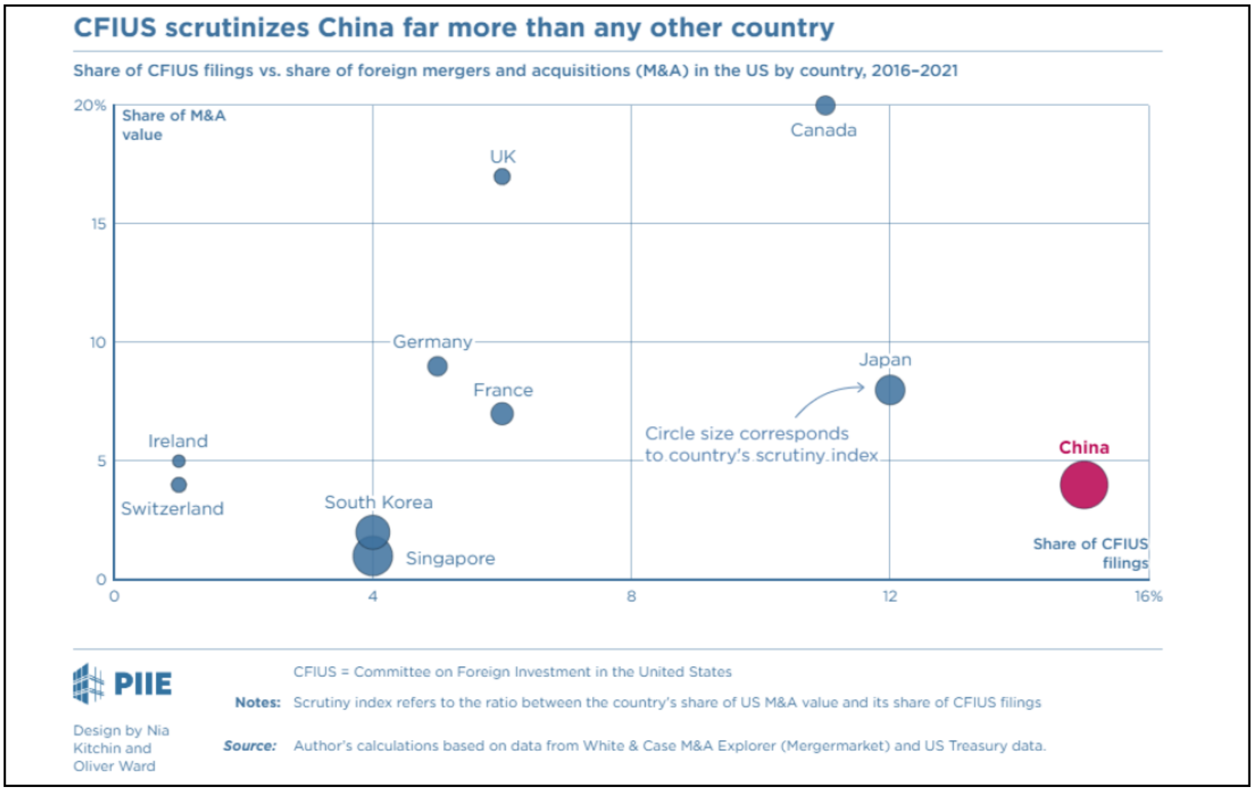
Topic: Reciprocity in US-China Relations for Foreign Direct Investment (FDI)

Does "reciprocity" in the relationship promote openness in the markets?
Advancing reciprocal access through the use of national security investment reviews – fact vs fiction

BLUF: Establishing forms of economic reciprocity are often identified as part of a comprehensive solution to address the imbalance in global competition with China. However, **regulatory reciprocity with respect to foreign direct investment, particularly within national security investment reviews, is unlikely to address any of the outstanding issues relative to market access.**

Key Question: Would U.S. companies, and the U.S. government, agree to the same type of conditions of a national security investment review performed in China if "reciprocity" existed for U.S. companies to enter the Chinese market (i.e., providing "market access" under the same / similar / reciprocal conditions as Chinese companies operating under CFIUS in the U.S.)?

- Framework for "Reciprocal" Conditions - TikTok Project Texas, the comprehensive security and governance framework developed during negotiations with CFIUS[1]
  - ***Would a U.S.-based social media company agree to the same conditions, oversight, and cost for Chinese market access?***
- The Peterson Institute for International Economics released a "scrutiny index," comparing countries share of M&A with their share of CFIUS reviews, concluding that China's scrutiny index is almost 4x larger than its share of M&A[2]



[1] What is Project Texas. Retrieved from: https://usds.tiktok.com/what-is-project-texas/
[2] U.S. Security Scrutiny of Foreign Investment Rises, but so Does Foreign Investment. Retrieved from: https://www.piie.com/blogs/realtime-economic-issues-watch/us-security-scrutiny-foreign-investment-rises-so-does-foreign

National Security Investment Reviews - Reciprocity: Both the U.S. and China maintain processes for national security reviews of foreign investments; in the U.S. this is the Committee on Foreign Investment in the United States (CFIUS) processes which regulates foreign investments if the transaction poses a risk to national security, and in China it is the Foreign Investment Security Review Measures (NSR) which took effect in 2021.[3]

China's NSR legal regime was introduced partly in consideration of the global trend to launch of enhance similar frameworks – including the expansion of CFIUS through the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA).

Issue: ***The conventional wisdom is that there is a substantial imbalance in the relationship between the United States and China across a number of critical market sectors, and that the U.S. should insist on reciprocity in the relationship to promote openness in the markets.*** The lack of economic reciprocity includes factors such as: (1) market entry restrictions – foreign companies are not allowed to invest in certain sectors; (2) competitive disadvantage – foreign companies face difficulties when operating in China compared to Chinese-owned companies; and (3) China utilizing the openness and transparency of other nations regulations but not extending reciprocal treatment.

A key component in evaluating reciprocity is the concept that this imbalance creates an unreciprocated level of access and influence on U.S. businesses, and conversely U.S. economic and technological superiority.

Research concludes that bilateral FDI flows are affected by national security concerns, particularly where national security risk is considered high, and the foreign firm is government owned as compared to privately owned.[4] Specifically, in the relationship between the U.S. and China as it relates to business operations and FDI:

"The Government of the People's Republic of China uses multiple policy tools, including caps on foreign equity ownership, data localization, and other administrative procedures, to coerce foreign companies to transfer technology as a precondition for market access. These policies pose immediate and far-reaching challenges for United States companies and limit market access for United States products and services in ways that Chinese counter parts do not face in the United States market."[5]

The Solution? An often-cited resolution to this issue is to establish "reciprocity" on trade restrictions or investments within each respective country, such as committing to structural changes in trade and economic policies, meeting previously made bilateral and multilateral commitments, and ***addressing national security concerns related to the targets of Chinese investments in the U.S. and U.S. investments in China.***

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[3] FAQ regarding China NSR. Retrieved from: https://www.ibanet.org/frequently-asked-questions-regarding-the-National-Security-Review-in-China

[4] Reciprocity and Public Opposition to Foreign Direct Investment. Retrieved from: https://scholar.harvard.edu/files/dtingley/files/cmt-mergers.pdf

[5] Excerpt from the *True Reciprocity Act of 2023*, legislation to address the substantial imbalance in the relationship between the U.S. and China. Retrieved from: https://www.sullivan.senate.gov/imo/media/doc/reciprocity_102423.pdf

Examining Reciprocity in National Security Reviews of FDI:

To examine whether reciprocity is a viable option, one must consider whether process, standards, and outcomes would be agreed-upon if they were "reciprocal" (i.e., treated in a mutually agreeable similar manner). Using TikTok's Project Texas as an example framework, ***would the U.S. government permit and/or would a U.S.-based social media company agree to the same conditions, oversight, and cost for Chinese market access?***

Consider the following comprehensive security, governance, and compliance controls of Project Texas, for which TikTok has claimed to develop with CFIUS over the last 2+ years, and spent more than $1.5 billion to date, addressing the following key risks: (1) unauthorized access to data; (2) state influence over content; and (3) untrustworthy software and systems.[6] [7]

- **TikTok U.S. Data Security Inc. (USDS):** TikTok established USDS in July 2022, which is a subsidiary that houses the functions of TikTok's business that are most likely to give rise to national security concerns, such as access to U.S. citizen data, and decisions on content moderation. In addition, it will be governed by an independent board of directors, and Oracle will oversee the data entering and exiting the entity. USDS houses U.S. user data, software code, backend systems, and content moderation, as well as replicating several core functions of TikTok's global business.
  - *Would a U.S. company operating in China agree to:*
    - *Establish a new operating subsidiary, with an independent board of directors approved by the Chinese government – who then report to the Chinese government?*
    - *Agree to all content moderation to be handled in China based on local regulations?*
    - *Agree to house all data and source code for the application with a Chinese tech company – such as Tencent, Huawei or Alibaba Cloud?*
- **Oracle Cloud (Data Storage and Access):** As of June 2022, 100% of all U.S. user traffic is routed to the Oracle Cloud Infrastructure in the United States, and all access to that environment is managed exclusively by TikTok U.S. Data Security. Oracle Cloud hosts the TikTok platform in the U.S., including the algorithm and content moderation functions. Oracle will use a combination of automated processes and human review to monitor the data flows for security breaches or improprieties.
  - *Would a U.S. company operating in China agree to:*
    - *Agree to permit the Chinese tech company to review and monitor data flows?*
- **Oracle (Software Security Review Process):** Oracle will also lead a security review process that will examine all TikTok software. Oracle will conduct its own assessment of all TikTok code, alongside a third-party inspector who must be approved by CFIUS. Once the code passes this inspection, it is digitally signed by Oracle. After that, the software is permitted to run. If Oracle does not provide a digital signature, the software cannot run. Oracle will also be responsible for delivering updates to the Google and Apple app stores.
  - *Would a U.S. company operating in China agree to:*
    - *Agree to place the key intellectual property – the application algorithm – with the Chinese tech company (i.e., Tencent, Huawei, Alibaba) – and permit that company to inspect and monitor the code (with a Chinese government-approved third-party inspector)?*

[6] TikTok Project Texas. Retrieved from: https://usds.tiktok.com/faq-tiktok-usds/
[7] Project Texas: The Details. Retrieved from: https://www.lawfaremedia.org/article/project-texas-the-details-of-tiktok-s-plan-to-remain-operational-in-the-united-states