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Presidential Report Recommends U.S. Action to Counter Chinese Policies in the Semiconductor Industry

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Late last week, a group of technology industry leaders, researchers, and former policymakers comprising the President's Council on Science and Technology ("PCAST") issued a report entitled *Ensuring Long-Term U.S. Leadership in Semiconductors*. The report concludes that China is seeking to reshape the global semiconductor industry in a manner that threatens U.S. leadership in that sector. Given the criticality of the semiconductor industry to U.S. national security, the report recommends a three-part strategy to (1) counter Chinese policy actions, (2) improve the business environment for U.S. semiconductor companies, and (3) help "catalyze transformative semiconductor innovation over the next decade."

The report does not reflect a new focus on the semiconductor industry; rather, it is the culmination of several years' worth of study and analysis throughout the executive branch of a vexing industrial policy challenge—the apparent hegemony that China seeks to exert over the semiconductor industry, and the associated implications for U.S. national and economic security. Nor does the report itself mark a U.S. change in law or regulation, or even announce a specific policy shift. That said, the report is notable because it lays a marker for even greater scrutiny of Chinese investments in the semiconductor and adjacent sectors by the Committee on Foreign Investment in the United States ("CFIUS"), and conveys a message for the incoming Trump Administration policymakers who will inherit the challenges addressed in the report. In this regard, we expect there will be considerable discussion within the new Administration and the Congress of the report's suggested legal and policy responses, including expanded multilateral collaboration on export controls and investment reviews, and the use of other trade tools to combat Chinese government-supported activity that the report characterizes as market-distorting. We discuss certain aspects of the report, and some takeaways, below.

Report Conclusions and U.S. Government Concerns Regarding Industry Trends

Among the report's more notable conclusions are the following:

- China has made a concerted effort to re-shape the semiconductor industry through a range of policies backed by over $100 billion in government funds. These policies include (i) subsidies intended to encourage foreign companies to locate facilities in China and domestic firms to acquire foreign companies and technologies, and (ii) "zero-sum" tactics, such as requiring domestic customers to purchase from Chinese suppliers, forcing technology transfers in exchange for market access, and misappropriating intellectual property.

- These Chinese policies are "distorting the market" and "put U.S. national security at risk." Maintaining a leading position in semiconductors is critical not only to "defense systems and U.S. military strength," but also to mitigating cybersecurity risks given the ubiquity of semiconductors in electronics.
- The U.S. government should "attempt to influence Chinese behavior" by improving transparency around Chinese policy, working with allies to "coordinate and strengthen inward investment security and export controls," and "responding firmly and consistently to Chinese violations of international agreements."

As we have reported previously, the industry trends that the report identifies, and the high-level focus on the issue from U.S. policymakers, have been long in the making. Commerce Department Secretary Penny Pritzker took the unusual step of making a major policy address late last year focused specifically on the semiconductor industry and China, noting the Chinese government's announced objective of spending $150 billion to increase China's self-supply of integrated circuits to 70 percent by 2025. For its part, CFIUS has for some time been conducting a thorough risk-based analysis for every transaction in the semiconductor sector involving China—and even some that do not involve China directly, but where there could be Chinese interests, such as where there are Chinese operations or customers of the existing U.S. business—regardless of how benign the transaction may appear.

We also have seen U.S. concerns regarding China's activities in the semiconductor industry play out in regulatory actions, including through CFIUS. Most recently, on December 2, 2016, President Obama issued an Executive Order prohibiting the acquisition of the U.S. business of Aixtron SE ("Aixtron"), a maker of semiconductor manufacturing equipment, by a company ultimately owned by Chinese investors.[1] The order marked the first time that a president formally has utilized the authority of the CFIUS statute to block a foreign acquisition prior to consummation of the transaction. In a statement, the Department of the Treasury—which chairs CFIUS—observed that "the national security risk posed by the transaction relates, among other things, to the military applications of the overall technical body of knowledge and experience of Aixtron, a producer and innovator of semiconductor manufacturing equipment and technology."

While the industry trends identified by the report are not new, the report characterizes the U.S. national security concerns about those trends more starkly than we previously have seen conveyed publicly. We accordingly expect the report will intensify the focus within the U.S. government on addressing the perceived risks to the U.S. semiconductor industry presented by China's actions.

[1] For more information, please see our client alert on the Aixtron executive order here.

Lessons for Cross-Border Acquisitions and Investments

We see the following takeaways from the report for companies in the semiconductor industry:

1. **<u>Semiconductor Transactions Involving China Will Receive Greater Scrutiny, Including from CFIUS.</u>** The report notes that Chinese firms have been "increasingly active in the acquisition space" and that "the most likely avenue for growth will be acquisition of global players (or divisions of them) in the United States, Europe, or Japan." CFIUS will continue to scrutinize semiconductor transactions involving Chinese parties to determine whether the transactions present any risk to U.S. national security. Notably, the report recommends that the U.S. government continue to maintain its policy focus, including through CFIUS, exclusively on the national security impacts of China's actions, and not utilize tools such as CFIUS to pursue economic—as opposed to national security—goals. At the same time, in addressing "Chinese policies that distort the global market by limiting access of U.S. companies and U.S. exports to China's large and growing semiconductor market," the report says:

   > One way to respond would be to tie U.S. assessments of the national-security threats posed by particular technology exports, investments, and contracts to Chinese policy. (For example, if China pursues a policy of undermining cutting-edge, defense-critical U.S.-based companies by flooding markets using government support, that should alter U.S. assessments of whether Chinese acquisitions of the capabilities required to do so are acceptable.) The main goal here should be to deter dangerous Chinese actions; this means that the United States will need to be more open and clear about how its investment and export restrictions actually work. If, however, this effort to deter fails, changes in U.S. national security threat assessments will presumably lead to changes in the specific exports and acquisitions allowed by the U.S. government.

   This, to our knowledge, is the first time that a report sponsored by an executive branch agency has overtly recommended the inclusion of a reciprocity-like factor in a national security review. While the recommendation does not reflect official policy, it does reflect views being expressed within industry and government discussions, to which government officials in the CFIUS process are sure to be attuned.

2. **<u>Securing Approval for Transactions with Chinese Parties in the Semiconductor Industry Will Be Harder—but Not Impossible—Absent a Change in Policy by the Trump Administration.</u>** As a result of increased scrutiny and sensitivity, securing CFIUS approval for semiconductor transactions will likely be even more challenging than it already has been in recent years. Transaction parties should be prepared to respond to extensive inquiries relating to the transaction and to work aggressively with counsel to identify and address any potential national security issues arising from the transaction, ideally *before* the transaction is filed with CFIUS. That does not mean, however, that semiconductor transactions with Chinese parties will be impossible. CFIUS continues to approve such transactions where there are no perceived national security risks, or where it determines that the risks can be fully mitigated—and, as a legal matter, CFIUS must continue to comply with its clear statutory mandate only to take action where transactions threaten to impair U.S. national security.

3. **<u>The Most Intense Focus Will Be on Leading Edge Technologies.</u>** The report notes that leading edge semiconductor technology is "critical to sustaining a national-security edge," and concludes that policymakers should focus principally on such technologies. As a general rule, therefore, we expect transactions involving leading-edge technology to receive more scrutiny than those involving less advanced or more commoditized technologies. In transactions involving less advanced technology, CFIUS is more likely to focus on other issues such as supply security and integrity.

4. **<u>The U.S. Government Is Likely to Use Available Authorities, Including CFIUS, to Address Perceived Risks from Transactions, Including Transactions That Are Principally Outside the United States.</u>** Given the globalized nature of the semiconductor industry, even transactions with only a tangential connection to the United States may be viewed as presenting risks to U.S. national security. The Aixtron transaction, for example, principally involved assets that were outside the United States, and while the President's order carefully focused on the U.S. business of Aixtron, its scope potentially could encompass assets of Aixtron *outside* the United States, to the extent those assets are "used in, or owned for the use in or benefit of" Aixtron, Inc.'s activities in the United States. As a result, transaction parties should not assume that they do not need to file with CFIUS because a business has only a tangential connection to the United States, but rather confer with experienced CFIUS counsel early in the process to identify potential issues and solutions.

5. **<u>The U.S. Government Is Likely to Work More Closely with Allied Governments to Address Perceived National Security Risks Arising in the Semiconductor Industry, Including on Export Controls.</u>** The report recommends that the United States work with allies to strengthen global export control and inward investment security. In the Aixtron case, media reports suggested that the German government withdrew its approval of the transaction after receiving previously-unknown security-related information from U.S. intelligence officials. We expect that U.S. authorities will increasingly work with counterparts in U.S.-ally countries that are leaders in semiconductor technology, including Japan, Korea, Germany, and the Netherlands, among others. In the export controls area, this could take the form of seeking agreement with such countries on approaches to licensing the export of technology to China or Chinese persons, and pressing for greater enforcement of export control rules when there are violations involving China or Chinese persons.

6. **<u>There Is Increased Potential for Legislative Activity in the U.S.</u>** While the PCAST report generally seems supportive of decreasing regulatory burdens on the semiconductor industry—and it does not call for any reform of CFIUS—the concerns raised by the report could be cited by those exploring CFIUS-related legislation as further grounds for reforms targeted at China. As we have written previously, while the legislative landscape in the new Congress is still being defined, there is a greater chance now than at any time in the last decade of potential legislation to amend CFIUS. Among the reforms being considered include amendments that would expand CFIUS to cover licensing transactions or transactions that result in a contribution of technology or know-how from the U.S. to overseas joint ventures—which are being driven in part by concerns over transfers of semiconductor expertise to China. Thus, while the report does not call for legislation, it could be cited to substantiate potential reforms that will be debated in the next several months.

We hope that you find this analysis useful. Please do not hesitate to contact the following members of our International Trade Practice Group if you would like to discuss any aspect of the foregoing in further detail:

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