the big ones like Beijing and Shanghai, as well as the autonomous regions.

So they also have a state and even a local enforcement structure that is in some senses even more, even a more cracked pane of glass than the United States system is. So that local and regional diversity exists in their system as well. So this is a very complicated question, but keep in mind that there are some very powerful institutions sitting on top of these three agencies, and it makes you wonder whether a great degree of coordination might occur in dialogue with the higher levels rather than necessarily horizontally agency to agency.

CHAIRMAN REINSCH: A good point. Dr. Wang, do you want to add anything?

DR. WANG: I don't have much to add to what Tad and Bill said. What I do want to make observation is that in the conferences I go to China, oftentimes I do see three agencies' representation at the same table talking about whatever hot issues at this stage. So they do want to show at least the appearance that they are heavily involved in what's happening.

CHAIRMAN REINSCH: Okay. Thank you.

Now for a reprise. Commissioner Shea. Oh, I'm sorry.

COMMISSIONER BARTHOLOMEW: It just came up. Well, I'm listening to the three of you. First, it's unusual that we have so much unanimity among our panelists. Usually we have a little bit of divergence of views among our panelists, but I keep hearing what sounds to me like equivalencies as you're sort of making the case for what China is doing, and I just wondered, you know, do you believe that the U.S. has a national industrial policy?

MR. KOVACIC: Absolutely.

COMMISSIONER BARTHOLOMEW: A national industry policy? The United States?

MR. KOVACIC: Yes. Definitions would probably be helpful here and maybe I should have asked first what do we mean by that?

COMMISSIONER BARTHOLOMEW: Well, I mean the Chinese

government has these five-year plans. They are a centralized economy. Do you believe that our economies are the same?

MR. KOVACIC: We certainly don't have the degree of economic centralization. We certainly don't have the extent of state involvement, by no means, but if we asked does the government of the United States have broad industrial objectives which it seeks to accomplish through a variety of different policy tools, I would say certainly.

Would you disagree? On tax policy--

COMMISSIONER BARTHOLOMEW: Yeah, I mean I don't--

MR. KOVACIC: R&D, education.

COMMISSIONER BARTHOLOMEW: I, you know, usually people have an allergic reaction when we talk about having a national industrial policy in this country because it's anathema to free market capitalism. So I guess I just think that I don't see China's economic situation, both its structure and its coherence and its plan towards where it's going as being equivalent to the United States and free market capitalism. So I'm just trying to understand these equivalencies.

MR. KOVACIC: Maybe I'm, again, struggling with a phrase that is so often used and so rarely defined in trying to address the basic propositions you've suggested. Are there fundamentally different economic systems at work? Fundamentally different methods of governance and representation? Unmistakably.

The number of state-owned enterprises in the United States, for example, is strikingly few. We have the U.S. Postal Service. We have a couple of power authorities, Bonneville, TVA; Amtrak. You can't count them on two hands. You only need one to come up with the ones that matter. So the degree of state involvement is dramatically less. The extent of private entrepreneurship is dramatically more important. So certainly no equivalence there at all.

But is the government of the United States, through its Congress, through its executive branch, through its departments, is it involved in some way in pursuing these broader economic policy objectives, and is the mechanism of government used to pursue them at different times, I would say certainly yes. So if industrial policy means those kinds of measures to accomplish them, I'd say we have one, but is the government's role as encompassing, as expansive and as deeply ingrained in the economic system as it is in China, certainly not.

At the same time, is China changing? And, again, I pose my question, which I did to your colleagues before: who predicted in 1970 or in 1980 that the economy of China would look the way it does today that there would be the extent of reliance on what might be called generally a market-based process? I don't know many people who called that one. So, to me, that says within a system that still has some tremendous rigidities and limitations, severe differences from the U.S., there's a great difference between now and then.

COMMISSIONER BARTHOLOMEW: Ms. Wang? Dr. Wang, any

answer?

DR. WANG: I don't have any opinion on this.

COMMISSIONER BARTHOLOMEW: Okay. Mr. Lipsky.

MR. LIPSKY: I think I would endorse Bill's remarks, and I think it's a compliment to the system that we generally have an allergic reaction to industrial policy. It seems like most of my adult life I listened to complaints of various nature along the lines of, well, when are we going to have an energy policy?

Well, how about somebody, you know, invents horizontal drilling and turns the United States from the largest net importer of oil to the largest producer of oil in the world, you know, just within a five or ten-year period? How about that for an energy policy? Had very little to do with government policy. In fact, you might say it occurred in spite of government policy.

So I'd certainly agree with Bill that there are tremendous differences in that regard between the U.S. and China.

COMMISSIONER BARTHOLOMEW: Thank you.

MR. KOVACIC: I would say further, Commissioner, that our industrial policy in many ways is designed to create enabling conditions in which this private investment mechanism can succeed. Where are some of our most important investments? Education, infrastructure assets, basic research and development of a type that individual firms will not support. I would say the overwhelming emphasis of our investments have been in these areas and, in many ways, to create what economists have called the enabling environment in which other forms, in which private activity can be more significant.

When I use the term "industrial policy," and I mean saying do we have one, to some extent, yes, we do. We make those kinds of investments to facilitate the operation of the market, but quite fundamentally the government sees its role as the referee, not as the player on the field.

CHAIRMAN REINSCH: Okay. I can't resist adding a sentence to that. I would agree that we have had one. We've had one since the Lincoln administration. These days it's mostly disguised as a national security policy. We get a lot of industrial favoritism, if you will, pursued in the name of developing industries that have a security link. I take your other points as well.

I think our time is up. You haven't all disagreed, but that's all right. I think you've all added some important elements to the overall picture, and very articulately, I might add, and within time limits, which is great. So thank you very much for your contributions. We appreciate it, and we will recess now until 1:45, when we'll reconvene for the last panel.

PANEL III INTRODUCTION BY COMMISSIONER DANIEL M. SLANE

HEARING CO-CHAIR SLANE: Welcome back. In our first panel today, our expert witnesses--I'm sorry--in our final panel today, our expert witnesses will assess China's progress in implementing meaningful reform objectives relating to opening up foreign investments and discuss the potential for China's planned reforms to create a more transparent, cooperative and fair environment for foreign investors.

Lucille Barale is a visiting professor at Georgetown University School of Law and is a specialist in the legal aspects of doing business in China. In practice for more than 25 years, she has advised foreign companies in China on direct investments, mergers and acquisitions, as well as technology licensing, engineering and construction projects, distribution and retailing operations, and the protection of intellectual property rights.

During her years in China, Ms. Barale took an active role in the American Chamber of Commerce. She was elected president of AmCham China in 1989 and later served as China Business Committee chair, Board of Governors member, and chair of AmCham in Hong Kong.

Following Ms. Barale is one of our own, Dr. Josh Eisenman--welcome back--who is an assistant professor at the Lyndon Johnson School of Public Affairs at the University of Texas at Austin and a senior fellow for China Studies at the American Foreign Policy Council.

Before joining the AFPC in 2006, Dr. Eisenman served for two-and-a-half years as a policy analyst at the U.S.-China Commission. He has also worked as a fellow at the New America Foundation and Assistant Director of China Studies at the Center for the National Interest, formerly The Nixon Center.

Lastly, we welcome Dr. Scott Kennedy, a Deputy Director of the Freeman Chair in China Studies and Director of the Project on Chinese Business and Political Economy at CSIS.

A leading authority on China's economic policy and its global economic relations, his research examines Chinese industrial policy, business lobbying, multinational business challenges in China, Chinese participation in the global economic regimes, and philanthropy.

Dr. Kennedy was a professor at Indiana University for over 14 years. From 2007 to 2014, he was Director of IU Research Center for Chinese Politics and Business, and he was founding Academic Director of the IU China Office.

Again, thank you all for being here. Each witness will have seven minutes to present his or her testimony. Ms. Barale, we'll start with you.

**OPENING STATEMENT OF LUCILLE BARALE
VISITING PROFESSOR, GEORGETOWN UNIVERSITY SCHOOL OF LAW**

MS. BARALE: Thank you very much. Thank you for inviting me. It's a pleasure to be here today.

I have to admit that when I was first approached about this hearing, I had some reservations because I thought the timing was premature. We have been seeing some efforts to reform the government approval system for investments this year. It has primarily come from the State Council and through the National Development Reform Commission, trying to streamline--that's may be an overstatement--but streamline the system for approval of projects for both Chinese and foreign investors, and then NDRC, the National Development Reform Commission, following through with some important regulations last May on that.

But we had heard nothing from the Ministry of Commerce. We'd heard nothing with regard to foreign investment reform, which is what we would like to talk about today.

And then last week, the Ministry of Commerce announced a new draft Foreign Investment Law. This draft Foreign Investment Law, which has been issued to the public for comments, to solicit comments for the following month, would replace the three Foreign Investment Laws that we have been using for foreign investment since 1979, for decades.

The Equity Joint Venture Law, the Cooperative Joint Venture Law, and the Wholly Foreign Owned Enterprise Law will be scrapped, and they will be replaced by a new Foreign Investment Law, as proposed in this draft. So there's a lot of attention on this New Foreign Investment Law.

There are also, well, frankly, there are some exciting developments in this law. The first that we might highlight would be that China's policymakers and the drafters of this law are willing to allow that in some cases, there will not be a need for government approval for foreign investment.

They have put in this law something we thought we might never see actually proposed, but the principle of national treatment has now been introduced, and this proposal involves national treatment for pre-entry into the market, not just post-entry. So provisions relating to national treatment have been introduced, although it's a qualified national treatment, and we need to talk a bit about that.

But the proposal has been put forth that at least for some types of investments coming into China, government approval would not be necessary. This is revolutionary, a fundamental change in thinking, the idea that the government and MOFCOM would be willing to step back from the rule that they must approve, or lower levels of foreign investment authorities must approve, every investment on a case-by-case basis.

So there are some very exciting developments to talk about there, but at the same time while we're looking at what MOFCOM is proposing and foreign investment approval reforms involve, we have to keep in mind that

there is this parallel track for investment approval, another channel called "project approval." And as I mentioned in the start of my remarks, referring to what the State Council and the National Development Reform Commission have been working on, they are reforming this system regulating the types of projects that need government approval, whether with Chinese investment or foreign investment.

About a year ago, December 2013, State Council issued a new catalogue on this, paring down the type of projects, the number of projects that would need government approval. There are 13 categories of projects that need government approval regardless of the source of the investment, and at present category number 12 is foreign investment, and category 13 is outbound investment, but categories one to 12 are energy, transportation, agriculture, other types of investment categories involving fixed asset investment, where government approval is required. One question addressed is whether approval is required by the central government or provincial government.

As we move into a new era of perhaps national treatment, at least national treatment in some instances, we will be more focused on some of these other parallel approval processes that will continue to apply.

On another point, just to set up our discussion before I finish off, is the question about what is meant by national treatment in the draft law. National treatment, of course, would mean that foreign investors and their investments in China would be treated in a manner that is no less than that which is accorded to Chinese investors unless there are exceptions-- and there will be exceptions. There is a proposal in the draft Foreign Investment Law to establish a catalogue of restrictions--there are various translations for this, but appears to be a catalogue of special administrative measures for investments in fields that are restricted. There will also be, of course, a list of prohibited investments.

This sounds similar to what we see in the Foreign Investment Guidance Catalogue, but I think we might be seeing something else that's will be happening in this catalogue. There is, as you know, a large portion of highly-regulated investment that will likely continue to be subject to foreign investment approval by MOFCOM, in addition to project approval that comes through the NDRC channel there.

But for those investments that will fall into the category of not being restricted, or not being prohibited, these investments will be able to move into China without a foreign investment approval by a government agency. This opens up some exciting, I think some exciting benefits, which may seem small to some of us in the beginning. The fact that our contracts may not need to be reviewed, the choice of where disputes are settled may not need government approval, whether it's arbitration in China or whether it's arbitration outside of China--that's where it's often preferred--these sorts of issues can be decided between the business partners and not subject to a negotiation with government authorities. So it's an encouraging change.

The other fundamental change involved here is that not only will you

not need government approval to get into some of these investments, you won't need it to get out of your investments, and the ability to move capital in and out of investments and to find the most efficient investments is also a major development that is going to be bringing more freedom to the way foreign investment is brought into China.

So at this early stage, I think one of the things that we can talk about today are some of the questions that we should be focusing on as we look at this draft law and consider where the reforms in foreign investment system and the investment approval system in general are headed. I look forward to discussing these things with you.

OPENING STATEMENT OF JOSHUA EISENMAN, PH.D.
ASSISTANT PROFESSOR, UNIVERSITY OF TEXAS AT AUSTIN, LYNDON
JOHNSON SCHOOL OF PUBLIC AFFAIRS SENIOR FELLOW FOR CHINA
STUDIES, AMERICAN FOREIGN POLICY COUNCIL

DR. EISENMAN: Thank you, Commissioner.

It's great to be back and to see so many old friends and faces. So it's also great to be next to Professor Scott Kennedy, who was my professor and taught me Chinese politics in Beijing. So to me it's a double honor.

So let me go ahead here and jump right in. I am probably not going to speak on the same level of detail as some of my co-panelists. I'm going to speak at perhaps a bit of a higher level of abstraction, but I have for you one condition, three points, and two recommendations, and I'm going to try to summarize here, and, of course, you have my written testimony.

The one condition which I think many of us already know but it's worth restating is that the Communist Party of China will never adopt any policy that weakens its political control of China. All interactions and negotiations and policies are bound under one phrase, and that phrase is "under the Party's leadership."

And this is one condition we must always bear in mind, I believe, when we look at China's economic, political and security relations. As it pertains to this hearing, it means that the only economic reforms that we can expect are those that do not threaten the Party or, better yet, enhance its control. I would not expect areas, progress in any areas that the Party believes it must control in order to maintain its political power. So that's our one condition.

In terms of the points, then, and this is more or less a summary of my written testimony, of late, the Communist Party is making it harder for foreign firms to do business in China, whether this is Microsoft, OSI Foods, or the myriad of other cases I've listed in my testimony and that you're well familiar with.

Perhaps U.S. Secretary of Commerce Pritzker said it best last month when she said to her Chinese interlocutors in Chicago that, quote, "concerns over issues like the sanctity of contracts, transparency, rule of law, intellectual property protection, and other issues are beginning to take their toll. Foreign companies need to know that they're on an equal footing with domestic companies if governments hope to attract their capital."

And I think that statement really says it all, and I'll refer you to the written testimony for further detail.

The second point I want to make is that China is utilizing its free trade zones and negative list approach to channel and limit foreign investment into selected geographic areas and to specific sectors that it prefers, and this contrasts with the special economic zones of the 1980s that we're all familiar with which foretold of an opening to the world.

These free trade zones represent a cloistering of foreign firms in select areas and sectors, and I don't expect if I had to read tea leaves that they

will do much to help enhance foreign access to the larger Chinese market. Of course, history is yet to be written on that matter, but I do think that it's unlikely. In fact, I would consider almost a step backwards in some ways.

And, in fact, China is willing, the Communist Party is willing, to accept what we would consider market inefficient outcomes in sectors like telecom, software, computers and others where it feels that the success of foreign firms might threaten its political interests. So politics comes first.

Third and final point to make is that China is giving increased access to capital markets, and this is a very unique special part of the Commission's portfolio. I worked on it myself actually when I was here with Commissioner Robinson, but it's now actually that we're seeing China through the Shanghai to Hong Kong link and a future link between the Shenzhen and Hong Kong exchanges giving new access to Chinese capital markets.

Last month, as of January 7, the link has yet to be fully exploited. Only 25 percent of the bandwidth has been used and only six percent going from the mainland to Hong Kong, but there's upcoming fixes that I go into in my testimony, my written testimony, and that process by March should be evened out and adjusted.

And so based on these three points, and this one kind of overarching theme, I have two recommendations or two ideas I'd like to put forward. The first is with regard to capital markets. While right now the flow of U.S. funds into Chinese capital markets is very, very, very small, it's just begun, but like all things that have just begun, we don't know where it's going to go, and so I would suggest that the Commission keep an eye on this.

I would hate to see retirement funds, pension funds being invested in large quantities in China given the structural problems that you all know quite well. So it would seem to me something that would be under the Commission's mandate to keep an eye on this, and if it does begin to go up, and if we do see people's retirements going to state-owned firms on the Shanghai Exchange via the Hong Kong link, that might be something to call attention to.

The second point, in the last two minutes, is about effectiveness of dialogue that we have with China. American policymakers, like Americans generally, are optimistic and believe in their own capability to change the world and make it a better place. And this enduring optimism and this can-do spirit are who Americans are in many ways, but they have been misplaced with regard to the Communist Party of China.

No amount of savvy diplomacy or camaraderie among leaders or policymakers can influence the policy direction of the Communist Party of China, which has one primary overriding objective: the complete control of China and those areas it claims.

U.S. policymakers should give up the old mission task of trying to change China, accept the Party for what it is, and move on from that point. Today, this misunderstanding materializes in the scores, hundreds of

dialogues we have with China, between 350 and 400 dialogues a year, more than one a day, the central idea being that we can make gains through these increasing dialogues with the Communist Party on a myriad of topics.

Now, it's here I would propose that the Commission undertake a research project to track and measure and evaluate the fruits of each Track 1 U.S.-China dialogue, to help the U.S. taxpayer understand what is the value, which are the valuable dialogues that we want to keep and which are not.

And then based on that, and this again would be my own personal view, that without prejudging the outcome of such an investigation that those judged as effective should receive the preponderance of the funds and those dubbed as ineffective should be mothballed and restarted when necessary.

Such a policy I believe would help to incentivize people on both sides, the Chinese and the American side, to produce meaningful cooperation and not to simply keep the tea warm, as it were, just in case a crisis were developed, but were to incentivize them to deliver results for the peoples of both the United States and China.

Thank you very much.

HEARING CO-CHAIR SLANE: Thank you, Josh.

**PREPARED STATEMENT OF JOSHUA EISENMAN, PH.D.
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Evaluating China's Foreign Investment Reforms

Testimony before the U.S.-China Economic and Security Review Commission
Hearing on "*The Foreign Investment Climate in China*"
January 28, 2015

By: Joshua Eisenman, Ph.D

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&
Senior Fellow for China Studies, American Foreign Policy Council

Summary:

- The only economic reforms we can expect are those that do not threaten the Communist Party of China (CPC) or, better yet, enhance its control. Do not expect progress in areas that the Party believes it must control in order to maintain its political power.
- China's new more restrictive political environment has forced economic policymakers to think creatively about how to liberalize the economy in ways that do not jeopardize the CPC's hold on political power.
- China has been making it harder for foreign firms to operate in the mainland by disproportionately targeting them in crackdowns on corruption, food safety, etc.
- China appears to be transitioning from an FDI-focused approach to foreign investment and toward a more capital market-based approach centered on the Shanghai and eventually the Shenzhen Exchanges.
- China appears to be using the Free Trade Zone (FTZ) scheme in Shanghai (and soon Guangdong, Fujian and Tianjin) to maintain access to foreign technology transfers, marketing expertise, and intellectual property, while cloistering foreign firms into select geographic areas and sectors that it can control, benefit from, and, if necessary, easily restrict.
- The CPC appears to have successfully manipulated the negative list approach to its advantage; using it to win foreign partners and governments' acquiescence to Party control over select sectors. In this way the CPC has accepted and applied an ostensibly free trade mechanism to bolster and legitimize its political control.

- China is relaxing its capital controls by making it easier to trade the yuan and for Chinese firms operating abroad to repatriate foreign exchange. This is necessary to allow for more types of Chinese firms to expand investments abroad. The U.S. remains China's top destination for outward FDI.

Introduction:

“We shall proceed with reform and opening up without hesitation,” China's President and CPC General Secretary Xi Jinping told the members of the Politburo Standing Committee at a symposium marking the 110th anniversary of the birth of Deng Xiaoping in late August 2014. These comments are not surprising. Since he assumed power in 2012, Xi has consistently advocated an agenda purported to continue the “reform and opening up” policies initiated under Deng. With an eye toward giving market forces a “decisive role” in the economy and “rectifying the relationship between markets and the state,” Xi's campaign includes a call to reduce government meddling in the economy, a more level playing field for private sector firms to compete with privileged state-owned enterprises (SOEs), and promises to allow enterprises and individuals to invest more freely overseas.

Xi's reform agenda was publicly affirmed last November at the third Plenum of the 18th Congress of the CPC Central Committee; an occasion compared by many to the celebrated third plenum in December 1978 that laid the groundwork for Deng's historic reform campaign. Now, as then, the paramount leader seeks to strengthen CPC rule and marketize the economy by overcoming “vested interests” that produce inefficient outcomes. Now, as then, entrenched interests resistant to change include a web of central government ministries, provincial and local governments, powerful families, and state owned enterprises (SOEs). This time, however, the difference is that China's leaders have not encouraged more foreign competition in the domestic market; instead they are pursuing a strategy that includes the channeling of foreign investment into Free Trade Zones (FTZs), controlled expansion of select foreign investment via Chinese capital markets, the expansion of outward FDI and the establishment of ways to repatriate profits back to China.

Background: “Opening up” to Foreign Investment

It is widely acknowledged in China today that market-based competition, in principle, can help ensure more efficient outcomes. This assumption was at the heart of Deng's economic reform strategy that sought to gradually “open up” China's market to foreign firms. Throughout the 1980s, a decade-long political struggle pitted radical reformers against powerful entrenched interest groups, and was only decided after Deng's famous 1992 Southern Journey. Similarly, in the late 1990s and early 2000s, Premier Zhu Rongji used WTO membership to successfully create new pro-reform constituencies that counterbalanced reactionary conservative forces that maintained control over the means of production in several key economic sectors. The fairer treatment of foreign firms within the China market proved a powerful cudgel that Deng, Zhu and other reform-minded leaders used to realize reform over the din of powerful and deep-rooted opposition forces within the CPC.

“Opening up” to foreign investment was the key concept behind both Deng’s Special Economic Zones and Zhu’s drive for WTO accession. It was an essential ingredient in China’s recipe for successful reform, one that both improved Chinese firms’ competitiveness by forcing change upon SOE managers and attracted precious foreign technology and capital into the country. As noted above, Xi - in keeping with this tradition - has also made pronouncements suggesting that his administration will adopt an “opening up” strategy. During last month’s 25th annual U.S.-China Joint Commission on Commerce and Trade session, Vice Premier Wang Yang reassured U.S. firms that: “China has not slowed the pace of reform and opening up, and the investment environment is not tightened.”¹

The current logic for continuing a strategy of increased opening to foreign competition was set forth by Liu He, a chief economic advisor to Xi, in a 2010 interview with *Caixin* magazine: “Domestic drive often needs to be activated by external pressure. From the perspective of China’s long history, a unified domestic drive and external pressure has been key to success.” In an effort to harness this “external pressure” to push Xi’s reform package leaders at a politburo meeting on August 27, 2013 called for a “full mobilization all positive factors inside and outside the country to form a great cohesive power for promoting reform.”²

The Third Plenum was announced as an ambitious, longterm undertaking intended to “allow market forces to play a decisive role in the economy.”³ Nevertheless, a report from the Center for American Progress noted that: “Even if the Third Plenum and related reforms are implemented fully as announced, China’s economy will still operate with broad state involvement in ownership, finance, and authority over key economic decisions and prices.”⁴ Thus, it is not surprising that the only economic reforms we can expect are those that do not threaten the Party or, better yet, enhance its control. Conversely, we should not expect progress in areas that the CPC believes it must keep control over in order to maintain its political power.

Recent Developments:

1. Tightened Restrictions on Foreign Firms and Technology in China

President Xi has not been enthusiastic about bringing foreign pressure to bear on China’s SOEs. In 2009, he referred to SOEs as “an important foundation of Communist Party rule” and in March while speaking to the Shanghai delegation to the National People’s Congress (NPC) he said, “deepening the reform of SOEs is a major task; not only should SOEs not be weakened, they must be strengthened.” These comments were accompanied by an increasingly less friendly investment and operational climate for foreign firms operating in China. In 2006, China came to the end of a five-year schedule of market-opening measures it had pledged upon entrance to the

¹ Wohl, Jessica. “U.S., China aim to talk more on Biotech” *Chicago Tribune*. 17 Dec 2014.

² 刘鹤2010年对财新《新世纪》杂志表示：“从中国长期历史的进程来看，外部压力和内部动力相统一是事物成功的关键，内部本身的动力常常需要外部压力来激。”Xi introduced Liu He to then U.S. National Security Adviser Tom Donilon in the fall of 2013. Xi said: “This is Liu He. He is very important to me.” See Davis, Bob. “Meeting Liu He, Xi Jinping’s Choice to Fix a Faltering Chinese Economy,” *Wall Street Journal*. 6 October 2013.

³ Yao, Kevin, and Ben Blanchard. “Fearing Graft Probes, Chinese Officials Shun Spotlight, Seek Retirement.” *Reuters.com*. Reuters, 8 July 2014.

⁴ Hersch, Adam. “Assessing China’s Economic Reform Agenda.” *Americanprogress.org*. Center for American Progress, 1 May 2014.

WTO. After the WTO-mandated reforms expired, foreign firms began to complain of an increase in various discriminatory practices, including more difficulty in getting licenses and approvals, and a less friendly attitude from Chinese officials and partners. But while pressure on foreign firms began to rise under Xi's predecessor, it has reached a crescendo over the last two years with foreign firms regularly being excoriated in the Chinese official press and provincial agencies arresting and detaining executives.

In some cases, like that of meat distributor OSI International in Shanghai, entrenched domestic interest and local authorities appear to have made it far more difficult for foreigners to do business in China by clamping down on their operations and employing innovative discriminatory tactics to restrict their ability to conduct business.⁵ From Microsoft in the tech industry to OSI International in the food and agriculture sectors to Chrysler in the auto space, U.S.-based companies across the board are being targeted. These come despite numerous high-level statements declaring just the opposite, most recently last month from Vice Premier Wang in Chicago.⁶ According to Deutsche Bank, more than 130 reform announcements occurred between the Third Plenum and October 2014. Despite the positive rhetoric from Beijing, the targeting of foreign interests in China continues apace. Beijing is essentially saying one thing and doing another such that one year after the Third Plenum, despite extensive government action in some areas, foreign firms are consistently saying that it has become increasingly difficult for them to do business in China. As U.S. Secretary of Commerce Penny Pritzker noted last month: "Concerns over issues like sanctity of contracts, transparency, rule of law, intellectual property protection and other issues are beginning to take their toll. Foreign companies need to know they are on equal footing with domestic companies if governments hope to attract their capital."⁷ These views echo those of the European Union Chamber of Commerce in China, which has declared an end to the 'golden age' of foreign business in China, and Transparency International which bumped China 20 spots to 100 on its annual ranking of 175 countries.⁸

The uncertain business environment and a lack of transparency have made longterm business planning difficult, thus engendering a "wait and see" approach among some foreign investors. During a visit to Hong Kong this month Nitin Nohria, dean of the Harvard Business School, explained the rational behind this approach: "For the last 10 to 15 years there was a certain vector to how China was developing, which was export-driven growth; multinationals all coming here; a government that was very encouraging of letting them get business done. There seems to be a shift, and people are trying to understand what this shift implies."⁹ This sentiment is being reflected in investment flows to and from China. Earlier this month China's Ministry of Commerce said the growth of foreign direct investment into the country slowed last year, rising just 1.7 percent from 2013 to \$119.6 billion.¹⁰

China is also in the process of purging all foreign technology from banks, the military, state-owned enterprises and key government agencies and replacing it with Chinese software and

⁵ Sachdev, Ameet. "Another Setback in China for Aurora-based Meat Supplier" *Chicago Tribune*. 6 January 2015.

⁶ Wohl.

⁷ Wohl.

⁸ "China Slips in Transparency International Corruption Index - FT.com." *Ft.com*. Financial Times, 3 Dec. 2014.

⁹ Quoted in Goughjia, Niel, "To Invest, or Not, as China Shifts" *The New York Times* 20 January 2015.

¹⁰ Goughjia.

servers by 2020. The plan, which is justified by national security concerns, is an intentional move by the Xi administration away from foreign suppliers. Microsoft Windows is being replaced with a homegrown operating system called NeoKylin from China's Inspur Group Ltd and foreign servers are being swapped for those made in China. In September, the China Banking Regulatory Commission ordered banks and finance agencies to dedicate at least 5 percent of their IT budgets to ensure that at least 75 percent of their computer systems were "safe technology" by 2019. U.S. companies operating in China's IT sector are vulnerable including Cisco Systems Inc., International Business Machines Corp., Intel Corp. and Hewlett-Packard Co. Last year, regulators pursued anti-trust probes against Microsoft, raided the firm's China offices and banned Windows 8 from government computers.¹¹

Increased control over foreign firms operating in China and supervision over their investment is not entirely unexpected, however. It reflects a "transformation in the country's strategic thinking," as Wang Jisi, Dean of the School of International Studies at Peking University, wrote in the March/April 2011 issue of *Foreign Affairs*. According to Wang, China appears to be focusing on sustaining "the country's high growth rate by propping up domestic consumption and reducing over the long term the country's dependence on exports and foreign investment."¹²

There are some exceptions, however. In November, the Ministry of Commerce and the Ministry of Civil Affairs of China jointly issued an announcement seeking to encourage foreign investment "to set up for-profit senior care institutions in China, in order to promote the healthy development of China's domestic senior care services industry." As China's population ages, senior care services are suffering from supply shortages that experienced foreign firms can help address: officially, the number of citizens over 60 years of age in China reached 194 million at the end of 2012, and is expected to reach 243 million in 2020 and exceed 300 million in 2025.¹³

Parcel delivery is another area where there are signs of liberalization. The State Post Bureau has recently approved Yamato (China) Transport Co Ltd, OCS Overseas Courier Service (Shanghai) Co Ltd and Kerry Logistics Co Ltd. But the impact of liberalization in this sector is likely to be minimal given the already stiff competition and low prices. There are more than 35,000 express delivery companies operating in China, including FedEx and UPS, and some can ship packages hundreds of miles in the same day for as little as two yuan.¹⁴

2. Channeling Foreign Investment using FTZs and the 'Negative List' Approach

After years of U.S. pressure China's decision to move from a 'positive list' to a 'negative list' approach was widely hailed as a diplomatic victory in Washington. With the announcement of the Shanghai FTZ (SFTZ), Beijing began the negative list approach to regulate foreign investment. Instead of classifying industrial sectors as 'encouraged,' 'permitted,' 'restricted,' or 'prohibited' this approach specifies only those areas in which foreign investment is 'restricted' or

¹¹ Yang, S., Zhai, K., Culpan, T. "China is Planning to Purge Foreign Technology and Replace With Homegrown Suppliers" *Bloomberg News*. 18 December 2014.

¹² Jisi, Wang. "China's Search for a Grand Strategy." *Foreignaffairs.com*. *Foreign Affairs*, Mar.-Apr. 2011.

¹³ Dai, D., Qin, M., Kim, M. "China Encourages Foreign Investment in Senior Care Services" *National Law Review*. 7 January 2015.

¹⁴ Blanchard, Ben. "China Approves Three New Foreign Courier Firms -Xinhua" *Reuters*. 31 December 2014.

‘prohibited.’ The key distinction between the negative-list approach and the restricted investment market access that China enforces outside the zones is that firms that invest in the zone are supposed to receive a more predictable and expedited document approval process. They are promised first access to investment incentives, such as expedited administrative decisions for investment and lower levels of required capital to open a business. All told, however, foreign investment in FTZs remains subject to a government approval process – albeit a less bureaucratic, expedited one.¹⁵

The CPC appears to have successfully manipulated the negative list approach to its advantage; using it to win foreign partners and governments’ acquiescence to Party control over select sectors. In this way the CPC has accepted and applied an ostensibly free trade mechanism to bolster and legitimize its political control.

The initial “negative list,” released in 2013, disappointed foreign investors. This dissatisfaction, slow progress and Li’s absence from the SFTZ’s opening ceremony led some American observers to note that the scheme had “failed to deliver meaningful concessions for investors.”¹⁶ According to the managing director of China Market Research Group in Shanghai: “It’s great talk by [Premier Li Keqiang] and a lot of senior government officials, but there’s no execution. Nobody knows what you can do.”¹⁷ Perhaps in response, in June 2014, the number of restricted industries and activities for foreign investment was reduced from 190 to 139 and in November 2014, the National Development and Reform Commission released a new draft of the Catalogue Guiding Foreign Investment. Changes in this latest draft, which was open to the public for review until December 3, include reductions in the number of restricted sectors for foreign investment, the number of industries limited to only joint ventures and partnerships, and the number of industries that required a Chinese majority stakeholder. The proposed revised Catalogue also retains the same foreign ownership caps introduced in the 2007 Catalogue.

To date investing in the SFTZ has served primarily as a hedge for foreign firms based on unclear future promises, as one strategist with Silvercrest Asset Management explained: “A foreign company might want to establish some kind of presence in the SFTZ, so that if some day actually there’s a rule that allows you to do something interesting, you’re there.”¹⁸ According to the American Chamber of Commerce in Shanghai, by September there were 12,226 companies registered in the SFTZ of which only 1,677 were foreign firms.¹⁹

To address lackluster interest among foreign investors in the SFTZ, Li, the scheme’s key backer, visited the site in September and “urged government officials to push through new policies.”²⁰ Xi himself has endorsed FTZs, first at the Third Plenum and again during a meeting with the Shanghai NPC delegation in March. More recently, on December 12, the State Council announced a “new round of high-level opening,” and its intention to establish three new free-trade zones “replicating” the experience of the Shanghai Zone in Guangdong, Fujian and Tianjin.

¹⁵ Hersh.

¹⁶ Martin, P., Cohen, D. “Inside Xi Jinping’s Reform Strategy” *The National Interest*. 20 March 2014.

¹⁷ Sigalos, MacKenzie, “The Shanghai Free Trade Zone is a dud,” *CNN 12 October 2014*.

¹⁸ Baccam, Veomayoury. “Shanghai FTZ Promises New Reforms and Vows to Further Trim Negative List.” *Insight (American Chamber of Commerce)*. 29 September 2014.

¹⁹ Baccam.

²⁰ Tiezzi, Shannon. “Can China Save the Shanghai Free Trade Zone?” *The Diplomat*. 20 September 2014.

The announcement also said the SFTZ would continue to shorten its “negative list.”²¹ It remains to be seen, however, if FTZs, the Xi administration’s flagship “opening up” policy project coming out of the Third Plenum, will produce tangible results in the reduction of tariff and non-tariff barriers. In sum, the consensus appears to be that the SFTZ is moving forward in fits and starts and that the fast-changing rules have created confusion about what is actually permitted.

3. Expanding Foreign Investment in Chinese Firms via Capital Markets

There appears to be a transition from the traditional types of foreign investment in China toward foreign investment via capital markets. In November, China launched the Shanghai-Hong Kong Stock Connect trading link, which opened up 568 Chinese companies valued at \$2 trillion to foreign investors via Hong Kong. Before the link, only a select group of foreign institutional investors with special government permission were able to trade mainland-listed stocks.

The Stock Connect program, which took months to develop, was launched with fanfare with a week’s notice.²² During the first month, however, the link was underutilized. Under the scheme, the daily limit on investment bound for Shanghai is 13 billion yuan (\$2.1 billion) and for Hong Kong-bound investment it is 10.5 billion yuan. But as of January 7, foreign buyers had filled only about 25 percent of the quota to buy mainland shares and 6 percent of the quota for Hong Kong stocks.²³ One reason Hong Kong has suffered is because a minimum investment amount of 500,000 yuan (\$80,405) is required – far more than most non-institutional investors can invest. Furthermore, hedge funds wanting to sell holdings of Shanghai-listed shares are required to deliver the shares to banks’ brokerages before 7:45 am on the day of the sale – an idiosyncrasy that exists in no other major stock market. The result has been low demand with the bulk of activity coming from short-term speculative investors, rather than from mutual funds, pension funds and private banks – as Beijing been hoped.²⁴ To address this problem this month the HKEx announced plans to launch a system fix in March that would allow custodians, which hold stocks on an investor’s behalf, to open a separate account in the investor’s name. HKEx has reassured investors they retain ownership of shares until they are sold, although legal opinion differs over whether investors could enforce their claims should the HKEx’s clearing house go bankrupt.²⁵

Furthermore, the HKEx is working with China’s Shenzhen Exchange to develop a similar link that would allow foreign investors access to some of China’s more dynamic private companies in the technology and health-care industries. The ChiNext index of small and medium size companies, listed in Shenzhen, has more than doubled over the past two years fueled by speculation about China transition to an economy driven by domestic consumption rather than investment and exports. The HKEx-Shenzhen link is set to be tested next month and launched as early as March.²⁶

²¹ Yao, Kevin. “UPDATE 1-China to set up three new free trade zones” *Reuters*. 12 December 2014.

²² Hunter, Gregor S. “Money Surges Into Shanghai Stocks” *The Wall Street Journal*. 17 November 2014.

²³ Zhang Shidong. “Shenzhen Studies Hong Kong Tie-Up as Shanghai Link Boosted” *Bloomberg News*. 7 January 2015.

²⁴ Chatterjee, Saikat. “China’s Landmark Hong Kong-Shanghai Stock Link Has Not Been Nearly As Successful As Hoped” *Reuters*. 21 December 2014.

²⁵ Price, Michelle. “Hong Kong Stock Exchange Seek to Reassure Investors over Shanghai Trading Link” *Reuters*. 7 January 2015.

²⁶ Zhang.

Last month, the China Securities Regulatory Commission (CRSC) released draft guidelines that proposed allowing foreign investors and brokerages to trade some futures contracts, granting them access to a historically volatile – although large and potentially lucrative – market. The CSRC said the initiative is “necessary” to bring in foreign institutional investors to reform its commodities futures markets and bring domestic markets in line with international practices through improved risk control and pricing.²⁷ Like the Shanghai-Hong Kong link, this is another effort to draw in investment from abroad to improve the liquidity and predictability of domestic capital markets.

4. Outbound FDI and Profit Repatriation

Previously restricted to sovereign entities such as China Investment Corp., Beijing now allows outbound foreign investments by private equity firms, financial conglomerates, insurance firms, and other financial players such as Fosun International. Last year, according to Rhodium Group, financial investors accounted for 22 percent of China’s outbound mergers and acquisitions (M&A) value, twice as much as the average of the previous five years. Despite, this increase, however, Rhodium found that in 2014, China’s foreign M&A acquisitions dropped 13 percent to \$53 billion a trend it attributed to “a sharp drop in natural resource asset buying.”²⁸

There are large disparities in the estimates of total Chinese outward investment. According to China’s Ministry of Commerce, 2014 witnessed an 14.1 percent increase to \$102.9 billion.²⁹ The American Enterprise Institute (AEI), by contrast, reported total outbound Chinese investment had risen only 0.7 percent to \$84.4 billion. AEI also reported that Chinese investment in America setting a new record in 2014 and for the third year in a row the U.S. extended its lead as China’s largest recipient country. Over the past decade, the U.S. has received more Chinese investment than any other country – \$78 billion.³⁰

The freer repatriation of foreign capital is an essential component of the larger liberalization of outward Chinese investment that occurred in 2014. Most recently, beginning this month the State Administration of Foreign Exchange (SAFE) will no longer require Chinese firms that go public abroad to get approval to remit foreign exchange raised in their listings. This step toward relaxing inward capital flows means overseas listed firms need only register their IPOs or other fund-raising activities with the foreign exchange authorities and can then freely send funds home. The new rules also include amendments that make it much easier for overseas listed companies to send back foreign exchange surpluses. In another move to permit freer flow of foreign exchange and relaxing restrictions on yuan trading, this month SAFE published new rules giving banks leeway to short dollars by replacing daily caps on banks’ foreign exchange positions with weekly limits.³¹

²⁷ Shen Hong. “China May Allow Foreigners to Invest in Futures” *The Wall Street Journal*. 31 December, 2014.

²⁸ Shih, Toh Han. “Rhodium Says China’s Cross-border M&A Falls 13 Pct to US\$53 Billion in 2014.” *Scmp.com*. South China Morning Post, 8 Jan. 2015.

²⁹ Goughjia.

³⁰ Shih.

³¹ Sweeney, P., Lu Jianxin. “China eases rules for overseas listed firms to send foreign exchange home” *Reuters* 31 December 2014.

Conclusions:

- Beijing is restricting the presence of foreign firms in China and undermining their ability to apply real economic pressure to SOEs in ways that could reduce the Party's control over the economy. The goal is to exploit foreign firms' capital, technical innovations and marketing techniques, while preventing the emergence of a true free market for foreign products in most of the country.
- By pushing foreign investment towards its four designated FTZs, China seeks to channel it into those geographic areas the party prefers. Similarly, the negative list approach continues China's tradition of channeling FDI away from sectors that the CPC sees as politically sensitive. Such policies are more reminiscent of the open ports established in the 19th century to contain and limit foreign influence than the Special Economic Zones established by Deng Xiaoping during the 1980s that were intended to expand it.
- By granting foreign investors increased access to Chinese equities and futures via state-controlled markets and banks (rather than through FDI and joint enterprises as had been the case) Beijing both maintains control over the flow of foreign investment and can take advantage of those institutional investors that had been wary of investing directly in China due to the aforementioned risks associated with conducting business operations on the mainland.
- Reduced barriers to foreign entry into China's capital markets provide new revenue streams, increase market liquidity, and improve domestic firms balance sheets. But the door swings both ways, and the same system that allows overseas portfolio money in may later be a conduit for investors, foreign and Chinese alike, to escape during rough times. In short, contagion becomes both more likely and more serious as China expands foreign access to its capital markets. Similarly, the more foreign institutional investors become invested in Chinese firms, the more foreign markets become susceptible to contagion risk from China.
- The CPC seeks to contain and limit the domestic political externalities it associates with foreign investment, while keeping foreigners (along with their liberal ideas, religious values, and perceived security threats) limited primarily to a select number of sectors and geographic regions.
- China is working to expand the number and type of firms that can invest abroad and improve their ability to repatriate profits. Although financial firms accounted for a larger percentage of overseas Chinese M&A investment in 2014, China's total M&A fell largely due to a reduction in purchases of natural resource products. There are large disparities between the official and AEI estimates of China's total outward FDI for 2014.

**OPENING STATEMENT OF SCOTT KENNEDY, PH.D.
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STRATEGIC AND INTERNATIONAL STUDIES**

DR. KENNEDY: Good afternoon. It's an honor to appear before the Commission today. I spoke before the Commission in 2007 so things must have not gone horribly wrong because you've invited me back, and it's an honor obviously to be sitting next to Professor Eisenman and my other co-panelist.

I've been asked to speak about how China's ongoing economic reform efforts affect the foreign investment climate. So my bottom line message is twofold: China's economic reform efforts are serious and comprehensive and consistent with the interests of foreign investors, but there are several political and economic factors that suggest that while China's foreign investment climate will continue to improve, China is not headed toward a purely free market economy where government simply acts as the provider of public goods and the dispassionate referee ensuring fair competition.

Anyone hoping for that scenario would be, to paraphrase Samuel Beckett, "Waiting for Godot." American business and the U.S. government need to maintain a realistic attitude about what is possible so as to avoid creating overly optimistic expectations that would then leave them disappointed.

I've submitted written testimony to the Committee that explains my position in detail, and let me briefly summarize those key points here.

In broader historical perspective, China's economic reforms have been amazingly successful. Since 1978, the country has had higher growth for a longer period of time than any country in history. In the process, foreign industry has benefited immensely through trade and investment, but China's success has come at a high cost, extensive waste, corruption, inequality and pollution that we can all see, feel, breathe, and smell any time you're in China.

Now there is wide consensus in China that the country's development model needs to be changed in order to avoid falling into what's been called "the middle-income trap." Chinese President Xi Jinping and Premier Li Keqiang appear to agree with this analysis, and since they came to power in late 2012, they have been pushing forward a wide-ranging blueprint for reforming the economy and the country's governance institutions.

Over the past two plus years, they have issued and begun to implement a long list of reforms, including liberalizing the financial sector, streamlining business licensing and regulatory approvals, fiscal reform for the central and local governments, and greater penalties for pollution, among others.

They've also begun to focus on reforming state-owned enterprises by allowing some private investment in previously banned sectors and changing the compensation system for SOE executives. There are currently

113 central SOEs, but I expect by the end of next year, there will be about half that many as reforms go forward.

Finally, as you've heard, there have been further steps, many still in the draft stage, to liberalize foreign trade and investment.

Now if China were to adopt and fully implement everything past and on the drawing board, we'd be witness to a watershed in China's economic governance. But based on past experience and certain core features of China's political economy, it would be naive to expect a rapid, straightforward and full adoption of these policies. Instead, gradual, incremental and partial movement in many areas is far more likely.

And let me explain why. First, this leadership is well aware of China's economic problems and the need for change, but they're not economists from the University of Chicago or the University of Texas or Georgetown. They are politicians. They are not only trying to promote growth but also protect the leadership of the Communist Party as we've heard and expand China's international influence.

So they're giving a greater hand to the market, but they're never going to take their hands fully off the wheel.

Second, although Xi Jinping has amassed substantial power, China's policy process is still highly incremental. Key policies are increasingly being set in Party organs that Xi Jinping controls, but the government bureaucracy is still highly influential and bent on ensuring they'll remain relevant.

They still have the green light to pursue industrial policies of all kinds, and they're also grasping for new reins of authority. This partly explains why the bureaucracy has embraced the Anti-Monopoly Law. Beyond Beijing, local governments are toeing the line on the anticorruption campaign, but they have been less responsive on various economic reforms. They're waiting to be compensated for their lost benefits that they've built up over the last 15 to 20 years under the current system.

Outside the state, you have a whole complex of stakeholders and interests trying to shape policy in a wide variety of directions, some seeking greater liberalization, others hoping to protect their privilege positions. This further encourages an ebb and flow dynamic and two steps forward, one step back, and sometimes one step forward and two steps back.

Navigating this process is no easy task even for a leadership as powerful and determined as this one.

Third, the international system has been an important source for encouraging, facilitating and in some ways requiring China to liberalize their economy. WTO entry was a watershed, and WTO membership has been critical for negotiating additional liberalization measures and addressing areas of backsliding on China's commitments.

At the same time, the comprehensive nature of the international trade order isn't matched in other areas of the international system. Norms and rules related to capital flows, prudential banking, foreign exchange, competition policy and cyber, to name a few, are far weaker and less

entrenched.

In her written testimony, FTC Commissioner Maureen Ohlhausen mentioned the International Competition Network. But the ICN is a voluntary group that puts forward general guidelines about competition policy. It is not a full-fledged governance regime. The limited nature of international rules in many areas means that limited external pressure or guideposts and models exist that could provide a clearer path for China.

Fourth, and lastly, the final factor that makes an uneven trajectory of economic reform highly likely is the evolving status of foreign businesses in China and the relevance of the global economy to the country's overall economy. China has long been the top destination of foreign investment in the developing world but foreign invested firms account for a declining share of the economy.

For example, their share of total fixed investment has fallen from a high of 12 percent in 1996 to 4.4 percent in 2003 to only 0.9 percent of total investment in 2013.

The picture is similar on the trade front. Total trade was equivalent to 65 percent of the economy at its peak in 2006, and that figure has consistently fallen and was less than 42 percent 2014.

So although Chinese firms will continue to be deeply dependent on exports and imbedded in global protection networks, foreign trade and investment will inevitably be a declining share of China's growing continental size economy. And as a result, the calculus of China's leadership will be drawn even further toward domestic concerns, and the influence of foreign industry and international organizations may continue to fall, particularly if there aren't robust international agreements on which to base their agreement with China.

In sum, the mixed world view of China's leaders, the complex policy process and incomplete international economic governance system and the growing domestic orientation of the entire economy mean that reforms will likely on the whole move forward but in a halting and incremental manner with periods of progress interspersed with moments of backtracking--not a new picture.

This complex view of China suggests a multi-pronged response from the international community and from governments. There is much that can be done at the bilateral, regional, plurilateral, multilateral levels, and I'd be happy to go into these in more detail during the discussion, but in the interest of time, let me stop here.

Thank you.

**PREPARED STATEMENT OF SCOTT KENNEDY, PH.D.
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Hearing on Foreign
Investment Climate in
China: Present
Challenges and Potential
for Reform

January 28, 2015

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

by

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Summary

Since coming to power in November 2012, the administration of Xi Jinping and Li Keqiang has embarked on an intensive effort to reform the country's economy, governance structures, and foreign policy. These initiatives do not represent a complete break from the Hu Jintao-Wen Jiabao administration -- Xi and Li have been members of China's political elite for some time -- but it is clear that they have set comprehensive new goals, many of which aim to address problems created under the previous leadership. Although the regime draws on international experiences, suggestions, and norms in developing their plans, the true initiative for these changes are internally generated. They are not being undertaken in response to treaty obligations, demands from foreign governments, or as a favor to multinational businesses. Their goal is to ensure the country's long-term sustainable economic growth, improve the machinery of governance, solidify the dominant leadership of the Chinese Communist Party (CCP), and expand China's regional and global influence. As a result, multinational businesses and foreign governments need to be clear-headed about what to expect. Foreign companies are already doing well in China, and China's wide-ranging reforms, if adopted, would improve their operating environment further and generate more business opportunities. However, even if largely implemented, foreign companies will always face substantial regulatory, political and social challenges in doing business in China. Hence, foreign governments' policy responses and multinationals' business strategies need to see the

current wave of policy changes not as a final battle to turn China into a pure free-market economy, but as part of a long-term, continuous process of engagement aimed at gradually strengthening the overall economy and business environment.

The Domestic Roots of Reform

Foreign investors have done very well in China over the last few decades. Every survey taken by the chambers of commerce of the United States, the European Union, and Japan has indicated that a large majority of their members are profitable in China. At the same time, survey after survey reveals substantial challenges to doing business. And in the last few years, the proportion of companies reporting high profitability has dropped, while the sense of current unfairness and worries about the future have risen. This has been highlighted by apparent abuse of the Anti-Monopoly Law and discrimination against Western high tech firms, particularly in information and communications technologies. Many multinationals worry that the costs of doing business, in terms of demands made by the Chinese government, are rising, and that once domestic companies become technologically independent, these firms, with Chinese government support, will eventually displace them in China and in third-country markets.

Although the Xi-Li leadership is far from blameless, much of the responsibility for the current angst deserves to be placed at the foot of the previous leadership. Although the Hu-Wen administration made great strides in implementing China's commitments under the WTO and in absolute and relative terms China's private sector grew under their watch, their primary focus was on making Chinese companies competitive, particularly SOEs situated in key areas of the economy. A substantial portion of these efforts were carried out as part of China's "Indigenous Innovation" strategy, which included providing unprecedented levels of financing for firms and specific projects, ramped up attention to domestically-set technical standards and locally-owned intellectual property, and encouraging government agencies and others to buy domestic products. China's industrial policy initiatives under Hu and Wen yielded success in terms of rapid growth in GDP, greater exports, rising inward FDI, higher corporate profits, and the emergence of some well-known Chinese companies. But the costs were just as massive: highly inefficient use of capital, corruption, rising inequality, environmental degradation, and ongoing economic tensions with trading partners. Winners in industry and the bureaucracy under this system gained substantial economic and political power, becoming bulwarks against change.

The Xi-Li administration appears to be fully aware of the problems bequeathed to them by their predecessors. Even before they assumed office, they signaled that China's original economic development model had outlived its usefulness and that fundamental changes were needed to avoid China slipping into the middle-income trap and instead to move on a trajectory toward long-term sustainable growth. Among those signs was the *China 2030 Report*. Jointly written by the World Bank and State Council's Development Research Center, this document provided a blueprint for a new direction. The "Decision on Several Major Questions about Deepening Reform" issued at the 3rd Plenum of the 18th Party Congress held in November 2013 restated in definitive, politically appropriate language many of the goals

and approaches found in the *China 2030 Report* and other speeches made by Xi Jinping and Li Keqiang.

In the 15 months since the Decision was released, authoritative documents and leadership statements, including Li Keqiang's speech to the World Economic Forum in Davos on January 21, 2015, have reinforced a singular message about the direction of policy. Equally important has been a long series of policy announcements and regulations, national and local, which touch upon just about every area of the economy. Among the most important are liberalization in the financial sector, streamlining business licensing and regulatory approvals, incremental liberalization of energy and water prices, reducing government intervention for major investments, expanding the revenue base for local governments while making them more responsible for debt obligations in their localities, higher penalties for pollution and greater support for green technologies, and liberalization of the residency permit system. Reforms involving SOEs have so far included permitting some non-state investment in previously banned sectors, such as rail; selling minority stakes in central SOEs to private investors; and changing the performance measurement system and salaries of SOE executives.

China has also taken initial steps to further liberalize foreign trade and investment, including creation of free trade zones in Shanghai and three other cities, the adoption of FTAs with Australia and South Korea, and the launching of negotiations for others; permitting foreign investment in domestic debt and futures markets; progress toward upgrading of the WTO's Information Technology Agreement; a new, somewhat more generous proposal to join the WTO's Government Procurement Agreement; and a willingness to carry out intensive negotiations for a bilateral investment treaty (BIT) with the United States that goes beyond protection of investor assets to provide national treatment for foreign investors except in specifically designated sectors. The latest draft of China's "Foreign Investment Law," released for comment on January 19, 2015, enunciates the basic principle of treating domestic and foreign companies on equal terms.

Reform and Foreign Business: A Political Economy Balance Sheet

Although there are certain specific elements of China's emerging regulatory system that one could take issue with, on the whole the changes represent a major positive path forward. If China were to adopt and fully implement everything already passed and on the drawing board, we would be witnesses to a watershed in China's economic governance, and foreign business, would be a huge beneficiary, as would truly competitive Chinese firms and China's consumers.

But based on past experience and certain core features of China's political economy, it would be naive to expect a rapid, straight or full adoption of these policies. Instead, as in the past, the more likely outcome is gradual, incremental and partial movement in many areas that will eventually yield an improved, though far from ideal operating environment for foreign business.

There are four factors that point toward a more incrementalist trajectory: the leadership's overall goals, the nature of China's policy process, an uneven international economic regulatory system, and the evolving place of foreign business in China's economy. Each area

encompasses a mix of contradictory forces that balance against each other and make radical change unlikely.

First, the leadership hold a complex worldview. On the one hand, they have demonstrated a deep understanding of China's economic and governance challenges and in principle believe that liberalization and market forces are required to address many current deficiencies. Yet on the other hand, they also appear to believe that government intervention is necessary and that in principle there are no places where government should not be permitted to intervene. Although they have dropped the language of "indigenous innovation," they have by no means put industrial policy aside, just adjusted some of their approaches. China's leaders are nationalists who believe China was mistreated by foreign powers during the 19th and 20th centuries, and that China's rejuvenation involves a competitive element in which they should be champions of Chinese industry, particularly toward companies that are politically loyal to them.

Second, China's policy process is highly incremental. Xi Jinping has amassed substantial powers, and created new working groups within the CCP under his leadership that are making the key decisions on policy. Over the last two decades China's civil service has become more professional, particularly at the central level. Nevertheless, although policy has been centralized, the national bureaucracy is still highly influential, and most policies require their involvement. In this context, bureaucracies that are slated for losing some of their old powers are grasping for new reins of authority, and they still have the green light to pursue industrial policy with new tools. This partly explains why the Ministry of Commerce, National Development and Reform Commission, and State Administration of Industry and Commerce have so zealously implemented their respective areas of the Anti-Monopoly Law. Beyond Beijing, provinces and local governments are also central to policy implementation. Although they understand that they are supposed to be implementing reforms, they are finding it hard to prioritize amongst the many new strands of policy, and they clearly are waiting to be compensated with greater sources of income before yielding to new policies that will cut into their existing revenue streams.

Outside the state, new actors have emerged who participate at various stages of the policy process, including companies, industry associations, the media, and the courts. They are important sources of ideas and accountability. Their level of activity has risen appreciably and in some cases led to greater liberalization consistent with the interests of foreign business, but in many instances the addition of more actors has resulted in greater gridlock or the discriminatory applications of rules against foreign business. Moreover, endemic corruption that blurs the lines between officialdom and industry has made radical policy change even harder to achieve. China's anticorruption drive, clearly the leadership's number-one priority at the moment, is aimed at weakening many of these entrenched interests, but without greater reliance on other more independent accountability mechanisms, such as courts and the media, it is hard to see how the current effort is sustainable over the long-term.

Third, the international economic system has been an important source of encouraging, facilitating, and requiring China to liberalize its economy. Despite all the challenges of implementation, China's entry to the WTO was a watershed, and the WTO has been an

important venue for negotiating additional liberalization measures and addressing areas of backsliding. Since it joined in late 2001, there have been 20 WTO cases launched against China, of which 15 have been completed. The complainants have won a full victory in 13 of these cases, and in most instances China has responded by modifying the relevant domestic regulations. Although in some instances, compliance has been slow and not had an immediate positive benefit on the related sectors, the overall effect has been to constrain greater Chinese protectionism and to make Chinese more committed to the multilateral trading order.

At the same time, the comprehensive nature of the international trade order is the exception to the rule. Governance for most areas of the international economy is far from complete, with unclear norms, ambiguous rules, and insufficient mechanisms to enforce compliance. Regimes governing capital flows, prudential bank management, equity and debt markets, foreign exchange, mergers and acquisitions, cyber, climate change and the environment, and labor are all incomplete. These are precisely the areas where China's economy requires the most change. The limited nature of international norms and rules means limited external pressure or clear guideposts and models that provide a path for China to follow.

The final factor that makes an uneven trajectory for China's economic playing field likely is the evolving status of foreign businesses in China and the relevance of the global economy to the country's overall economy. Foreign industry has been critical to China's economic success since the 1980s, providing technology, products, services, capital, and management expertise. Chinese companies have become deeply embedded in global production networks and have developed strong partnerships with companies from the United States and elsewhere. Exports have been a central source of corporate revenue, consumer demand, and economic growth, particularly since the mid-2000s. Moreover, foreign-invested enterprises have been central to China's export success, accounting for over half of all exports and over 80% of high-tech exports in during the last decade. And in the last few years, Chinese companies have made overseas IPOs and debt issuance a central part of their financing strategy.

However, the status of foreign business is in some ways on the wane. China has been the top destination of foreign direct investment in the developing world for two decades, but foreign investment is a declining share of the economy. In 2003, foreign-invested firms accounted for 21.0% of all registered capital in China. By October 2014, that number had shrunk by half to 11.2%. Foreign firms' share of total fixed investment has fallen from a high of 11.8% in 1996 to 4.4% in 2003, and to only 0.9% in 2013. Similarly, although foreign trade has contributed much to economic growth, it is of declining relevance to the overall economy. At its peak, in 2006, total trade was the equivalent of 65.2% of the total economy. That figure has fallen consistently, coming in at 41.5% in 2014. China is moving from having a trade profile like Singapore to one like a mature continental-sized economy where foreign trade is a much smaller share of economic activity. Exports from foreign-invested firms are still substantial, 45.9% of total exports in 2014, but this number is also destined to continue falling. Moreover, if one takes into account that a sizeable portion of "foreign" investment and trade is with Hong Kong, and hence, to some extent masks domestic firms who simply

funnel capital through the city, then the true share of foreign investment and trade is even lower.

By the simple logic of economic gravity, we can expect that foreign companies and the global economy will maintain a significant yet declining place in the country's political economy. In a country where domestic state-owned and private companies increasingly dominate and where most economic activity is internal, the concerns of foreign industry and the global community may have more difficulty finding their voice, particularly if they are not supported by international agreements to which China is a party. The primary counter-trend is growing Chinese reliance on overseas equity and debt markets, but it is unclear what kind of constraints or incentives these relationships create, particularly when majority ownership and management remain clearly in Chinese hands.

In sum, the mixed worldview of China's leaders, the complex policy process, an incomplete international economic governance system, and the growing domestic orientation of the entire economy mean that reform will likely on the whole move forward, but in a halting and incremental manner, with periods of progress interspersed with moments of backtracking.

Implications for Policy and Business Strategy

Anyone hoping for a clearer and faster trajectory to a free-market economy will likely end up feeling like the characters in Samuel Beckett's "Waiting for Godot." Given these dynamics, there are several steps foreign governments and the international business community can take to encourage a reformist trajectory.

The first is to hold China accountable to its existing bilateral and multilateral commitments, through the WTO, regional trade arrangements, and bilateral trade remedies laws. These institutions have largely been successful and need to continue to be utilized and supported.

The second is to continue and strengthen the bilateral dialogues and cooperative arrangements already in place. The Joint Commission on Commerce and Trade (JCCT) and the Strategic & Economic Dialogue (S&ED) have both been beneficial to identifying and addressing significant problems in the commercial relationship. The American business community saw particular progress emerge out of the December 2014 JCCT meeting in Chicago, and the next S&ED in Washington this spring is another opportunity for further progress.

Third, we need to develop regional, plurilateral, and multilateral governance mechanisms in those areas of activity that currently lack such institutions. The thorniest problems with China often exist where the rules are the least clear. The adoption of the Trans-Pacific Partnership (TPP), a US-China BIT, renewal of the Information Technology Agreement, and Chinese accession to the WTO's Government Procurement Agreement all need to be pursued. In addition, there are aspects of existing major multilateral institutions that need reforming of their own. The WTO's governance related to trade remedies and the distribution of voting rights within the IMF are two of the most obvious, but there are likely others deserving attention. At the same time, we need greater focus on areas of the global economy where rules are currently insufficient, including in capital flows, banking, and

competition policy.

Finally, international business needs to continue to engage in its own brand of diplomacy, stepping up its engagement of the Chinese central and local governments, and have greater consultation on policy matters with its Chinese business partners. One area ripe for substantial expansion is greater consultation with Chinese chambers of commerce and industry associations. At a minimum, these organizations are sources of additional information about the policy environment, and in some cases, due to shared business interests, they could become allies with the foreign business sector, all seeking a fairer, more transparent regulatory environment.

Finally, it is important to keep in mind that regardless of whether the policy engagement occurs at the bilateral, regional, plurilateral, multilateral, or commercial level, there needs to be extensive coordination across government agencies and between government, industry, and other stakeholders.

Chinese industrial and macro economic policies are complex and involve a range of measures and actors at the local, national, and international levels. An effective response does not require the US itself to adopt an industrial policy, but it does mean the US needs, to the extent possible, to coordinate information collection, analysis, and policy actions. None of these activities, no matter how well coordinated, will yield an unfettered market. Yet a clear-headed, multi-pronged strategic approach will make continued progress in the direction consistent with the interests of the foreign business community more likely in the years ahead.

PANEL III QUESTION AND ANSWER

HEARING CO-CHAIR SLANE: Thank you very much, Dr. Kennedy.

Michael, we'll start with you.

COMMISSIONER WESSEL: Thank you to all of you, and, Josh, welcome back. I believe you may be our first graduate who's come back to be with us. So thank you, and it shows how great we've been in training, et cetera. So I enjoyed your testimony. It was spot on.

I'm trying to look at where we are, whether we're at some kind of crossroads here. Ms. Barale, you talked about the new investment laws and the uncertainty. We have a number of companies and industries that have come before us over the last several years. Since the beginning, there was-- when China became a member of the WTO, there was a great deal of enthusiasm for the prospects of the Chinese market, how engagement would result in dramatic changes.

Yes, there have been changes, but I think the returns from the China market have not been as robust as some would like, and with what's happening in cyber, IP, a number of other things, there's a much greater uncertainty, and what we always hear is if you're going to go to China, you need to go there with your eyes wide open.

So against that thought, why do we want to stimulate more investment in China from the position of the average American? As I understand it, 56 percent of China's exports come from foreign invested enterprises. The potential returns in the market are not as great as they used to be or not as great as hoped for. The potential for theft of your IP and realizing all of your objectives is diminished.

The administration is rushing to complete a Bilateral Investment Treaty, now in their 18th, I believe it is, round of negotiations, which would cement in place our rules. We're very rule oriented. But we have tremendous uncertainty about what China is actually going to do. Shouldn't we be taking a pause? Isn't it a little premature at this point for us to engage in a whole new embracing of a new round of investment by U.S. companies? Shouldn't we be sitting back and really taking stock of what's happening? And for each of the witnesses, please.

MS. BARALE: I guess, first of all, to start with, whether we are trying to stimulate more investment or some other purpose is discussed here, from where I sit, the type of work I've done in the past and where I'm teaching now, the starting point is that we already have a lot of U.S. investment in China.

Therefore, we care very much whether the laws are written in a way--

COMMISSIONER WESSEL: Agreed. Agreed.

MS. BARALE: --that is going to be fair dealing; right? So are we at a crossroads? I think we are very much at a crossroads. I think we need to devote some serious study to what this new draft Foreign Investment Law is, to see whether along with the introduction of some international standard concepts, like national treatment, they are also introducing various

systems that are going to keep restrictions on foreign investment in place for the years to come.

And I have to say that, one of the concerns I have about the negotiation of a Bilateral Investment Treaty is that the use of a negative list, even with sunset provisions in it, is going to lock us into a very restricted or ancillary role in the economy, unlike what we've seen with WTO and Schedule 9, which has extensive lists of these sorts of opening up provisions, but which also function as limitations on foreign investment some point once they were implemented.

WTO negotiations are more of an ongoing nature. When we enter into a Bilateral Investment Treaty, it pretty much stays put, and so with that in mind, I am concerned that, on the one hand, things are changing, they could be opening it up for perhaps a more even playing field, but, on the other hand, we can see when we look at the structure of this law, and maybe the structure of some of our other negotiations using a negative list, that we would be stuck in a very limited role in the economy.

COMMISSIONER WESSEL: Understand. Josh. Thank you.

DR. EISENMAN: Well, it's a great pleasure to see you again, Commissioner Wessel. So, gosh, how to answer this. Yes is the answer.

COMMISSIONER WESSEL: All right.

DR. EISENMAN: I believe you are correct, sir. But how to go from there? As I said in my testimony, I'm concerned about U.S. entities investing in Chinese capital markets too fully and too quickly without fully understanding if it's even possible to understand from an outsider's perspective what they're getting into. Then you have risks of contagion, which magnify from there depending on the level of investment.

I'm also, as my co-panelists, somewhat concerned about a negative list approach. It seems that on the American side, we're quite pleased to know that we're now using a negative list approach. That's a good approach compared to where we were, but it does allow for certain sectors to be taken off the table, and we're still congratulating ourselves while these sectors, in which we may have comparative advantage, such as software, are being taken off the table.

So, yeah, I would agree with your assessment, and I think that it would be good to have an assessment, but I think not only an assessment on the economic side. I think that, as I said in my testimony, it would be right to have a more full-throated reassessment of our interactions to figure out what is working on the economic, political and military sides so we're using taxpayer money effectively to achieve objectives, not just having dialogue for dialogue's sake, which we're all very familiar with.

Thank you.

COMMISSIONER WESSEL: Agree. Thank you.

Professor.

DR. KENNEDY: Thanks. You know, your question is well taken. The surveys that the various Chambers of Commerce, U.S.-China Business Council, and others conduct of their members who are doing business in

China consistently come back showing that a very high proportion of them make a profit, and so despite all those problems they're still making money. It's probably to their disadvantage to publicly state that they're making lots of profit in China because as soon as you say that, you got folks coming into your wallet, Qualcomm being a good example with what they did last year, reporting how much they're making in China.

But it does seem that despite the challenges, China is the place to make money, and they've done relatively well. Whether it's benefited the rest of the American economy, the competing sectors that we have, labor, et cetera, that's an even larger question.

But I think on the whole, the U.S. has benefited even though we haven't achieved some of the dreams that some people expected. I was trying to suggest in my original remarks that we need to not do that again, that we need to be more realistic about what can be achieved and what we ought to be aiming for.

Are the BIT negotiations taking place prematurely? I think that's a great question, and it's very awkward because we're dealing with all of these defensive problems at the moment. With all of these problems that are popping up, you would think that we ought to be putting out fires, and how can you be talking about national treatment where everyone is treated exactly the same, where it seems like there would be no room for industrial policy, yet you see industrial policy after a thing, one after the other.

My sense is that you could say China is at a crossroads everyday, but I think of it more as sort of this long transition because it's such a huge country and it's changing. China today looks very different from the way it used to be, and in ten years it will look even different.

But what is China's interests in negotiating? To some extent I think they've watched us negotiating TPP and some of these other potential agreements, and they're worried they're going to miss the boat, and so to some extent, TPP is already beginning to fulfil some of its utility in forcing conversations on topics that they originally didn't want to discuss.

But will we get to a BIT this year? I'm not super-optimistic about that, and I think there are probably other areas where we could focus on and also just observe, as the other panelists suggest. If for some reason we get incredibly lucky, as Professor Eisenman said, it won't be because we demanded it; it will be because they decided it was in their best interests.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR SLANE: Dennis.

VICE CHAIRMAN SHEA: Well, thank you all for being here, and, Josh, I never knew you, but I'm glad you're back and I like a lot of what you have to say.

This question is, I guess maybe for Professor Barale, about the draft Foreign Investment Law that you described. Josh, I'm proud to say we continue to have a great staff here at the Commission, and they wrote us a memo, and it said the draft Foreign Investment Law appears to be the first time China would definitively classify VIE, the variable interest entity,

structured firms as foreign firms. And that raises the question of Alibaba, which is the largest IPO, I think, in U.S. history, and it's structured as a VIE entity.

Do you have any insights? This suggests that maybe the VIE structure of Alibaba would be illegal under this draft Foreign Investment Law. Do you have anything to shed some light on?

MS. BARALE: Well, we'll try. Let's see.

VICE CHAIRMAN SHEA: Okay.

MS. BARALE: It's a very important question, and it certainly is one that everyone is talking about. The draft law brings about some really fundamental changes for the way China regulates foreign investment. Until now, China has regulated foreign investment according to the form of investment--if it was an equity joint venture, or a cooperative joint venture, or a wholly-owned foreign, then you had to go get your foreign investment approval.

And then foreign investors started doing things like acquiring a Chinese company. In such cases, then they are not forming an equity joint—they are not forming a new company, and it doesn't fall neatly into the existing law needing MOFCOM approval. So MOFCOM had to write merger and acquisition rules.

As business and the economy grows, and Chinese investors, foreign partners, all grow in their experience and sophistication, there are new forms of doing business, or things get structured in different ways as needed, and they don't fit neatly into law.

So what's happening in the new draft law is they're not going to try to regulate according to the form of investment, but they are going to regulate foreign investment by the definition of who is a foreign investor, and what is a foreign investment. And so for the first time, they will be looking to the ultimate beneficial owner of the investment. It won't matter that the investment was made through a Dutch NV or a Luxembourg company or whatever treaty jurisdiction you chose to make your investment through. Government regulators could look through ultimately to see who is the real investor--is that an American investor behind that or another nationality?

So this is what brings into question whether some of these rules are going to be applied to evaluate the VIE structures--

VICE CHAIRMAN SHEA: Well--

MS. BARALE: We have, also, as you probably are very well aware, this phenomenon for China called "U-turn investment," where Chinese money goes out, and comes back in in the form of a Delaware company or something.

VICE CHAIRMAN SHEA: So, excuse me, so with respect to Alibaba, a foreign firm cannot be a controlling--

MS. BARALE: Cannot get the license that's--

VICE CHAIRMAN SHEA: Right. In the Internet sector. Now Alibaba got around that by creating this workaround, this VIE structure, and, as I recall, setting up contractual relationships with a Chinese domestic entity

controlled by Jack Ma and some others, but people were investing in a Cayman Islands holding company that had contractual relationships with the true owners of the licenses in China.

Now, well, it's unclear. So I'm just trying to get a sense of how this draft law appears to be the first time China would definitively classify VIE structured firms as foreign firms. So Alibaba is operating in a space where foreign firms cannot operate under Chinese law.

MS. BARALE: Uh-huh.

VICE CHAIRMAN SHEA: So shed some light, please.

MS. BARALE: It's interesting that in the draft law, the provisions that seemed so relevant for this provision are actually put on as an attached explanation so they looked like they're being evaluated. But let me just say that the way the draft law would go about evaluating whether there is a foreign investor or a Chinese investor behind the structure, according to the procedures that would be proposed in the laws, a process whereby investors in existing structures that might be irregular under the new law would have a chance to come forward and apply for government approval and to determine whether the ultimate--

VICE CHAIRMAN SHEA: It's a roll of the dice there; isn't it?

MS. BARALE: And that we would assume that the full structure involved in these investments in China will be disclosed, and the actual beneficial owners and their nationality will be truthfully disclosed. There is also a proviso that it is possible for the State Council to make an exceptional decision that would allow some of these to perhaps go forward.

VICE CHAIRMAN SHEA: Yeah.

MS. BARALE: But I think what you're reading in the memo is the takeaway that everybody has got that VIEs are dead, and that, in most cases, maybe not in an extraordinary case, but in most cases, we would assume that when the beneficial owners and the true nationalities are disclosed, the application will be denied. The application for a foreign investment approval would not go forward, would be denied in most cases, but the law does provide for a determination of an exception.

VICE CHAIRMAN SHEA: Okay. Yes, Professor Kennedy.

DR. KENNEDY: I'm not an expert in the details of the law, but since your question was prompted by Alibaba, I think using a little "Zhongnanhai-ology" here to analyze their own political situation, we know they've been given approval to invest in a whole lot of areas where you wouldn't expect. These public statements by Li Keqiang and others to endorse their investment in electronic payment services and the financial sector is the biggest challenge to companies like UnionPay and others that have dominated in this sector that we've seen. At the same time, just last week, we saw Alibaba's Chief Jack Ma in Davos interviewing Li Keqiang.

They are on camera with each other all the time. I don't think Alibaba is going to be facing a whole lot of troubles. They've done the government relations job probably better than any of us could have done. And they still have a lot to do, but at the moment, they're looking pretty solid. I think

they will allow this type of legal structure to continue, or if they don't, they'll find a way to change it so that Alibaba and others can move to other types of structures.

VICE CHAIRMAN SHEA: Can I just ask a quick factual question? Has this draft law been in the process for quite some time? Has it been publicly noted that it's being drafted?

MS. BARALE: We knew, I knew, and I imagine others know even better, that the Ministry of Commerce had a special team working on how they were going to revamp the Foreign Investment Law. You probably know that in the decision of the Third Plenum of the Party Central Committee, the plenary session in November of 2013 talked about some of these reforms that were proposed and slated for going forward, and one of them was the reform of the investment system.

There was the use of this term "national treatment" and that sort of thing. But we didn't see anything for a long time, and so this is only come out since the 19th of January. Today is the 28th.

VICE CHAIRMAN SHEA: It would be interesting to look back at some of those prospectuses. I know, Josh, you said you have an interest in the capital--you worked in the capital markets as part of our mandate is, you know, these prospectuses with these IPOs, VIE, Chinese VIE entities, whether--that's why I asked the question, whether this draft law was known, whether--

MS. BARALE: January 19.

VICE CHAIRMAN SHEA: --this type of information was disclosed because it's obviously material about if the whole structure is potentially illegal, whether the fact that the draft law was in process, whether that risk was disclosed? And I don't know in these prospectuses.

MS. BARALE: As I understand, there is a statement in the Alibaba prospectus about the risk involved with--

VICE CHAIRMAN SHEA: Yeah. I just don't know. There was a lot about the risk, but about this draft law. I don't know if there was any mention of a draft Investment Law being worked on.

MS. BARALE: No. In fact--

VICE CHAIRMAN SHEA: Okay.

MS. BARALE: --we really didn't know whether they would be revising the existing laws because they are so well understood across China. You know, one of the questions you have to raise is why fix something that's not that broken? You have all of these government offices across China where they understand equity joint ventures quite well, thank you, and they know how to approve them. You just have to look at foreign investment statistics to know it has worked pretty well.

So now they're going to scrap all of that and go with a new system. It is really a big decision but it wasn't clear that what was going on.

VICE CHAIRMAN SHEA: Okay. Thank you.

HEARING CO-CHAIR SLANE: Jim.

COMMISSIONER TALENT: Yeah, three questions. Dr. Eisenman,

you mentioned that given the attitude of the Chinese government, you thought as American or as foreign investments grow, you thought that pension funds, et cetera, should be careful about what they invest in. I'll just give you all three questions, and I'd like you to elaborate on that because maybe that's something where we should make a recommendation to the Congress.

The second question, I'm just curious about something, I know that the Chinese leadership is concerned about the effect of the huge increase in corporate debt in China that's occurred as a result of their stimulus policy and others over the last few years.

And I'm wondering if there is any connection between that concern and this recent wave of sort of discriminatory actions against American companies investing? Whether there's a sensitivity about the SOEs now because they're carrying this extra debt that they didn't have before? I don't know if you have a comment on that.

And, then, finally, generally, do you see any circumstances where the regime would conclude that comprehensive economic reform, you know, including predictable and nondiscriminatory rules for investment, might outweigh the risks to Party control, might actually be in their interests so that they would do it?

DR. EISENMAN: Well, thank you, Commissioner, for those cogent questions.

In terms of the issue of pension funds, what I've tried to do here is really get out in front of an issue which has not materialized yet, but is an issue which could materialize if China is successful in drawing large amounts of foreign investment into its capital markets.

And so it's one thing to sit before a Commission such as yours after it's been done and say look what has happened. So in a way I'm trying to put my finger on something in the hopes that we can get an eye on this as early as possible because, as we've seen time and time again, the more interwoven the economies get, the more contagion becomes possible.

The U.S. and Chinese economies are highly interreliant, but if U.S. pension funds were to be investing in state-owned enterprises that are black boxes, I would be deeply concerned about it. But again I want to stress that I don't have any proof that that's happening, but I want to make sure that if it does happen, that this body is aware of it.

COMMISSIONER TALENT: I don't mean to be critical. I appreciated it, and I know as a former member of Congress, somebody has a concern about my constituents' pension funds, you know, even prospective ones, you want to know it. So that's why.

DR. EISENMAN: No, thank you very much, Commissioner.

In terms of the increases in foreign debt and that perhaps being a reason to put pressure--I'm sorry--in corporate debt, and perhaps that being a reason to put pressure on foreign firms, I believe that this has been, and it was written about actually by Wang Jisi of Beijing University as early as 2011, that this has kind of always been the plan, to dial back on foreign

direct investment, especially into industries that they might consider dirty industries, polluting industries, as soon as they felt that they'd acquired the know-how and the capital investment that they were after.

And then reaching a point that they felt that they could do it on their own, moving on and moving up the value-added chain, and I think that this is something which is not I would say directly related to this corporate debt although I would say having thought about it now that you've asked the question, it certainly couldn't help; right? It certainly would be a reason why you'd want less competition in the market in order to have a higher price, but I don't know that that's necessarily the number one driving factor, but it's certainly not a countervailing factor. Does that not make sense?

And the final question, I--

COMMISSIONER TALENT: Any circumstances where--I agree with you. They make decisions based on what they think is in the interest of the regime.

DR. EISENMAN: Uh-huh.

COMMISSIONER TALENT: So could you see any circumstances where they might on balance conclude it would be in their interests to have a set of rules or a regime for foreign investment that was predictable and nondiscriminatory? I mean what if I was in the Standing Committee of the Politburo, and I wanted to make that argument, is there any argument I could make that you think might be persuasive in the future?

DR. EISENMAN: Well, I think they'll take it on a sector-by-sector basis, and in those sectors where they feel that they can gain from foreign involvement, and there is no political threat to them at all, then that's fine. But for those sectors, including the ones that I've mentioned and others that they feel are politically sensitive and even pose a modicum of threat, there's just no reason to open themselves up.

So to answer your question very directly, no, I don't think that there is. In some sectors, if you were to say, you know, we can save a lot of money by having Microsoft on all of our government computers rather than the domestic system, I don't think that's going to be convincing at this date.

COMMISSIONER TALENT: And if the other panelists or witnesses want to comment, I'd love to hear it.

DR. KENNEDY: Excellent questions for which I don't think anyone has perfect answers except for Professor Eisenman. I'd say, you know, if you look at China established a system called "qualified foreign institutional investors" several years ago and gradually increased the quotas to allow foreign investors to invest in Chinese capital markets directly and in the stock market, the bond market.

We know what the quotas are. We don't know how much they've used, but essentially what we seem to know is that they haven't used their quotas because of the risks that you talked about and that others have mentioned, that it's a very risky thing because you just don't know what's under the hood even if you've read the paperwork, even if it's audited paperwork, even if they have a credit rating. If our credit rating companies have

trouble, you ought to see what a Chinese credit rating company is like, and I spend a lot of time looking at what they do.

That's the first thing. So I think they're already very hesitant so even if the quotas continue to expand or they're allowed to go into other areas like China's future markets or derivatives markets, I would expect continued hesitancy both for the individual company problems and the structural issues.

The second point is that this makes even more important Chinese local government fiscal reform because Chinese companies according to the budget law aren't allowed to directly issue their own bonds or their own debt. They got around that by creating these local government investment vehicles which could do so, and they'd be called corporate bonds.

That debt has expanded dramatically. It's not directly on the books of the governments. Sometimes, in principle, they're supposed to essentially be sovereignized with the government stepping in if there's a problem, but we're seeing reports in some places they do step in, in some cases, they don't, and so I expect to see some defaults, which I don't think is necessarily a bad thing because that tells me what the risk is.

The reforms that they're considering would be to allow local governments to issue municipal bonds and put their debt on the books, make it much more transparent. And then make the provinces, not the central government, the ultimate guarantor to stand in and be responsible, and so instead of having one guarantor have 31.

I think that's potentially a much better system. China's financial system at its heart, the problem is moral hazard. You loan out money. You expect people to return it. They don't. Then what do you do? Then someone else steps in. So this is one way to potentially address that issue, but we'll just have to see. It's, you know, everything in China is about implementation.

The last thing is, you know, what will the Chinese, what would the Party allow, you know? I tend to see just about everything in China as instead of yes/no as part of a sliding scale, as some part of shades of gray. And just about every Chinese policy that they implement or adopt is very specific, and they go step by step, cut things 75 different ways, and so I can see lots of ways in which they would gradually yield on policies and rules that would be beneficial to business including foreign business.

I don't expect any monster jumps in one direction or not because it's just not part of their character.

MS. BARALE: If I may make a comment? I'm intrigued by your last question. I think it's one that really makes us want to think about why would they do this, so I think your question was something like if you were in the Politburo, how would you make the argument?

COMMISSIONER TALENT: Persuade them on their terms because I agree very much with what Josh said. All this talking and expecting that they're just unenlightened and that they'll learn and grow as they're exposed to us, it really does them a tremendous disservice. I mean they know what

they want to achieve.

MS. BARALE: That's right.

COMMISSIONER TALENT: So you have to persuade them on their terms, and I just wondered if you saw any circumstance where they might produce a policy that was consistently more, you know, in line with what we're urging them to do?

MS. BARALE: I can imagine conversations that go something along the lines of we're no longer a state-planned economy, we've outgrown an old Soviet socialist style legal system. We have a much stronger legal system. And we are ready to take our place on the world stage in international organizations, and we've also learned enough about foreign laws. We can use antitrust law. We can use a national security regime. We can work with national treatment and add our own definitions and preserve China's interests but using the concepts that we find used in the legal systems of other major countries.

And I think we could imagine that conversation and see that some of what's coming out in front of us is exactly that. You know, it's an antitrust law, with some special, with their own definitions to it. And here for national treatment, it's going to be national treatment for foreign investors but with some major qualifications.

And in this new draft foreign investment law, we also have a chapter on national security review, and we've had a couple of regulations on national security review for acquisitions by foreign investors, but they are definitely going to be ramping that up in this new Foreign Investment Law as well.

HEARING CO-CHAIR SLANE: Carolyn.

COMMISSIONER BARTHOLOMEW: Thank you and thank you to all of our witnesses.

Professor Barale, and I hope we're not all slaughtering the pronunciation of your name, I have a question for you and then a question for all three of you. I guess the question for you is every time you're now mentioning the draft Foreign Investment Law, and it's a week old, so you're right, it's way too new for us to be drawing any sorts of conclusions, but to me one of the issues, of course, is what sectors will be exempt and what are the major qualifications that are going to be happening in order to be able to measure it?

But I wonder if you could say anything about what benchmarks you think we should be all thinking about as things move forward in terms of gauging both the seriousness of intent regarding economic reform and also the success of implementation? What are, say, the three or four key things that you think that we should be gauging when we're looking at that?

And then the question for all of you is I'd just like your thinking about so why now? I mean is the release of this something to do because they think that it will help address the economic slowdown that's taking place or, you know, why would you think that this is happening now?

MS. BARALE: I think we're not going to be able to evaluate the

proposed new way of doing foreign investment regulation until we see this special administrative measures on restricted and prohibited investments. Some people have said, well, just look at the Foreign Investment Guidance Catalogue now. We have encouraged, prohibited, and, in fact, the NDRC came up with a new draft in November. Take a look at that.

But I'm not sure that that is going to tell us. I'm not sure it's going to be the same, and we don't know what kind of restrictions are going to be in it. The things that we're concerned about are not only the areas where we can't invest or where we have limited options, but also those areas and types of investments where we must have a Chinese partner or we must have a Chinese partner who has a majority say in the venture.

And whether there would be other restrictions or, conditions put on the investment.

One of the things that comes along with this new law is the possibility that new investments won't necessarily be for a limited term of years. With national treatment, if you're in the national treatment scheme, it appears that the foreign investor would be determining its investment under the Company Law and how long that investment should last.

But if you are found to be in the restricted sector, then there are conditions that can be attached to the approval of your investment, and we don't know what those conditions might be. We know that there are going to be procedures for the formulation of these restricted lists and that they must be formulated in a way that will be consistent with their obligations under international treaties, but at present it's all blank.

COMMISSIONER BARTHOLOMEW: So we really, I mean we're at a stage where we don't know if it's real or if it's sound and fury signifying nothing. I mean until we see more information.

MS. BARALE: I guess it looks real. I guess the way I would look at it is we don't know whether the opening up is this big or is this big. Until we see the list and we see just how much is put on the list and what kind of conditions would be attached that would restrict these types of foreign investment, I don't know.

When we look at the Foreign Investment Guidance Catalogue now, and we see that it's an investment in a certain type of energy or a school or something, we know whether we have to do a joint venture and whether it needs to be a cooperative joint venture, and whether the foreign or the Chinese investor needs to be the majority stakeholder, and so that very basic information for those industries that are listed, those types of investments in the Foreign Investment Guidance Catalogue is stated.

So there's a certain amount of transparency on that. Well, we'll talk about transparency later.

COMMISSIONER BARTHOLOMEW: So then the other question is just thinking about so why now? Why is this happening now?

MS. BARALE: Well, I have to say that I put the same question to Chinese academics when we could talk about this, and it seems to be tied to the need to spur the economy forward and that greater competition from

foreign investors spurs more development in the Chinese economy.

But I defer to my panel members to see from a different point of view whether we can get at a better answer.

DR. EISENMAN: It's a great pleasure to see you again, Commissioner Bartholomew.

So why now? And again this is a very difficult, to put yourselves in the shoes of another in a very complicated set of circumstances so, you know, with a grain of salt, to be sure, please take these comments.

I would say one is you've got a new leadership, and they want to push forward change in the economy. There were concerns about the way that the Chinese economy was functioning generally, speaking in macro terms, and so there's a desire now to change that, to make it cleaner to avoid, as Professor Kennedy talked about, the middle income trap, to be proactive in addressing these problems, and to have the new leadership seem to be proactive in a political sense, both for the intra-Party audience and to some degree the Chinese people generally speaking.

We've also seen falling foreign investment into China, and so there could be a desire to stimulate increased foreign investment. When that number is falling in sock factories and things like this, you want to try to lure it in in different ways, and you use different new policies to attract foreign investment into those sectors you'd like it to be in.

As one person in the Party had mentioned to me, you know, you can't come to China and build a toy factory in Shenzhen anymore; right? We don't want that kind of investment. And so if you don't want that kind of investment, now you have to change the rules so you can lure and draw in the kind of investment you want.

And, then, thirdly, I would say the growth of outward FDI as a factor is something we hadn't seen much of in the past, and this goes with the general historical trend. The U.S., as everyone probably knows, invested in Japan. We invested in Korea, and then Korea and Japan--well, Japan invested in Korea and it invested in Taiwan, and now everybody invested in China, and so now China seeing margins fall with rising labor costs, et cetera, is looking outward to see where it can find high returns.

And most of that capital appears to be flowing into the United States if I'm not mistaken, but, of course, there is a great bit going into Africa and other places as well. So in order to have an investment climate, an outward FDI climate which is suitable to that policy objective, you've got to put in place a legal structure which facilitates it and makes it possible to do. So that's why I would say now certainly a political component, but a good economic one as well.

Thank you.

COMMISSIONER BARTHOLOMEW: Dr. Kennedy, anything to add?

DR. KENNEDY: Sure. You know the planning of laws, anything that gets put out like this by the government for consideration, there is a long process by which it's placed on a list and part of their agenda, This is the first draft that's been issued publicly for comment, and so we know it's

never gone before the National People's Congress or the Standing Committee of the National People's Congress.

And typically now any law that's passed nationally goes through three readings, and so the 30 days will end in mid-February. I think it's highly unlikely that it will go through a full reading of this meeting of the NPC beginning of March. So you're looking mid-April for the first, sometime in the summer for the second.

So I think we're over a year away from actually seeing this thing passed and coming into effect. So it will probably take effect in 2017 would be my guess if they keep along the path, but, of course, we've got other Chinese laws that get stuck many times. So this is early, and so that we get to see it now. There will be plenty of chances to debate this within. I'm sure we'll see a lot of conversation.

Why are they doing this? Well, beyond the possibility that maybe they've seen the light and they need to make things better for foreign companies because of all the problems. You know, I don't know if this is being cynical or not, but when China was trying to decide 20 some years ago whether to allow private companies to expand in China, you know, the original categories they had in statistical yearbooks and that they would report made the possibility that it would like this, would be an economy that wouldn't be run by state-owned enterprises, that it would be private, that it would be privatized, not with privatization of individual companies but by the expansion of more private companies.

And so they changed the definition of these companies and the categorization to make it so that conservatives couldn't criticize them for going capitalist. And we may be seeing the same thing here. They may be changing the categorization and eliminating the category of foreign companies so that if foreign companies expand, they can't come under attack by someone pointing at the data and saying, hey, look, there's a lot of foreign companies here.

So it could be that. It could be the opposite. It could be foreign investment is facing more difficulties, but we can't find the data to tell them that, hey, the investment is going down or we're facing more problems. So it could be either way.

Another possibility is this may be the policy side of what may eventually come in terms of various bureaucratic reforms. So currently there is a big distinction in the responsibilities of the Ministry of Commerce and the National Development Reform Commission. This may be part of an eventual readjustment of what those two institutions do or the merging or elimination of one of them, and so we're seeing the legal policy side of what's going on first, and then maybe eventually there will be institutional changes that would occur in early 2018.

COMMISSIONER BARTHOLOMEW: Thank you.

HEARING CO-CHAIR SLANE: Katherine.

COMMISSIONER TOBIN: Thank you all, professors.

You've given us a window into the changes in China, and earlier

Commissioner Wessel asked about the Bilateral Investment Treaty. I believe it was you, Dr. Kennedy, who said you didn't foresee it happening any time soon, and part of our question was is this the time for it?

But I'd like to hear from each of you, if we were to conclude the BIT this year, next year, what effect, if any, do you see it having on the American economy? You three are as expert as they come on this. If we were to move forward, and it may be just negative, but what positives or negatives can you see in terms of effect of a Bilateral Investment Treaty?

MS. BARALE: I think that U.S. businesses are hoping, and we certainly heard this from some of the business associations, that they are very keen to see a BIT put in place, and they see that it will enhance business opportunities. And I guess specifically in the short-run that whatever Bilateral Investment Treaty is negotiated, and let's assume that it has a negative list, we would assume that the negative list on the BIT would be an expansion, a step beyond the limits that we've got in Schedule 9 of China's Protocol for Accession to the WTO.

So that there would be in the short-term, more opening up of opportunities. The concern I expressed earlier about using a negative list is that those windows that open up for further investment or larger stakes in particular styles of investment would eventually serve as a limitation, but in the short-term, it would mean that there would be some new opportunities opening up.

COMMISSIONER TOBIN: Thank you.

DR. EISENMAN: Well, thank you, Commissioner.

I think I'm generally going to punt, but before I do I want to associate myself with the comments that were just made, which is to say that I think there is a fear, and again I went into this in my written testimony, about the negative list being a short-term bonus but a long-term institutionalization of restrictions, and that, you know, walk out of the room, okay, we got a deal done, but then later when U.S. companies can't access those sectors, that's already inked.

So we want to, I think, be cognizant of that and--

COMMISSIONER TOBIN: And before you punt fully, are you punting because you think it would be unwise to proceed, or because you think it would have significant negative effects, and if so, negative effects on what?

DR. EISENMAN: Well, to be quite honest with you, I'm punting because I don't know the answer.

COMMISSIONER TOBIN: Uh-huh.

DR. EISENMAN: I think it's so broad, and we don't even know what the shape of it might look like so to project what it might do to the U.S. economy is a step beyond what I think I'm qualified to speak to at this time. So more out of modesty than out of concern at this point.

COMMISSIONER TOBIN: Okay.

DR. EISENMAN: But I'll certainly look into it and would be happy to speak to you further about it once I have more evidence.

COMMISSIONER TOBIN: Thank you.

DR. EISENMAN: Thank you.

COMMISSIONER TOBIN: Thank you.

DR. KENNEDY: Last year, U.S. investment in China was about \$3 billion. The U.S. has a \$17.4 trillion economy. These investments in China matter a lot to the specific companies that are making them and to the supply chains that they're part of, and there could be significant benefits to companies in some of those sectors and help those companies as they're adjusting in the wake of adapting after the global financial crisis and trying to take better advantage of the, you know, opportunities that they have in China and elsewhere.

Certainly for many companies that are investing in China, they're not using China as an export platform as much as they used to. They're looking at the Chinese market, and a Bilateral Investment Treaty may be helpful in them achieving that.

To the extent that American companies that are more profitable wisely invest those profits in R&D and other types of investment that benefit American workers or the American consumer, that's, you know, something for a different panel for those companies and what they do and other considerations about American laws.

I would say this is also connected to the benchmarks that were asked before about what we should be looking for. You know I think in addition to wanting the opportunities to be able to invest in areas that have been off limits, and in addition to wanting some stability, I think really what one of the big goals that they want, that American business is seeking and others, is greater stability with acquiring existing Chinese companies, private Chinese companies, state-owned companies, and not just minority stakes but majority stakes. And a BIT may help them.

I'm just amazed that any time I talk with the American business community here or in China, the BIT is their number one priority, that is the top of the list right now, and whether we think it's going to have a huge effect or a very small effect or it's awkward in the context of the problems that we're facing, that we see, it's the number one priority.

COMMISSIONER TOBIN: Yes, I would agree, and it seems like a lot of eggs in one basket.

Thank you.

HEARING CO-CHAIR SLANE: Josh, I wanted to start with you and ask you your opinion on the Strategic Economic Dialogue that's been going on for eight or nine years. There are people who say we should continue the dialogue with China, and this is a positive thing.

Other people are saying all talk, no action. We're just enabling the Chinese to keep holding us off. They make commitments which they never implement, and we should stop doing it.

What are your thoughts?

DR. EISENMAN: Thank you, Commissioner.

That's a difficult question, honestly. I mean generally speaking when I see all of these kind of spaghetti bowl of dialogues that we've created from

all of these different agencies, Track One dialogues, to say nothing of the Track One-and-a-half, and the Track Two and the track whatever, I am just generally concerned that we're not getting as much out of it as we should, and so I want to start with that general statement.

I believe one of your recommendations in the 2014 Report was to look at this issue. In fact, the first recommendation was to evaluate--I believe the--what--Congressional Budget Service to evaluate this question. So at this point, you know, having not done a review of this particular dialogue, it's hard for me to sit here and say yes or no to your question in an authoritative way.

And it's precisely because of that, I don't think that or I have yet to see what I would consider an authoritative report on the benefits of that dialogue, and so that's why I think that might be something the Commission could put on its research agenda to help us better understand and answer the question you've put forward.

But I think that, generally speaking, the question you're asking is a broader question that goes beyond the particular SED dialogue and it goes to a whole litany of dialogues that we have on a whole variety of issues that we, I think, need to evaluate.

HEARING CO-CHAIR SLANE: Anybody else?

DR. KENNEDY: Sure. I think it's incredibly important that the U.S. and Chinese leadership have strategic dialogues with each other.

China is incredibly important for what happens, positive and negative, in the world. Obviously, being the world's only superpower, they ought to care a lot about what we think and what we do, and misunderstanding is incredibly dangerous.

Understanding doesn't mean you agree with each other; it means you also know where you disagree, and so I think strategic dialogue, the more these leaders can be together, the better, and in addition, these types of meetings also generate a lot of activity in the bureaucracies, and it forces our Cabinet members and their staffs to focus and come with deliverables or at least pay attention and learn about the other side and vice versa.

Chinese officials are highly focused on the domestic political system and figuring out how to survive, avoid the anti-corruption campaign, avoid getting on the bad side of others, and getting their tasks done. So to get to them to focus for a little while on the United States is not a bad idea.

There is a good question about whether the S&ED as it is currently constructed is the most effective way to do that. And it's gotten bigger. It's gotten larger. It's added grammar to the middle of the dialogue name. It's got now two leaders on each side which makes it challenging so there definitely is a worthwhile discussion to be had about the form in which this dialogue takes. But to me in general even if it doesn't lead to obvious lists of deliverables each time, which we can put on the front page of the paper, I still think it's better than looking at each other across the Pacific.

MS. BARALE: I would agree with that. I think the Strategic Economic Dialogue and the other exchanges we have are important for

putting on the table those issues, those items which we feel need to be addressed. Whether we are successful always in putting it forward or getting some results is another question. But it is important to be able to have some channels for putting those issues out there.

The other thing is, especially in preparatory meetings, as well as the higher level meetings, it allows discussion to take place with a fair amount of technicality discussed, and not the broader generalizations that might be associated with a more political discussion. Whether it's IP or whether it's finance and treasury issues, it is necessary to be able to speak specifically in the technicalities of that field. I think that is important for trying to establish communication on these issues rather than hearing general descriptions of what the discontent or the complaints are about.

HEARING CO-CHAIR SLANE: Jeff.

COMMISSIONER FIEDLER: Two quick questions. We were talking earlier about certainty and uncertainty, and China has always been an uncertain place to do business on some level.

I'm interested in the impact, whatever you've picked up on the impact of the anti-corruption campaign on business operations and government decision-making regarding business operations in the first instance.

And not completely coincidentally, foreign investment in the United States that you made reference to earlier--I forget who it was--I think it was Dr. Kennedy who mentioned--I think it was--no, you mentioned the U.S. investment in China. How much of Chinese investment in the United States is capital flight?

MS. BARALE: I haven't been in China for over six months so I don't have any firsthand discussions about how foreign companies are feeling about the anti-corruption investigations. My secondhand reports are that they are sensing in Chinese offices a lot of anxiety about how they should be conducting themselves and how much contact they're able to have to some extent. This may be too anecdotal perhaps for you to draw conclusions, but--

COMMISSIONER FIEDLER: You've had a lot of experience in China, and younger people have had less because they're younger, and the old argument was that anti-corruption campaigns were always just simply factional disputes. This one strikes me as--

MS. BARALE: No.

COMMISSIONER FIEDLER: --as very much deeper, and more, less factional. It includes factional--

MS. BARALE: Uh-huh.

COMMISSIONER FIEDLER: --victims, but that it is different. Do you share my view of that?

MS. BARALE: The anecdotal, you know, what I'm hearing secondhand is that it is, it's reaching into more offices at more levels. It's something different. It may be, as you say, in addition to factional targeting, but there are also attempts to or efforts to look at places where there's corruption, if there is corruption in one part of a system to take a serious look at a wider

part of that agency or that system, and that's got a lot of people nervous, whether or not they have been involved.

COMMISSIONER FIEDLER: You had the number two guy of the NDRC who was just taken away.

MS. BARALE: Uh-huh.

COMMISSIONER FIEDLER: We're talking about a seriously important decision-making position vis-a-vis foreign business.

MS. BARALE: Uh-huh.

COMMISSIONER FIEDLER: And even domestic business.

MS. BARALE: No, no.

COMMISSIONER FIEDLER: That's why I was wondering what kind of, you know, reaction are the American businessmen having to the anti-corruption campaign, and I think it's going to go way--you know. What do you guys say? What do you young guys say?

DR. KENNEDY: I need you to get on the phone with my sons after this to let them know that their dad isn't a geezer.

COMMISSIONER FIEDLER: Well, everybody is young to me now.

DR. KENNEDY: Thank you.

[Laughter.]

DR. KENNEDY: The anti-corruption campaign I think is motivated by several goals. The first is in general to reduce the level of rent seeking, not to eliminate it. There's a lot of rent seekers all the way at the top, but to reduce the extent of it, and so these cases, to some extent, have had that effect.

The second is, you know, I think there is some factional element to this, eliminating political opponents just because they're your political opponents or the friends of your enemy. I think we could see some of those cases.

And then I think the third is to eliminate or push aside or weaken entrenched interests that are going to be opponents of state-owned enterprise reform and other types of reforms which will come down the line but can't really make any progress until you shake the system up.

So this is really about taking things, shaking them up like a game of Boggle and then hoping that once the board is reset again, you're in control of it and folks will listen. I think that's the goal. The short-term consequence is that everyone is on pins and needles because they just don't know where the sword is going to drop.

Foreign companies are extremely nervous about this and are investing a great amount in lawyers, so lawyers are benefiting tremendously to make sure they don't violate the Foreign Corrupt Practices Act and reexamine all of their practices in China and elsewhere, and I think that's probably a good thing.

It probably has contributed to the overall slowdown in growth in these numbers that we've seen, 7.4, which is probably not really 7.4. Our 3.0 is much better than their 7.4.

I think one of my concerns about the anti-corruption campaign, you

know, everything in China is always done less focus on process and more focus on outcome. The way this is going forward, even though they spent the Fourth Plenum talking about rule of law and have a long list of things to do, you know, my sense about the, if you really want to get corruption under control long-term is to build the institutions of civil society to provide external accountability--a press, independent courts, NGOs and others. And this just reinforces that there's one source of accountability in the country, and that's the Communist Party.

So in the short-term, I think they make a lot of headway because Wang Qishan and the others who are leading this, you know, leave no stone unturned, but in the long term what does it mean? Will they be able to sustain it? Will this be the new normal? I'm a little bit dubious that that will be the positive outcome although I recognize the logic, given this type of political system, that they're approaching it in this manner.

DR. EISENMAN: Thank you.

First, just to take a step back for a moment and just qualify the comments I made on the previous question. I think that when we look at a dialogue, the S&ED dialogue, we should just be not overly optimistic. I think over-optimism would be our enemy in this case, and so I just want to add that to my comments.

COMMISSIONER FIEDLER: Let me get my capital flight question answered here. Anybody got any idea?

DR. EISENMAN: Well, the Communist Party has said that massive amounts of money have left the country through corrupt officials.

COMMISSIONER FIEDLER: What's massive?

DR. EISENMAN: Oh, gosh. What was their number? Do you guys happen to know? It was in the billions, but there is a number--

COMMISSIONER FIEDLER: Is it the \$280 billion that the Treasury Department couldn't find but wasn't worried about because they thought it might be coming here?

DR. EISENMAN: Well, I don't know the answer to that, but I do know that the Communist Party has at one point put out a number although at this point I don't have it on my person, but I can certainly try to follow up with you and get you the number that the Communist Party says has left the country due to corrupt capital flight. Certainly having lived in Los Angeles and Austin, you see a lot of Chinese money coming in, especially to the real estate sector.

It's anecdotal, but it's certainly something that you can see with your own eyes. So I do think that there is certainly an issue of capital flight, but I do think it's also an issue of development, that China has reached a level where maybe all the low-hanging fruit, not all, but a good portion of it has been picked, and now they're looking for higher returns abroad. They're looking to generate higher returns for their portfolios.

COMMISSIONER FIEDLER: That is a very polite way of saying that the closet is full of cash that I can't spend in China, and I've got to get it out.

[Laughter.]

DR. EISENMAN: Well, certainly there have been plenty of those cases which have come to light.

With regard to your question about transparent, about the anti-corruption campaign, I would associate myself wholeheartedly with Professor Kennedy's comments. And when we look at Transparency International's recent rating of China, it went from 80 to 100 in the middle of--I mean that's the biggest drop of any country in the world, in the midst of anti-corruption campaign, which sets transparency as one of its primary objectives.

So that would suggest that those people who are experts on transparency are not pleased with what they're seeing. But I do think that there is a factional element to this, and there's been research done. I think an Australian scholar looked at those people who were purged and where they were associated with in terms of politics and concluded that the majority of those people who were taken out were from lower ends and the people of high means, those people who would be considered in the Xi clique have generally been unscathed.

Now I haven't done a backup to see if his research is correct or not, but I would agree that there is certainly a factional element to this beginning with the Bo Xilai case that we all know and going, you know--I won't go through all the cases.

But I also want to make an association here between what we see in corruption and then other crackdowns going on in the realms of culture, education, propaganda, Internet control, the online--I mean you name it. It's getting tighter in China, and so, you know, there is this socialist theme that is being expounded upon not only in terms of the corruption campaign but in campaigns across a wide variety of sectors within Chinese society that we have not seen or at least I haven't seen in my lifetime. The kinds of restrictions that are being put on are, you know, concerning, and I think were referred to by former Premier Wen Jiabao in his final NPC when he talked about how the possibility of a new Cultural Revolution was real, and he was the premier. So he knew what he was talking about.

And when we see these things that are developing, they are suggestive that Premier Wen Jiabao knew what he was talking about.

COMMISSIONER FIEDLER: Thank you.

HEARING CO-CHAIR SLANE: Thank you very much. It's been a terrific panel, very helpful. We appreciate everything, and with that, we're going to conclude our hearing.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]