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2020

## Great Powers and New Risks: What Businesses and Regulators Should Know about China's Strategic Ambitions

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# Great Powers and New Risks: What Businesses and Regulators Should Know about China's Strategic Ambitions

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October 2020

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*The views in this article are those of the authors in their capacities as academics only and not necessarily those of the U.S. government. The authors take no position on any pending or proposed legislative or other governmental actions.*

Abstract:

China's geopolitical ambitions give rise to risks that government agencies and the businesses they regulate need to address. In particular, Military-Civil Fusion (MCF), a whole-of-government legal and administrative machinery created by the Chinese Communist Party (CCP), aims to give China's military, as well as China's state-championed companies, the technologies essential to strategic competitiveness in the decades ahead. In service of China's effort to acquire technology, MCF breaks down barriers of professional responsibility and confidentiality that organizations and individuals in the West take for granted. Through both executive and legislative action, the United States has begun to address MCF. To continue benefitting from opportunities that China presents, those who do business in or with China therefore need both to heighten their situational awareness when they transact with Chinese partners and to increase their familiarity with the responses that United States regulators now are developing.

## Introduction

Businesses and regulators concerned with their integrity have a role to play in an unexpected place: the geopolitical arena of great power competition. Policymakers in the United States and like-minded countries have begun to recognize, after several decades of inattention, that we live, after all, in a world of

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competition between great powers. Nowhere is that competition more sharply felt than from the People's Republic of China (PRC), a country that the United States' free trade philosophy was indispensable to lifting to its current rank as second largest economy in the world. However, democratization, human rights, and rule of law have not gone hand in hand with China's economic advance, as it was once hoped they would. Moreover, the PRC now openly endeavors for supremacy in technologies that are crucial to its ambition to place China at the center of a global web of economic, political, and military dependency.

To respond to China's ambition, which it pursues through a whole-of-system strategy of technology theft,<sup>1</sup> Western governments are adapting across multiple substantive domains. The institutions of government that are directly tasked with responsibility for foreign policy and defense are the most obvious focal points for adaptation. However, to respond effectively to the challenge, the West must consider how great power competition affects others, both in the private and the public sectors. Businesses and regulators are no strangers to adaptation. Accordingly, so long as they have a clear picture of the challenge, they are well-positioned to adapt. This article argues, moreover, businesses and regulators can adapt in ways that not only mitigate the financial and security risks that China's geopolitical ambitions present, but also can do so in ways that affirm the values that define us.

With President Donald Trump's achievement of the Phase One Agreement between the United States and China before the global pandemic and Beijing's violation of international commitments to the autonomy of Hong Kong, opportunities were more readily at hand for mutually beneficial engagement with China. Those opportunities remain real. That said, individuals and institutions hoping to benefit need to approach business in, and with, China with the right information. They should be prepared to adapt in appropriate ways to the inherently competitive dynamic that exists between the United States and the PRC. This article offers insights into how the PRC's strategic behavior may present risks that even now remain underappreciated and explores several ways businesses and relevant regulators might adapt.

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<sup>1</sup> Presidential Proclamation: Suspension of Entry as Nonimmigrants of Certain Students and Researchers from the People's Republic of China, May 29, 2020: "The People's Republic of China (PRC) is engaged in a wide-ranging and heavily resourced campaign to acquire sensitive United States technologies and intellectual property, in part to bolster the modernization and capability of its military, the People's Liberation Army (PLA)."

## The Adaptable Regulator

A regulator, where appropriate, focuses its adaptations as it becomes aware of specific shifts in risk. Being alert to shifts in risk is a crucial part of the regulator's work. In recent years, the U.S. Securities and Exchange Commission (SEC), for example, has recognized the importance of risk awareness and has taken steps accordingly. In its Strategic Plan for 2018-2022, the SEC challenges itself to adapt to evolving risks and other developments in the markets that it regulates and to enhance its analytical capabilities to improve its understanding of those markets.<sup>2</sup> Other regulators, too, have been alert to changing risks. In December 2019, Heath P. Tarbert, Chairman of the U.S. Commodity Futures Trading Commission (CFTC), noted the transition away from the long-used London Interbank Offered Rate (LIBOR). He underscored that a firm's ongoing reliance on LIBOR is a source of risk to the firm and also to the global financial system.<sup>3</sup> Earlier, the CFTC chairman noted that digital and cyber currencies, as well as the blockchain technology behind them, present new regulatory challenges that the United States must adapt to. This adaptation is needed for the immediate purpose of mitigating security and market risks that abuse of those tools entail. In addition, adaptation is needed and for the long-term purpose of keeping U.S. regulatory oversight relevant and for supporting American leadership in the international competition for financial services.<sup>4</sup>

Risks to which regulators adapt thus run the gamut from the prosaic to the extraordinary and fundamental. Clearly, China presents extraordinary and fundamental risks. Regulators have been increasingly alert to these risks. Recently, for example, the SEC highlighted serious questions that corporate accounting practices in China raise about the reliability of information Chinese companies supply to the investing public. Lawmakers, too, have noticed. The United States Senate in May 2020 moved forward a bill titled the Holding Foreign Companies Accountable Act that would further shine a spotlight on Chinese companies and include the possibility that the least transparent among them will be delisted from United States exchanges.<sup>5</sup> On May 29, 2020, President Donald

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<sup>2</sup> U.S. Securities and Exchange Commission, *2018-2022 Strategic Plan* (Oct. 11, 2018), <https://www.sec.gov/reports-and-publications/strategic-plan/reports-strategic-plan-2018-2022>

<sup>3</sup> Tarbert Statement, Commodities Future Trading Commission, <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement121119>

<sup>4</sup> Tarber Statement <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement032420a> See also <https://fortune.com/2019/11/19/bitcoin-blockchain-fintech-regulation-ctfc/>

<sup>5</sup> <https://www.congress.gov/bill/116th-congress/senate-bill/945>

Trump, in the most significant initiative up to that point in time on corporate transparency and Chinese companies, directed the Presidential Working Group on Financial Markets to study Chinese companies listed on U.S. exchanges to protect the integrity of America's financial system.<sup>6</sup> Then, on November 12, 2020, by Executive Order 13959, the President established a prohibition on "any transaction in publicly traded securities, or any securities that are derivative of, or are designed to provide investment exposure to such securities, of any Communist Chinese military company," a list of such companies being defined in the Executive Order.<sup>7</sup>

Each regulator, unsurprisingly, is most attuned to risks facing business firms operating within its own national jurisdiction. But, as the CFTC chairman's remarks about LIBOR, as well as cryptocurrencies suggest, and as the initiatives by the SEC, the Senate, and the President illustrate regarding foreign accounting practices and Chinese military companies, regulators and political leaders alike recognize that certain risks are not confined to a single national jurisdiction.

Regulators also tend to focus on the risks arising directly from the subject matter they regulate. Such focus is natural—even necessary. Each regulator must prioritize where it allocates its time, expertise, and analytic capacity. Moreover, a national legal framework sets down the powers of a regulator. No one regulator is expected to spot every risk that might affect the markets that fall within its mandate, and no one regulator has a mandate to regulate everything.

The interplay of risks in the world at large, however, takes place without regard to formal delimitations. Sovereign states in which each regulator functions interact with other sovereigns in markets that span national borders. Consequently, the behavior of business firms in those markets is not the only source of risk.

### **Risk Enters a World of Great Power Competition**

For most of the twentieth century, to speak of geopolitics and competitive dynamics between states was the bread and butter of foreign policy, security policy, and a significant field of academic inquiry. During the Cold War, though people referred to them as "superpowers," the United States and the Soviet Union were engaged in a competition that—except for the specific technologies

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<sup>6</sup> Remarks by President Trump on Actions Against China, White House Brief, May 29, 2020, [https://www.whitehouse.gov/briefings-statements/remarks-president-trump-actions-china/?utm\\_source=link&utm\\_medium=header](https://www.whitehouse.gov/briefings-statements/remarks-president-trump-actions-china/?utm_source=link&utm_medium=header). See, also, "Trump Administration to Study Ways to Protect U.S. Investors from Chinese Firms," *Reuters*, May 29, 2020, <https://money.usnews.com/investing/news/articles/2020-05-29/trump-administration-to-study-ways-to-protect-for-us-investors-from-chinese-firms>.

<sup>7</sup> E.O. 13959 (Nov. 12, 2020): 85 Fed. Reg. 73185.

involved—would have been familiar to statesmen of the nineteenth century. They called it great power competition. Market economies have functioned over long periods in environments of great power competition. The Cold War is the most familiar example of such a period because it is the most recent. Moreover, many regulatory bodies, financial mechanisms, and business practices that are mainstays of today’s world economy and national economies already functioned or had recognizable antecedents at that time.

But today’s competitive environment is also different from that of the Cold War in important ways. Unlike the Soviet Union during the Cold War, the People’s Republic of China became a productive economy, attracting investment in practically every sector and traded on a global scale. A “complacent enthusiasm about the near-term potential for profits in the Chinese market” thus influenced much of the thinking, and action, regarding the PRC.<sup>8</sup> Consequently, through the 1990s and until recently, few policymakers were comfortable saying that China was emerging not just as an economy, but also as a competitor on a geopolitical stage. Reticence was understandable, at least for a while: Business firms and investors prospered in the China market; and some observers postulated that China would undergo a political evolution toward both democracy and rule of law as its prosperity increased. More recently, however, policymakers in the United States and like-minded countries have begun to refine their understanding of the PRC and its geopolitical ambition.<sup>9</sup>

The details of the PRC’s understanding of its place in the world have not been hidden from view. However, for a long time, they were rarely on the minds of English-language audiences and the business community—or regulators—outside of China. In the past several years under the Trump administration, U.S. policymakers have started to address the details. The Trump administration’s National Security Strategy, published in December 2017, initiated the much-

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<sup>8</sup> Christopher A. Ford, Remarks to the U.S. Chamber of Commerce, *Preventing U.S. Industry’s Exploitation by China’s “Military-Civil Fusion” Strategy* (Apr. 2, 2020): <https://www.state.gov/preventing-us-industry-exploitation-by-chinas-military-civil-fusion-strategy>

<sup>9</sup> “WTO members expected China to continue on its path of economic reform and transform itself into a market-oriented economy and trade regime. These hopes were not realized. Beijing did not internalize the norms and practices of competition-based trade and investment.”. See United States Strategic Approach to the People’s Republic of China (May 20, 2020): <https://translations.state.gov/2020/05/20/united-states-strategic-approach-to-the-peoples-republic-of-china/> See, also, Keith Krach, Under Secretary of State for Economic Growth, Energy, and the Environment: “It’s time to take off those rose-colored glasses and treat the Chinese Communist Party not as we hoped they’d be, but how they are”: [https://twitter.com/State\\_E/status/1266538567339302915](https://twitter.com/State_E/status/1266538567339302915) (May 29, 2020).

needed course adjustment by emphasizing that, whatever past U.S. administrations may have thought, our competitors never forgot about great power competition.<sup>10</sup> China, in that competition, presents a distinct challenge. As U.S. Assistant Secretary of State for International Security and Nonproliferation (ISN) Christopher A. Ford in a speech in September 2019 explained, China is a geopolitical revisionist, a sovereign seeking, in a strategy of great power competition, to change the rules of the road to favor its own emergence into the dominant socio-political system of the era.<sup>11</sup>

Great power competition has emerged as the PRC frustrates expectations that economic growth would correlate to democracy and rule of law. Certain indicators are well known of the PRC's continued divergence from a democratic and rules-based path. Front page stories include the PRC's crackdown on democracy activists in Hong Kong and, more recently, the liquidation of Hong Kong's internationally guaranteed autonomy (an extraordinary step that ignores legally binding treaty commitments that China entered into in 1984 to preserve that part of China's unique "one country, two-systems" approach); its military posturing and base building in the South China Sea (ignoring freedom of navigation in the world's busiest shipping lanes and running roughshod over environmental standards and other countries' valid rights and claims); and its strategically manipulative Belt and Road Initiative loans (ignoring international good governance standards in underdeveloped countries). But these examples, given due prominence in the West, are not exhaustive.

One facet of the PRC's strategy of great power competition that until recently had been overlooked largely is a doctrine that the PRC calls Military-Civil Fusion (MCF).

### **China's Military-Civil Fusion and Risk**

In June 2019, Robin Cleveland, Chairman of the U.S.-China Economic and Security Review Commission, described the concept of MCF as "a whole-of-nation effort [by the PRC] to foster linkages between commercial production, institutional

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<sup>10</sup> <https://www.whitehouse.gov/wp-content/uploads/2017/12/NSS-Final-12-18-2017-0905.pdf>

<sup>11</sup> Christopher A. Ford, State Department, Bureaucracy, and Counterstrategy: Meeting the China Challenge, Sept. 11, 2019: <https://china.usc.edu/christopher-ford-state-department-bureaucracy-and-counterstrategy-meeting-china-challenge-sept-11> See, also, Christopher A. Ford, *Competitive Strategy vis-à-vis China and Russia: A View from the "T Suite"*, ACIS Papers vol. I, no. 6, May 11, 2020: <https://www.state.gov/wp-content/uploads/2020/06/T-paper-series-6-Strategic-competition-508.pdf>.

research, and military programs.”<sup>12</sup> Public discussion of the Military-Civil Fusion, such as this, focused attention on the *outcomes* that the PRC hopes to achieve—in particular, military and economic dominance in critical emerging technologies such as artificial intelligence (AI) and quantum computing.<sup>13</sup> In a fact sheet on MCF published in May 2020, ISN, on the basis of a long-running examination of open-source PRC materials, describes MCF as a program of the Communist Party of China (CCP) for “systematically reorganizing the Chinese science and technology enterprise to ensure that new innovations simultaneously advance economic and military development.”<sup>14</sup> Indeed, official PRC organs are clear about the outcomes China aims to achieve through MCF. For example, the Xinhua News Agency describes MCF as a “powerful driving force and strategic support for realizing the China dream, [the] strong military dream.”<sup>15</sup> That “dream,” in both its civilian and its military aspects, means primacy over all other countries in any field of strategic or economic significance.

Outside China, while awareness is growing as to what Beijing hopes the MCF will achieve, less attention has been given to how it precisely works as a tool of sovereign strategy. It was thus subtle but critically important, when U.S. Secretary of State Michael Pompeo recognized in remarks to Silicon Valley technology leaders on January 13, 2020, that MCF is more than a set of goals. It is a mechanism to which PRC law gives meaning and substance:

It’s a technical term but a very simple idea. Under Chinese law, Chinese companies and researchers must—I repeat, must—under penalty of law, share technology with the Chinese military.<sup>16</sup>

The legal implications indeed are sobering—and, yet, they are only starting to be recognized and their full scope explored. MCF is implemented under a Law for Managing National Defense Requirements and Joining Programs in Economic Buildup and National Defense.<sup>17</sup> MCF also involves a wide range of further laws aimed at particular strategic sectors. For example, the PRC’s Atomic Energy Law mandates that Chinese industry “shall adhere to the strategy of ‘military-civilian

<sup>12</sup> <https://www.uscc.gov/sites/default/files/Opening%20Statement%20-%20Cleveland.pdf>

<sup>13</sup> <https://www.uscc.gov/sites/default/files/2019-10/June%207,%202019%20Hearing%20Transcript.pdf>

<sup>14</sup> *What is MCF?* <https://www.state.gov/remarks-and-releases-bureau-of-international-security-and-nonproliferation/mcf-and-the-prc/> (May 28, 2020).

<sup>15</sup> [http://www.xinhuanet.com/politics/2018lh/2018-03/12/c\\_1122526642.htm](http://www.xinhuanet.com/politics/2018lh/2018-03/12/c_1122526642.htm)

<sup>16</sup> <https://id.usembassy.gov/remarks-by-secretary-pompeo-on-technology-and-the-china-security-challenge/>

<sup>17</sup> <https://jamestown.org/wp-content/uploads/2019/10/Read-the-10-08-2019-CB-Issue-in-PDF.pdf?x97873>

integration” in order to “implement the overall national security concept” as “[t]he State strengthens the convergence of military and civilian science and technology planning . . . in the atomic energy field . . . and guides the transfer of advanced technology to the two-way transfer [between the] military and civilians to achieve military-civilian integration.”<sup>18</sup> Little public comment in the West has been directed at parsing the language of these and other MCF-related laws, much less at connecting the dots between the laws and the actual conduct of the myriad Chinese institutions and individuals who fall within their compass.

Connecting the dots is critical, if Western governments, companies, and the investing public are to recognize the full scope of MCF and the risks it presents to both national security and to those who do business in and with China. The ISN Fact Sheet on MCF elaborates on the various methods that MCF embraces:

The CCP is developing and acquiring key technologies through licit and illicit means. These include investment in private industries, talent recruitment programs, directing academic and research collaboration to military gain, forced technology transfer, intelligence gathering, and outright theft.<sup>19</sup>

Steps that the Trump administration is taking to secure the integrity of American research universities in the face of China’s technology theft are noteworthy. The Presidential Proclamation from May 2020 takes a hard look at the small subset of Chinese students and researchers who enter American university and other research labs for the purpose of stealing sensitive technology.<sup>20</sup> However, MCF comprises a range of tools and methods of which *male fide* entry into research institutions is just one example.

The reach of MCF is not surprising when one considers its keystone role in the CCP’s strategy to supersede and displace any competitors. Its origins, too, point to MCF’s reach: MCF has not sprung into being overnight. PRC writers referred to fusion-like efforts as early as the 1990s, and over time the concept entered PRC leaders’ parlance. One may surmise that PRC leaders needed no great

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<sup>18</sup> <http://www.china-nea.cn/site/content/33557.html>

<sup>19</sup> *How is The PRC Targeting These Technologies?* <https://www.state.gov/remarks-and-releases-bureau-of-international-security-and-nonproliferation/mcf-and-the-prc/> (May 28, 2020).

<sup>20</sup> *Proclamation on the Suspension of Entry as Nonimmigrants of Certain Students and Researchers from the People’s Republic of China* <https://www.whitehouse.gov/presidential-actions/proclamation-suspension-entry-nonimmigrants-certain-students-researchers-peoples-republic-china/> (May 29, 2020).

conceptual effort to accommodate and foster this development. For MCF, as a legal institution and mandate, has precedent in a much older Chinese tradition. “[T]he governing philosophy of the CCP,” writes ISN Assistant Secretary Ford,

owes [much] to ancient Chinese Legalism, a philosophy that aimed at achieving and consolidating absolute power, and which saw the purpose of law as being to support the power of the ruler rather than to make power in any way accountable . . . [a] system of governance . . . grounded not in the rule *of law* but rather in . . . rule *by and through law*.”<sup>21</sup>

Chairman Xi Jinping has made military-civil fusion a centerpiece of China’s national strategy today. If such apex-level espousal, plus a framework with deep roots in China’s tradition of legalism, were not enough to make the point, institutional changes further demonstrate that MCF is not just declaratory. The PRC government has given MCF substance with an institutional architecture. The Central Commission for the Development of Military-Civil Fusion began operating in January 2017,<sup>22</sup> and the Commission’s management is entrusted to Vice Premier Zhang Gaoli, one of Beijing’s most senior officials.<sup>23</sup> MCF—purposed to support the power of China’s ruler today, the CCP and equipped by the CCP with a range of legal authorities and personnel to use them—echoes the philosophy that views law as an accessory in service to those who rule the state.

If MCF were simply a declaration of intention associated with no real action in Chinese institutions and society, then it would still be important for the

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<sup>21</sup> Christopher A. Ford, *U.S. National Security Export Controls and Huawei: The Strategic Context in Three Framings*, ACIS Papers vol. 1 no. 8 (May 22, 2020), p. 4, <https://www.state.gov/wp-content/uploads/2020/05/T-Paper-Series-U.S.-National-Security-Export-Controls-and-Huawei.pdf>. See also *United States Strategic Approach to the People’s Republic of China* (May 20, 2020): “The United States rejects CCP attempts at false equivalency between rule of law and rule by law...” <https://translations.state.gov/2020/05/20/united-states-strategic-approach-to-the-peoples-republic-of-china/>

<sup>22</sup> Elsa B. Kania, *In Military-Civil Fusion, China Is Learning Lessons from the United States and Starting to Innovate* (Aug. 27, 2019), Real Clear Defense, [https://www.realcleardefense.com/articles/2019/08/27/in\\_military-civil\\_fusion\\_china\\_is\\_learning\\_lessons\\_from\\_the\\_united\\_states\\_and\\_starting\\_to\\_innovate\\_114699.html](https://www.realcleardefense.com/articles/2019/08/27/in_military-civil_fusion_china_is_learning_lessons_from_the_united_states_and_starting_to_innovate_114699.html).

<sup>23</sup> Lorand Laskai, *Civil-Military Fusion: The Missing Link Between China’s Technological and Military Rise* (Jan. 29, 2018): <https://www.cfr.org/blog/civil-military-fusion-missing-link-between-chinas-technological-and-military-rise>

message that it conveys. Yet, it would not necessarily cause much concern in the United States and like-minded countries' institutions and individuals whose business it is to be concerned with financial risk. But, clearly MCF is now not just a declaration of intention. It is an operational code with operational capabilities, and it finds fertile soil in a long tradition of legalistic mechanisms employed by China's rulers to cement their power. It is timely to consider how MCF might increase the risks faced by the United States and other foreign parties involved with China.

### **MCF Unknowns**

When businesses from the West began their first tentative forays into China following Deng Xiaoping's economic reforms of 1978, the country was largely *terra incognita*. The growth of the Chinese economy in the decades that followed unsurprisingly involved ever deeper and more diverse trade and investment relationships. As those relationships multiplied, whole cadres of Western financiers, investors, and business managers became acclimated to China's idiosyncrasies and challenges.

Even so, in recent years, the United States and like-minded countries have expressed heightened concerns over favoritism, corruption, intellectual property theft, and other practices endemic in the PRC that do not accord with free society expectations. PRC leaders have not been idle in the face of these concerns. Rather, their efforts have been visible particularly in the court system, where they have made high-profile adjustments, especially regarding courts that have jurisdiction over disputes that might concern foreign investors. Thus, for example, in August 2018, China announced the opening of the Shanghai Financial Court for high-sum finance-related cases<sup>24</sup> and a two-chamber China International Commercial Court (one chamber in Shenzhen, one in Xi'an).<sup>25</sup> Other institutional changes have been promised, especially to address intellectual property concerns. In a first of its kind, President Trump's Phase One Agreement between the United States and China provided that the PRC will observe the substance of intellectual property protection and will supply procedures, including before Chinese courts and regulatory agencies, for parties to protect their intellectual property rights.<sup>26</sup> China pledged in the agreement that its government personnel and third-party experts or advisers involved in legal proceedings shall not make unauthorized

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<sup>24</sup> [http://english.court.gov.cn/2018-08/22/content\\_36806558.htm](http://english.court.gov.cn/2018-08/22/content_36806558.htm)

<sup>25</sup> <http://cicc.court.gov.cn/html/1/219/193/195/index.html>

<sup>26</sup> <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/december/united-states-and-china-reach>

disclosure of trade secrets or confidential business information that parties submit in the proceedings.<sup>27</sup>

Winning this commitment was a significant negotiating achievement for the United States because it highlights a vital American interest, as well as an assent by the PRC to respect that interest. It further encourages the important ongoing improvements China had been making to the professionalism of its courts, regulatory agencies, and their staffs. These initiatives would help business entities outside China. They also would help China continue to contribute to—and benefit from—the world trading system from which it has profited so much in the past decades, including by drawing farther outside investment into the Chinese economy.

There is, however, a vital risk embedded in all of these actions. A focus on specific interactions between actors can obscure the larger forces and consequences involved. For investment in China, reliance on professional and fair dispute resolution between the parties involved may lose sight of overall China risk from MCF.

A metaphor illustrates how a party, if oblivious to the frame that MCF places around virtually all activity involving China, including in China's courts, might expose itself to risk. Let's imagine two people shouting and gesticulating at each other. The situation appears to escalate; it looks as though the two people are intent on violence. A man, sitting a few feet away, sees them, stands, makes his way forward, and breaks them apart. His intervention, however, is met with dismay, not applause, for the "fight" he thinks he's intervened to break up was, in truth, being acted out by performers on a stage as part of an opera. Ushers rush onstage and hustle the man away. The point is, some scenes, however realistic they may appear, must be understood in the context in which they are taking place. If we fail to discern the context, we run the risk that our actions will hurt more than help. In the embarrassing opera episode, all that is at stake is the rest of the audience's loss of enjoyment, and perhaps a misdemeanor citation. A business firm from abroad, if it fails to discern how MCF embraces China's citizens, companies, and public institutions, might err more subtly in its misperception of what is going. The consequences for the firm, however, may be a great deal costlier.

Business firms from abroad with dealings in China are resorting less reluctantly than before to Chinese courts and agencies. The shift is reflected, for example, in the attention that American and other lawyers are giving to the new

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<sup>27</sup> Economic and Trade Agreement Between the United States of America and the People's Republic of China: Phase One (Jan. 15, 2020), Article 1.9 sec.

1: "Protecting Trade Secrets and Confidential Business Information from Unauthorized Disclosure by Government Authorities"

Chinese judicial bodies.<sup>28</sup> Focusing purely on the conduct of proceedings in many PRC courtrooms—at least when it comes to commercial litigation—this trust in PRC institutions may appear justified. In recent years, PRC court judgments—whether concerning patents, trademarks, copyrights, or even trade secrets—have been reported to be generally well founded on applicable facts and law, reached through ever-improving professional procedures, and fair in avoiding bias towards either litigating party when both parties are ordinary commercial entities.<sup>29</sup> *Inter partes*—between Company A and Company B on a given day in the right Chinese court—PRC justice in some sectors has attracted increased confidence.

But even if the confidence seems well-founded, a party contemplating involvement in such PRC institutions should not lose sight of the larger stage on which they operate. As China's MCF communicates in clear terms, all persons and organizations in the PRC are called to a duty that transcends their personal and civilian identities in their readily observable roles. The true risk-return calculus to doing business in the PRC includes an account of how MCF imposes obligations flowing in multiple directions among personnel in Chinese courts and agencies, national leadership, national security apparatus, and state-owned or state-championed commercial firms.

To say that a Chinese court is a safe place to go because the judge applies procedure correctly and is fair between disputing parties on the day is to reach an incomplete conclusion. A court exists and functions within a larger social and political setting. A triumph of societies with well-established rule of law is the high degree of independence judges enjoy from social and political forces that exist outside the courtroom. It may give comfort to assume that independence of *curia* from *polis* is observed in China. However, to make this assumption exposes a litigant to a series of unknowns. A party doing business in China and finding itself in front of a seemingly modern, technocratically sophisticated Chinese court or agency must widen the lens beyond the courtroom and ask hard questions. Courts and agencies do not function in a vacuum. Western parties, if they are to have meaningful information about the risks involved, need a better understanding of the obligations, habits, and expectations that shape the conduct of each dispute

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<sup>28</sup> American: <https://www.wilmerhale.com/en/insights/client-alerts/20190605-chinas-new-financial-court>

Other: <https://hsfnotes.com/asiadisputes/2019/06/07/chinas-international-commercial-courts-hear-first-cases/>.

<sup>29</sup> See, e.g., <https://www.ipwatchdog.com/2019/03/28/china-court-delivers-first-judgment-in-favor-of-a-foreign-company-under-anti-unfair-competition-law/id=107750/>  
See also, for a PRC official highlighting IP adjudication, [https://www.wipo.int/wipo\\_magazine/en/2019/03/article\\_0004.html](https://www.wipo.int/wipo_magazine/en/2019/03/article_0004.html)

settlement institution and of its individual personnel. They need to consider the wider stage on which those courts and agencies perform their functions.

We think a category of risk may well inhere in the difference between how duties of loyalty run in the Chinese system and in the United States and like-minded countries. There is no doubt that China's MCF imposes duties of loyalty. A full range of individuals and institutions are obligated under MCF to put their know-how in service to the PRC's larger strategic objectives. This adherence includes making technologies available to military end-users irrespective of whether commercial or national security end-use commitments have been made to non-Chinese suppliers. The present authors are not aware that a convincing case exists to show that this fusion of information to sovereign strategy does not include information obtained in the course of business transactions, shared in joint ventures with foreign investors, or, learned by a judge in a Chinese court. Indeed, by the express terms of PRC law, such transfers are obligatory, not merely optional.

In the United States and like-minded countries, loyalty to the sovereign is generally understood not to interfere with, much less to override, loyalty to the profitability of a business. In these countries, private people and companies may refuse to cooperate with government demands for access to information or materials absent specifically tailored and properly issued warrants or subpoenas—which are, almost by definition, exceptions to standard practice. After paying taxes set at broadly applicable rates, private people and businesses are generally free to save, invest, or spend their money as they wish. And when individuals gain access to valuable inside information of a private business and then trade on that information, or give it to a business associate or relative to trade on it, they are liable to be prosecuted, even if—indeed, especially if—they are at a government facility and hold a government office.

In U.S. courts and administrative agencies, for example, personnel working in those institutions are bound explicitly by numerous rules backed up by powerful enforcement mechanisms. This enforcement presumptively bars people from using or revealing information learned in their jobs when they interact with most others, whether within the government or without. And the rules that bind judges and others who work in regulatory or dispute settlement processes are reinforced by a surrounding professional ethic that imprints itself on legal personnel at every phase of career development.

Government personnel across Chinese courts and agencies, however, are demonstrably different in these respects from their counterparts in the United States and like-minded countries. This is not an observation about cultural differences; every country has a unique culture. The observation, instead, concerns specific legal duties and government mechanisms to enforce those duties that Beijing has put in place in its prosecution of a sovereign strategy of great

power competition. Duties of loyalty in the PRC run deep toward the state. An outsider doing business in China might be tempted to dismiss such an observation as unremarkable, considering MCF as just another national security program would be justified—if MCF applied only to government personnel and if those personnel functioned under constraints that reliably distinguish between private and public interests.

The problem is, approaching MCF that way would be to ignore what it really is. Under MCF, the legal duties are omnibus. They do not apply just to government personnel, for all Chinese citizens are subject to coercive statutes that give MCF legal teeth. Moreover, as for government personnel, in many private and ostensibly commercial entities, Communist Party cells operate and report independently to Beijing. MCF is a tool that guarantees that duties of loyalty to the party and state are not abstract—and that guarantees that those duties encompass society as a whole. They must be performed, and their performance serves explicitly to further the national interest in pursuit of concrete national military and economic goals, which, as a matter of state doctrine, are fused together. Depending on how the PRC elects to enforce MCF, personnel in China's courts and agencies may be more than authorized to devote their efforts and information to the benefit of China's political system and its security institutions. They may be *compelled* to do so.

The adjudication in China of a typical trade secret suit between two private firms might have all the outward marks of a fair and technocratically correct process. The firms may each enjoy world-class adjudication of their rights as between themselves. Depending on precisely what the relevant Chinese authorities say MCF means, however, the government personnel involved in that suit may be obliged to provide the sovereign with any and all technological and business information that the firms introduced in the proceedings. Beijing may then deploy such information to further sovereign goals, which include helping firms in China compete against either or both litigants, or helping China gain military advantage.

The same risk might well arise when private firms submit information to regulators in China, for example, in relation to antitrust, consumer safety, environmental impact, or export control matters. Disclosures to personnel inside Chinese regulatory agencies may find their way across all sectors of the government, civilian, military, and ostensibly non-governmental commercial world.

### Further Risks—and Possible Mitigation

The tools of the PRC's competitive strategy also reach private Chinese citizens abroad. Some of those private citizens have access to information that falls within MCF's compass. Recently, attention has been directed toward Chinese citizens in American, British, and other Western universities who have links to strategic institutions in the PRC and are researching sensitive technologies. These are not the only Chinese citizens who have information that the PRC might tap. Consider the incentive that a U.S. or other non-Chinese firm conducting significant business in China or with China may have to populate its executive suite or board of directors with individuals who possess authentic China-specific human capital and who are able to wield clout within China. Perhaps these individuals are members of the Communist Party of China or have family who are members. Such individuals, whether they know it or intend it, may in time be called to act upon much the same duties of loyalty to the sovereign as full-time personnel of China's government. The PRC's legal-political system simply leaves them no other option.<sup>30</sup>

Military-civilian fusion, thus, clearly constitutes a distinctive form of possible risk to business. The risk, however, is one that certain tools may be able to mitigate. Where might the tools be found? To come full circle, regulators of financial risk, in their well-practiced adaptability to changes in how risk is understood, may have the tools.

One crucial tool is simply to require transparency about risk, so that commercial actors can price it into their market interactions with entities subject to PRC jurisdiction. In this respect, risk disclosure in securities regulation is an area where careful adaptation could address risks arising from China's MCF. In the law of financial securities, it is axiomatic that companies have ongoing duties of disclosure to investors. In the United States, companies must make annual SEC filings (10-Ks) and quarterly filings (10-Qs), as well as disclosures in solicitations for voting proxies around corporate meetings and public statements of corporate officials—such as those customarily made at important junctures in the life cycle of the business. One of the core obligations in these filings and disclosures is the obligation to report risk. Risk reporting, though the SEC has detailed forms on

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<sup>30</sup> See Christopher A. Ford, *Competitive Strategy vis-à-vis China and Russia: A View from the "T Suite"*, ACIS Papers Vol. I No. 6 (May 11, 2020), p. 3, col. 1: "The CCP is able and willing to use its tools of domestic political compulsion and overseas influence to coerce cooperation in pursuit of regime political and propaganda objectives, as well as to elicit or compel support for or facilitation of espionage, from private-sector Chinese and Chinese-influenced entities and persons." <https://www.state.gov/wp-content/uploads/2020/05/T-paper-series-6-Strategic-competition.pdf>

which companies are required to report their risks, is not a mere *pro forma* exercise. The concept of material risk entails that a company, in reporting risk, look at its risk exposures holistically and so convey the information that an investor needs to make informed decisions.<sup>31</sup>

Questions arise as to the scope of material risk even in relatively well-known areas; questions abound when new areas of risk come to view. New areas, for example, climate policies and cybersecurity, have entailed their own unknowns, and the SEC has adapted. Toward such new areas and their possible risks, the SEC has given thoughtful consideration that is informed by wide-ranging analytic resources, including input contributed from cabinet agencies and other parts of the U.S. government. Public interpretative guidances prepared by the SEC have improved the general understanding of various areas of risk over the years.<sup>32</sup> The SEC more recently has started to look at risks entailed by accounting practices in China that are insufficiently transparent to merit the regulators' confidence or the market.<sup>33</sup> It is timely to consider whether the likelihood of MCF-related technology diversion, too, might be examined as a distinct risk and, as are other risks, reported and, thus, made available for pricing into market interactions.

Other institutional and legal tools exist as well. A constellation of laws regulates the structure of markets by addressing issues such as fraud, collusion on price or output, theft of intellectual property, and dumping in breach of international trade agreements. Agencies such as the CFTC, mentioned earlier, and others, such as the U.S. Federal Trade Commission (FTC) and the U.S. International Trade Commission (ITC), form a web of jurisdictions regarding such issues. Claimants already have begun to experiment with ways to use these

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<sup>31</sup> <https://www.law.cornell.edu/cfr/text/17/240.12b-20>

Rule 12b-20, General Rules and Regulations, Securities Exchange Act of 1934, provides as follows: "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading" (emphasis added). 17 CFR § 240.12b-20.

<sup>32</sup> <https://www.sec.gov/rules/interp/2010/33-9106.pdf> and <https://www.sec.gov/news/press-release/2018-22>

<sup>33</sup> SEC Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman, and SEC Division of Investment Management Director Dalia Blass, *Public Statement: Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited*, April 21, 2020, noting, for example, that "in many emerging markets, including China, there is substantially greater risk that disclosures will be incomplete or misleading and, in the event of investor harm, substantially less access to recourse..." <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting>

agencies, as well as U.S. courts, to push back when they suffer harm in their dealings with the PRC. Cases have been brought in U.S. courts and at the ITC premised on allegations about China's power over global markets in Vitamin C and steel, for example.<sup>34</sup> If relevant decision makers find merit in such allegations (which in the vitamin and steel examples concern the PRC's full-spectrum coordination on price and quantity), then their decisions, in effect, would call out the PRC for its attempts to surveil and control the global supply chain in a range of product markets, as well as in related derivatives and securities markets. The risks thus exposed would include risks to Western firms of both upward and downward shocks to price and output, unfair competition through outright state industrial planning, and more. Institutions such as the Public Company Accounting Oversight Board (PCAOB), moreover, could perhaps more systematically incorporate into their work the risk that PRC accounting firms—or even Chinese branches of major non-Chinese firms—might, in certain circumstances, be compelled to massage their results to suit the sensibilities of party bosses.

Private litigants in the West, however patriotic, are not motivated primarily by a desire to help advance a national strategy; they use private rights of action to pursue private aims. But the substantive law and jurisdiction of a powerful range of public institutions already may be helping, if only by happenstance, to realize those private aims in ways that advance larger public objectives. The United States and like-minded countries now are bringing those objectives into focus. Institutions such as the ones we have mentioned may well have a further role to play in helping commercial decision makers account for public policy externalities in the current great power competitive environment, including the ever-present risk of MCF-driven technology diversion to potentially dangerous military applications.

### **Great Powers, Private Rights, and Defining Values**

The economic and social costs would be high, and the moral loss incalculable, if the justified concerns about the PRC slid into xenophobia

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<sup>34</sup> Steel: <https://supreme.justia.com/cases/federal/us/585/16-1220/>

Vitamin C:

[https://www.usitc.gov/secretary/fed\\_reg\\_notices/337/337\\_1002\\_notice\\_11012017sgl.pdf](https://www.usitc.gov/secretary/fed_reg_notices/337/337_1002_notice_11012017sgl.pdf)

For the vitamin C dispute, see *Animal Science Products, et al. v. Hebei Welcome, et al.*, 585 U.S. \_\_\_\_ (2018) (Ginsburg, J., for a unanimous Court).  
For the steel dispute, see *Certain Carbon and Alloy Steel Products, Inv.* No. 337-TA-1002.

against the Chinese people. The costs also would be high if great power competition escalated to a point of no return. No nation in the West desires isolation, much less military conflict. Being mindful of the ties that bind particular individuals and institutions located in and out of China to the PRC and to the CCP's strategic ambitions allows us to design our own strategies to mitigate risk in fair and measured ways. Indeed, if we place MCF in its proper frame—an operational tool in Beijing's strategy of great power competition, and an aspect of the PRC's Party-dominated socio-economic system—we can address risk more rationally. In so doing, our regulators and others can refine their understanding of the challenge that needs to be addressed. At the same time, we can avoid overreactions that could jeopardize the values that define us.

For financial regulators, this then becomes a relatively focused question of how to address heretofore underappreciated categories of risk that arise when doing business in and with China—such as MCF-based military diversion and potential sanctions or export control challenges that could arise therefrom. Regulators may be joined by private litigants who have plausible claims of injury in their own capacity as investors. To the extent that regulators, litigants, or both play a role in shining a light on these risk categories, our interests as a nation in an era of great power competition will be furthered, and our private citizens and firms will be able to make better informed choices for themselves.