International Trade: Isolationism, Trade Wars, & Trump

Friday, February 8, 2019
9 a.m. – 3:30 p.m.

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United Nations Commission on International Trade Law
Working Group III (Investor-State Dispute Settlement Reform)
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Possible reform of investor-State dispute settlement (ISDS)

Note by the Secretariat

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I. Introduction

1. At its thirty-fifth session, the Working Group requested the Secretariat to prepare a list of the concerns about investor-State dispute settlement (ISDS) raised during its thirty-fourth and thirty-fifth sessions and to set out a possible framework for its deliberations. The Working Group also requested the Secretariat to consider the provision of further information to assist States with respect to the scope of some of its concerns regarding ISDS (A/CN.9/935, para. 100).

2. This Note sets out some main concerns about ISDS raised in the Working Group during its thirty-fourth and thirty-fifth sessions and is supplemented by more detailed discussion of each topic in background reference documents A/CN.9/WG.III/WP.150 to A/CN.9/WG.III/WP.153. This Note also contains a suggested framework for considering the question of desirability of reforms. The topics discussed in the background documents are not intended to reflect a comprehensive set of issues regarding ISDS that the Working Group has discussed, or may yet wish to discuss. Additional concerns may have to be addressed.

3. As is the case for other documents provided to the Working Group, this Note was prepared with reference to a broad range of published information on the topic, and does not seek to express a view on the desirability of reforms, which is a matter for the Working Group to consider.

II. List of concerns about ISDS

A. General remarks

1. Characteristics of the ISDS regime under consideration

4. The international investment regime includes over 3,000 international investment treaties concluded over the last fifty years. These treaties, which are instruments of public international law, were conceived as a means to enhance confidence in the stability of the investment environment. To do so, they provide substantive guarantees to foreign investors and their investments in the form of enforceable obligations placed upon States. For example, in these treaties, States undertake to respect certain standards of investment protection (such as fair and equitable treatment, full protection and security, protection from expropriation, freedom to repatriate funds and non-discrimination in the treatment of the investment).

5. The ISDS regime was developed to allow a foreign investor (whether a natural or legal person) to bring a claim directly against the sovereign State in which it was an investor. The regime provided a significant break from traditional mechanisms under international law, which essentially relied on diplomatic protection or “espousal” by the home State of the investors’ claim to resolve disputes relating to investment.

6. While ISDS provisions in investment treaties vary, they generally provide for dispute settlement through arbitration, and include the following features: (i) the claimant-investor may bring a claim directly against the host State; (ii) the dispute is resolved by an arbitral tribunal constituted ad hoc for that particular dispute; and (iii)
both disputing parties, including the claimant-investor and the respondent-State, play an important role in the selection of the arbitral tribunal.4

2. Observations on information and data

7. At its thirty-fourth and thirty-fifth sessions, the Working Group noted the importance of a factual underpinning of its deliberations (A/CN.9/930/Rev.1, para. 42; A/CN.9/935, para 46). Efforts to increase transparency in ISDS have contributed to make more information publicly available not only with regard to its outcomes but also to its procedures. A more comprehensive data pool is available for cases administered by the International Centre for Settlement of Investment Disputes (ICSID), which are considered to represent 75% of investment treaty cases.5 This Note and the supporting reference documents (A/CN.9/WG.III/WP.150 to A/CN.9/WG.III/WP.153) therefore discuss, where available and appropriate, the statistical context of data on ISDS outcomes and procedures.

B. Concerns identified in the Working Group

8. This section provides an annotated list of the main concerns raised at the thirty-fourth and thirty-fifth sessions of the Working Group. They are grouped into three main topics (consistency, coherence, predictability and correctness of arbitral decisions by ISDS tribunals; arbitrators/decision-makers; and costs and duration), discussed in detail in documents A/CN.9/WG.III/WP.150 to A/CN.9/WG.III/WP.153, respectively. Within those groups, the concerns are further broken down into related elements, for ease of presentation.

1. Concerns pertaining to consistency, coherence, predictability and correctness of arbitral decisions by ISDS tribunals

9. Concerns expressed regarding the lack of consistency, coherence, predictability and correctness of arbitral decisions by ISDS tribunals, which are addressed in detail in document A/CN.9/WG.III/WP.150, relate to the following matters:
   - Divergent interpretations of substantive standards; divergent interpretations relating to jurisdiction and admissibility; and procedural inconsistency (A/CN.9/WG.III/WP.150, paras. 14-18);
   - Lack of a framework to address multiple proceedings (A/CN.9/915); and
   - Limits of the current mechanisms to address inconsistency and incorrectness of decisions (A/CN.9/WG.III/WP.150, paras. 19-26).

10. Regarding the latter point, the Working Group may wish to note that the existing review mechanisms (ICSID annulment procedure, as well as setting aside of awards, and recognition and enforcement proceedings by State courts) address the integrity and fairness of the process rather than the consistency, coherence or correctness of the outcomes (A/CN.9/WG.III/WP.142, para. 39 and A/CN.9/935, para. 23). Because of the notion of finality, remedies against awards are by nature limited.

2. Concerns pertaining to arbitrators and decision-makers

11. At its thirty-fifth session, the Working Group approached its consideration of arbitrators and decision-makers from two main perspectives: first, whether the existing ISDS regime offers a sufficient guarantee of an independent and impartial tribunal, and secondly, whether the existing approaches to the constitution of tribunals ensure that the tribunal members have the appropriate qualifications and

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4 See A/CN.9/WG.III/WP.142, paras. 5-7.
characteristics to decide the cases before them (A/CN.9/935, paras. 45-92). Documents A/CN.9/WG.III/WP.151 and A/CN.9/WG.III/WP.152 address these questions in detail.

12. The concerns expressed in the Working Group regarding the independence and impartiality of arbitrators and decision-makers relate to the following matters:

- The standards of independence and impartiality required of individual arbitrators, and the observation that those standards might be insufficiently clear in scope and homogeneous in practical application (A/CN.9/WG.III/WP.151, paras. 42-47);
- The existence of issue conflicts such as double hatting and pre-judgment of issues (A/CN.9/WG.III/WP.151, paras. 24-38); and
- The challenge mechanism (that is, an application to disqualify an arbitrator on the basis of an actual or perceived lack of independence and impartiality), and its limitations (A/CN.9/WG.III/WP.151, paras. 48-66).

13. The concerns expressed regarding the existing approaches to the constitution of tribunals, and the impact of those approaches on the qualifications and characteristics of tribunal members, relate to the following matters:

- The use of a party-appointment mechanism in cases involving a State, and its limitations including as regards ensuring competence and qualifications of arbitrators (A/CN.9/WG.III/WP.152, paras. 7 and 30-36);
- The impact of party remuneration, dissenting opinions and repeat appointments of certain arbitrators on the perception of arbitrator bias (A/CN.9/WG.III/WP.152, paras. 39-41);
- The limited number of individuals repeatedly appointed as arbitrators (A/CN.9/WG.III/WP.152, para. 18) and the possible impact on cost and duration of proceedings (A/CN.9/WG.III/WP.152, paras. 19-29); and
- The lack of diversity in terms of gender, age, ethnicity and geographical distribution of appointed arbitrators, so that professional background of arbitrators, differing legal systems and levels of economic development are not all proportionately represented in tribunals (A/CN.9/WG.III/WP.152, para. 18).

3. Concerns pertaining to cost and duration of ISDS cases

14. At its thirty-fourth session, the Working Group undertook a preliminary discussion on cost and duration of ISDS under the general topic of procedural aspects of the arbitral process (A/CN.9/930/Rev.1, paras. 35-78). States and intergovernmental organizations shared their experiences in connection with ISDS. It was said that deliberations relating to cost and duration should be fact-based, but that perceptions on those issues had an influence on the legitimacy of the ISDS regime (A/CN.9/WG.III/WP.153, paras. 10, and 38-65).

15. The concerns expressed in the Working Group relating to cost and duration relate to the following matters:

- Lengthy and costly ISDS proceedings (A/CN.9/WG.III/WP.153, paras. 7-9, 17-27 and 42-59);
- Allocation of costs by arbitral tribunals in ISDS (A/CN.9/WG.III/WP.153, paras. 14, 28-32 and 60-65);
- Difficulties faced by successful States being unable to recover some or all of their costs from claimant investors and the need for rules on security of costs (A/CN.9/WG.III/WP.153, paras. 15 and 33-37); and
- Lack of a mechanism to address frivolous or unmeritorious claims (A/CN.9/WG.III/WP.153, paras. 33 and 86).
16. During its deliberations, the Working Group identified a number of elements having an impact on cost and duration of ISDS proceedings: complexities of the case, the underlying treaties and the proceeding; large volume of evidence; quality of factual records; conduct of the proceedings and ineffective case management (including lengthy deliberations and excessive numbers of hearings); and the need to translate documents and evidence into the language(s) of the arbitration. In addition, the Working Group noted that the most time-consuming stages of ISDS proceedings included the appointment of the tribunal members, discovery or document production, and the issuance of awards (A/CN.9/WG.III/WP.153, paras. 76-92).

4. Other concerns

17. At the thirty-fifth session of the Working Group, it was emphasized that States would have the opportunity to raise additional concerns at future sessions of the Working Group (A/CN.9/935, para. 99). The Working Group may wish to consider whether other concerns pertaining to the ISDS regime, not identified above and in documents A/CN.9/WG.III/WP.150 to A/CN.9/WG.III/WP.153 would need further consideration. *

III. Framework for discussion

A. General remarks

18. The Working Group may wish to recall that its mandate contains three stages: (i) to identify and consider concerns regarding ISDS; (ii) to consider whether reform was desirable in light of any identified concerns; and (iii) if the Working Group were to conclude that reform was desirable, to develop any relevant solutions to be recommended to the Commission. In addition, the mandate focuses on the procedural aspects of dispute settlement rather than on the substantive provisions (A/CN.9/930, para. 20).

19. The Working Group may wish to proceed to consider whether reform is desirable in light of (i) the concerns set out above, and any other concerns it may wish to identify; as well as (ii) the available options of reforms. The options for reform outlined below and in the annex to this document are based on preliminary options identified in the Working Group at its thirty-fourth and thirty-fifth sessions. They are not exhaustive, and the Working Group may wish to consider any further options that could be developed.

20. The Working Group may wish to note that the suggested framework (see paras. 26-70 below) and the tabular presentation of the framework annexed to this document include a list of possible options for reform in light of identified concerns so as to enable the Working Group to consider the desirability of reform. The chart also contains a brief outline of the main possible impact of the reform options on the existing ISDS regime in order to allow the Working Group, should it so wish, also to consider the feasibility of reforms. The suggested framework for discussion does not seek to express a view on the desirability or feasibility of reforms, which are matters for the Working Group to consider.

21. As regards the rationale and desirability for reform of the current ISDS regime, the Working Group may wish to consider the policy objectives that the regime seeks to achieve. In that context, the Working Group may wish to consider the policy objectives of the ISDS regime and of possible reform in light of the 2030 Agenda for

* In this regard, the Working Group may wish also to take into consideration the issues raised in papers and statements submitted for its consideration at its thirty-fourth and thirty-fifth sessions (available at http://www.uncitral.org/uncitral/en/commission/working_groups/3Investor_State.html), and the materials available at the link entitled “Investor-State Dispute Settlement Reform: On-line Resources”.
the Sustainable Development Goals. It may also wish to note the consideration expressed by States that (i) investment policies should provide legal certainty and strong protection to investors and investments, tangible and intangible, (ii) access to effective mechanisms for the prevention and settlement of disputes, as well as to enforcement procedures; and (iii) dispute settlement procedures should be fair, open and transparent, with appropriate safeguards to prevent abuse.

22. The Working Group may also wish to consider the guiding principles for any reform. It may wish to recall that, at its thirty-fifth session, the need for any ISDS reform to strike a balance between rights and obligations of the States on the one hand and of the investors on the other was stressed (A/CN.9/935, para. 14). Efficiency, flexibility and cost-effectiveness were mentioned as the guiding principles when considering any reform (A/CN.9/935, para. 43).

23. The Working Group may also wish to consider the objectives for reform and main principles identified by UNCTAD, to (i) enhance the legitimacy of the ISDS system, (ii) enhance the contracting parties’ control over the interpretation of their treaties and/or (iii) streamline the process and make it more efficient.

24. As regards the various identified issues, the Working Group may wish to consider that they all constitute elements of an overall regime. At its thirty-fifth session, the Working Group heard suggestions that it would be necessary to strike the right balance between different concerns, and to consider thoroughly the impact of inconsistency on core treaty provisions, and on costs and duration. It was added that other concerns and issues, such as lack of transparency, lack of effective mechanism to address frivolous claims and issues of third party funding, should be considered as they also had an impact on the overall functioning of ISDS (A/CN.9/935, para. 44). Attention was drawn to the need to consider the issues of duration and costs in the broader context of (a) innovations in arbitration rules and investment treaties (such as early dismissal of frivolous, unmeritorious claims, preliminary objections, security for costs); (b) the need to ensure correctness of decisions; and (c) enhancing the predictability of decisions. It was added that a comprehensive analysis would require nuanced and not merely simple solutions (A/CN.9/930/Rev.1, para. 59).

25. The suggested framework for consideration of the desirability of reform is based on consideration of issues and possible solutions by the Working Group, suggestions for reform by States, as well as the roadmap for reform proposed by UNCTAD and the OECD scoping paper. The proposals for amendments articulated by the ICSID Secretariat are also mentioned where relevant. The Working Group may wish to note that there are a number of options, that can be undertaken in isolation or in combination. The presentation of options below is preliminary and consequently it does not provide an analysis of each option, nor of what each one of them would entail individually and in relation to the current regime.

B. Suggested framework for discussion

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8 See GA Resolution 70/1 of 25 September 2015, Transforming our world: the 2030 Agenda for sustainable Development.
11 UNCTAD World Investment Report, Reforming the International Investment Regime: An Action Menu, Chapter IV, pp. 112.
1. Inconsistency and related matters

26. At the thirty-fourth session of the Working Group, it was indicated that criticism of a lack of consistency and coherence was one of the reasons behind the Commission’s decision to embark on work on possible ISDS reform, thereby acknowledging the importance of ensuring a coherent and consistent ISDS regime. It was said that consistency and coherence would support the rule of law, enhance confidence in the stability of the investment environment and further bring legitimacy to the regime. It was also said that inconsistency and lack of coherence, on the other hand, could negatively affect the reliability, effectiveness and predictability of the ISDS regime and its credibility (A/CN.9/930/Add.1/Rev.1, para. 11).

27. The Working Group may wish to consider the questions raised in document A/CN.9/WG.III/WP.150, paras. 28-31, as well as preliminary views expressed by States (see A/CN.9/WG.III/WP.150, paras. 32-36). It may also wish to note the challenge of designing a framework that strikes a careful balance between conflicting demands: on the one hand, the need for an efficient and final dispute settlement mechanism and, on the other, the concern to protect the integrity of the process and the correctness of the decision-making.

28. Possible options for reform to address these concerns would include the following (see also A/CN.9/WG.III/WP.150, paras. 37-47).

(a) Enhancing contracting States’ control over their instruments

29. The Working Group may wish to consider as an option for reform tools that would reserve a wider role to States for the interpretation of their investment treaties. A number of provisions found in recent treaties aim at increasing the role of States in various manners, such as by providing for the possibility of joint interpretations, binding on arbitral tribunals, as well as other mechanisms to revise, amend or update investment treaties.  

30. In order to make such treaty provisions effective, or to encourage joint interpretation by treaty Parties more generally, this option could entail designing a mechanism at a multilateral level, fostering the use of interpretative tools. The Working Group may wish to consider the study carried out by the OECD on the matter, where it concludes that “with an increasing number of investment treaties covering relationships where governments have more complex and more overlapping interests, joint interpretive agreements are likely to be an increasingly important tool for ensuring that treaties are interpreted in accordance with the treaty parties’ intent and achieve their purposes.”

(b) Strengthening the involvement of State authorities for preliminary settlement of disputes

31. Recent treaties include provisions aimed at circumscribing investors’ access to ISDS (for instance, excluding from the scope of ISDS claims that relate to sensitive policy areas, relating to technical issues such as taxation, or arising from contractual...
obligations, thereby limiting arbitrable claims). They also include mechanisms for channelling sensitive or technical issues to State-to-State dispute settlement.

32. In that light, an option for reform could aim at designing a mechanism that would allow technical authorities established by treaty Parties to decide whether a claim falls outside the limited scope of claims that are subject to ISDS, as well as substantive matters such as questions relating to violations of national treatment and substantive MFN clauses. This option could entail the development of models for setting up a joint review committee by the treaty Parties together with a review mechanism or State-State appeal body to apply after a given time period, if the claim cannot be settled at the technical level. \(^{17}\) Such mechanisms may also constitute a means to deal with frivolous or unmeritorious claims.

\[\text{(c) Guidance to arbitral tribunals, claims commissions}\]

33. There are a number of procedural mechanisms that arbitral tribunals could resort to or be encouraged to use in order to coordinate better their decision-making, including in situations of concurrent proceedings. These tools are described in document A/CN.9/915, paras. 10-33. They are meant to address mainly two categories of situations. The first category is where different entities within the same corporate structure have a right of action against a State or state-owned entity in relation to the same investment, with regard to the same State measure and for the benefit of substantially the same interests, as long as all entities qualify as investors under an applicable investment treaty, or have a right of action under a contract or under domestic investment law. The second category is where a measure by a State has an impact on a number of investors which are not related (see A/CN.9/881, paras. 7 and 8).

34. Various options are available to address these situations. Regarding the first category, solutions could include proactive use of consolidation, exchange of information among arbitral tribunals, stay of proceedings, as well as use of the doctrines of lis pendens and res judicata. Regarding the second category, available solutions could range from exchange of information among tribunals, involvement of an administering institution, and increased transparency, including in the conduct of the proceedings and the establishment of claims commissions to deal consistently with the numerous claims. A further option may include broadening the use of ISDS to cover class-actions. The Working Group may wish to note that it has been suggested that while such solutions could ensure consistency within a treaty or specific set of issues, they may not be sufficient to provide harmonization across treaties, if such harmonization is considered desirable.

\[\text{(d) Introducing a system for prior scrutiny of awards}\]

35. A system allowing for prior scrutiny of arbitral awards could also be considered. Scrutiny of awards is a feature of the Rules of the ICC International Court of Arbitration. That system has often been described as beneficial in that it is said to enhance the quality and thereby the enforceability of awards. A similar system could be designed to ensure consistency, avoid legal mistakes and ensure quality of awards rendered by ISDS tribunals.

\[\text{(e) Introducing a system of binding precedent}\]

36. From an historical viewpoint, consistency and coherence are not features built in to the ISDS regime. Decisions are made by arbitral tribunals established on an ad hoc basis, with no formal obligation with regard to the principle of precedent. Currently, while tribunals seem to agree that there is no doctrine of binding precedent

\(^{17}\) See, for instance, Agreement between the Government of Canada and the Government of the People’s Republic of China for the Promotion and Reciprocal Protection of Investments (signed on 9 September 2012, in force since 1 October 2014).
per se, they also concur on the need to consider earlier cases. Nonetheless, this has not always secured consistency among arbitral awards as this approach is difficult to implement in a decentralised mode of decision-making, composed of ad hoc tribunals only.  

37. The Working Group may wish to consider that “consistency”, “coherence”, and “predictability” of decisions in ISDS could mean that decision-makers take into account, as appropriate, relevant pre-existing case law and conform to the extent possible or desirable to the relevant legal interpretations set out therein. The Working Group may wish to consider whether, in a “coherent” and “predictable” system, conflicting decisions should be based upon a consistent interpretative approach to the issues at stake, extending beyond the instant case, and taking into account pre-existing case law in order to contribute to the development of investment law and jurisprudence.

38. The Working Group may wish to note that, despite being primarily responsible for rendering decisions on the matters submitted to them, arbitral tribunals also operate in the framework of a larger adjudicatory context with public relevance. Indeed, investment treaty tribunals are often noted as contributing to articulating and clarifying the meaning of core treaty standards. Therefore, a related question the Working Group may wish to consider is whether arbitrators should be considered as being under a general duty towards an international system of justice, to act in the public interest (A/CN.9/935, paras. 85 and 86), and if so, how to implement such duty.

(f) Setting up a system of preliminary rulings

39. A “preliminary ruling” procedure means that a court may refer a decision on a specific issue arising in pending proceedings to a different court. The purpose of the procedure is to have a provision of law interpreted by the latter court. The proceedings before the court seeking the ruling are normally suspended pending the determination by the other court. The ruling will usually bind the court requesting it, which will then incorporate it into its overall resolution of the dispute before it. An option for reform may include a system of preliminary ruling, allowing arbitral tribunals to refer any question concerning the application and interpretation of a legal matter to a specific body.

(g) Introducing an appellate mechanism

40. A possible reform option may consist in the development of an appellate review mechanism that would go beyond the current limited scope of review as part of annulment process. The main functions of an appellate mechanism would be to ensure procedural and substantive correctness of decisions, and to increase predictability of treaty interpretation. It could be tasked with a substantive review of decisions and could permit implementation of a system of binding precedent. The appellate mechanism could be tasked with a review of first instance decisions, arbitral awards

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18 By comparison, in the International Court of Justice, there is no de jure *stare decisis* (see Article 59 of the ICJ Statute); there is, however, a strong reliance on earlier judicial decisions, which are listed as “subsidiary means for the determination of rules of law” in Article 38 of the ICJ Statute.

19 See *Glamis Gold Ltd. v. United States of America*, UNCITRAL Arbitration (NAFTA), Award, 8 June 2009, at para. 7, where the tribunal provided as follows: “this Tribunal, in undertaking its primary mandate of resolving this particular dispute, does so with an awareness of the context within which it operates. The Tribunal emphasizes that it in no way views its awareness of the context in which it operates as justifying (or indeed requiring) a departure from its duty to focus on the specific case before it. Rather it views its awareness of operating in this context as a discipline upon its reasoning that does not alter the Tribunal’s decision, but rather guides and aids the Tribunal in simultaneously supporting the system of which it is only a temporary part.” See also *Saipem S.p.A v. The People’s Republic of Bangladesh*, ICSID Case N0. ARB/05/07.

20 As an example of such procedure, see Article 267 of the Treaty on the Functioning of the European Union, whereby a court of a Member State of the European Union may, and in certain instances shall request the Court of Justice of the European Union (CJEU) to give a ruling on the interpretation of EU law.

as well as decisions of international commercial courts. This option could but would not necessarily require the establishment of a standing body. It may be noted that illustrations of appellate review mechanisms can be found in certain investment treaties.22

41. A matter that would nonetheless deserve consideration is the relationship between an appellate mechanism and the ICSID Convention, which excludes any appeal or other remedy, except for those provided for in the Convention itself (Article 53) (see A/CN.9/917, paras. 20-23). Similarly, the relation with the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958) would need to be considered. 23

(h) Setting up an appellate body

42. A reform option could consist of the creation of a separate appellate body, which would result in the current ISDS regime maintaining most of its basic features, while being complemented with a standing or at least semi-permanent appellate body. The appellate body could function as a review mechanism for arbitral awards. An appellate body could also function as a second instance of a multilateral investment court if one were to be set-up. Further, an appellate body could also function as a second instance to review decisions made by international commercial courts as established by several States. Lastly, it could also provide some degree of international review in claims of denial of justice by domestic courts. The creation of an appellate body is often cited as a possible response to demands for greater consistency in the decisions of ISDS tribunals, as well as legal correctness.

43. The Working Group may wish to note that despite the fact that most arbitration regimes emphasize the finality of the awards thus prohibiting appeals, there are nonetheless examples of institutional arbitration regimes that provide for appellate review of arbitral awards. Under some national arbitration laws, parties may agree on a two-level arbitration process, and there is no suggestion that the presence of an appeal makes the process different from arbitration. The questions mentioned in para. 41 above would need to be considered also in the context of the establishment of an appellate body.

(i) Setting-up an international court system

44. A reform option could include, as envisaged by certain recent investment treaties, the creation of a court, established as a permanent international institution.24 The stated rationale is that by sitting permanently and deciding cases over time, judges could deliver consistent decisions. A court could be conceived as a first instance tribunal, with or without an appeal tribunal and be composed of judges, obliged to adhere to underlying ethical standards. The purposes usually mentioned regarding the establishment of an investment court are to address concerns regarding inconsistency and incorrectness of decisions made by ISDS tribunals, as well as concerns regarding ethical requirements and appointment mechanisms for arbitrators and decision-makers.

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24 See for instance, the Canada-European Union Comprehensive Economic and Trade Agreement (CETA); the European Union-Viet Nam Free Trade Agreement.
2. Arbitrators and decision-makers

45. Based on the concerns above and as set out in more detail in documents A/CN.9/WG.III/WP.151 and A/CN.9/WG.III/WP.152, the Working Group may wish to consider reform options as far as arbitrators and decision-makers are concerned.

46. The Working Group may wish to note that ICSID has published a comprehensive set of proposed changes to modernize its rules for ISDS, which aims at addressing concerns identified to it. The proposals by the ICSID Secretariat include an enhanced declaration of independence and impartiality for arbitrators, and a new process for challenging arbitrators, including the introduction of an expedited schedule for parties filing a challenge. In addition, it is proposed to remove automatic suspension of the proceedings when a challenge is filed, and to broaden the possible role of the Chairman, the President of the World Bank, in case of challenge.

47. The Working Group may wish to note some questions for consideration in documents A/CN.9/WG.III/WP.151, paras. 72-85 and A/CN.9/WG.III/WP.151, paras. 69-71 as well as preliminary views expressed by States (see A/CN.9/WG.III/WP.152, paras. 45-50 and A/CN.9/WG.III/WP.152, paras. 41-44). Possible options for reform to address concerns regarding arbitrators and decision-makers would include the following.

(a) Code of conduct and other ethical requirements

48. The Working Group may wish to consider that the development of a code of conduct for arbitrators and adjudicators (A/CN.9/935, paras. 64 and 81) could aim at (i) ensuring that all stakeholders understand the thresholds for when independence and impartiality would be seen to be impaired (A/CN.9/935, para. 65); (ii) developing requirements for qualifications of arbitrators (A/CN.9/935, para. 65); (iii) providing clarity on arbitrators’ roles and requirements regarding diversity or appropriate regional representation.

49. It may be noted that recently concluded investment treaties have included a code of conduct for arbitrators, in order to ensure respect of high ethical and professional standards. It may be noted that such codes define procedures to be followed in order to ensure that any situation with the potential to give rise to real or perceived conflicts of interest would be fully disclosed. Such codes also include concrete steps to determine whether a conflict of interest could arise or has arisen.

50. The Working Group may wish to consider the suggestion expressed at its thirty-fifth session that harmonization could result in a code of ethics for ISDS being developed through possible joint work between UNCITRAL and ICSID secretariats.

(b) Development of further rules and procedures for the challenge mechanism

51. The Working Group may wish to consider the option of developing further rules and procedures on challenge mechanisms, aimed at: (i) harmonizing challenge mechanisms, including timelines; (ii) clarifying who decides on challenge and how; (iii) clarifying the effect of the challenge procedure; (v) introducing transparency requirements, reasoning requirements and publication of decisions on challenge; and (vi) introducing sanctions for frivolous challenges, or non-compliance by arbitrators of the duty to disclose. The Working Group may also wish to consider the provision of additional soft law guidance on the use of rules and procedures for the challenge mechanism.

(c) Establishment of control system for challenges

25 See ICSID Secretariat, Proposals for Amendment of ICSID Rules footnote 13, supra.
52. The Working Group may wish to consider whether a control system for challenges should be considered. Arbitral institutions, or ad hoc bodies could be tasked with a specified role, including with deciding on challenge procedures.

(d) **Appointments through alternative methods**

53. A reform option could involve adjustment to the appointment process of arbitrators by the parties. For example, whether the parties could agree to refer to a pre-established group of arbitrators under article 37 of the ICSID Convention and its Additional Facility Rules and whether article 6 of the UNCITRAL Arbitration Rules and its system of designating and appointing authorities could allow for adjustments to the appointment process are elements for further consideration. The Working Group may also wish to consider different means of appointing arbitrators; including (i) the increased use of appointing authorities or the use of rosters, (ii) a greater role for arbitral institutions in the selection of arbitrators; (iii) a role in appointment to for an independent body, or by a mechanism such as that available in other international courts and bodies (for instance, the WTO Dispute Settlement Body) (A/CN.9/935, para. 67).

54. Another possibility would consist of establishing a new mechanism for appointing arbitrators, which would come closer to a court system, in which the disputing parties do not choose the adjudicators.

55. Yet another possibility could be to depart completely from the adjudication by arbitrators and to submit the disputes to judges appointed according to procedures to be determined (see also para. 64 below).  

(e) **Training, rosters, and certifications**

56. The Working Group may wish to consider whether, in order to address the question of lack of diversity in ISDS, programmes could be developed, aimed at expanding the pool of arbitrators, and providing training. The Working Group may wish to consider the option of developing a broader roster system or exploring various ways of setting up pre-agreed lists of arbitrators/adjudicators.

3. **Cost and duration**

57. The working Group may wish to note the current efforts to increase the efficiency of the proceedings that have been made by States in the investment treaties, by arbitration institutions through the revision of their rules or other guidance material, and by tribunals with regard to case management based the discretion provided to them. UNCITRAL also revised its Arbitration Rules in 2010 to enhance the efficiency of arbitration under the Rules and in 2013 to incorporate the UNCITRAL Transparency Rules in Treaty-based Investor-State Arbitration. The Working Group may also wish to note that the proposed amendments to the ICSID rules also aim at addressing cost and time of ICSID proceedings.

58. In that context, the Working Group may wish to consider the following reform options to improve the cost- and time-effectiveness of ISDS proceedings.

(a) **Dispute prevention**

59. Any dispute or even the possibility of a dispute between a State and an investor is a burden on both parties. Such a dispute can be seen as increasing transactional costs of investors including possible loss of business opportunities and entailing economic and social cost for States including a negative impact on its foreign investment inflow.

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27 See ICSID Secretariat, Proposals for Amendment of ICSID Rules, footnote 13, supra.
Therefore, development of good practices and sharing of institutional information to prevent disputes could be considered.

(b) **Promotion of dispute settlement mechanisms other than arbitration**

60. The Working Group may wish to note that despite increasing efforts to promote forms of dispute settlement other than arbitration, such as mediation, still remain under-used in ISDS. The Working Group may wish to consider ways to enhance the use of such means of dispute settlement.

(c) **Expedited arbitration**

61. The Working Group may wish to consider developing tools to facilitate the use of expedited arbitration procedures, and uniform principles to improve quality and efficiency of the ISDS proceedings. This would in particular allow for a more effective resolution of disputes that are less complex and/or relate to smaller amounts.

(d) **Advisory centres**

62. The Working Group may wish to consider the establishment of advisory centres to support developing countries and SMEs in ISDS. Such mechanisms may provide legal services and capacity building programmes on ISDS.

(e) **Third party funding**

63. The Working Group may wish to consider whether third-party funding may be utilized to address the financial burden of the parties to ISDS proceedings. In that context, the need to provide more harmonized rules on the practice of third party funding may also be considered.

(f) **Replacement of ad hoc arbitrators by full-time judges**

64. The Working Group may wish to consider whether the costs incurred by the current ad hoc appointment mechanism could be alleviated by having ISDS resolved through a permanent body consisting of full-time judges. Such an option would be based on assumptions that the remuneration of judges would be determined using criteria different from the current fee determination for arbitrators, and that it would therefore be less costly to the parties (see also above, para. 55).

(g) **Streamlined procedure and tools to manage costs**

65. As a way to reduce the duration of ISDS proceedings, the Working Group may wish to consider the streamlining of procedures and the implementation of stricter timelines for the parties, as well as the tribunal, coupled with compliance mechanisms.\(^28\)

66. As a way to manage the cost of ISDS proceedings effectively, the Working Group may wish to consider requiring parties and the tribunal to establish a budget at the outset of a case; adopting a ceiling for overall costs; and requiring tribunals to provide parties with enhanced, real-time information about the status of a case, including the budget.\(^29\)

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\(^{28}\) Ibid.

67. A further way to address both the cost and time of ISDS proceedings could also be through improved case management. In that context, the Working Group may wish to consider suggesting consultations between the tribunal and parties regarding the organization of the proceedings, including early case management conferences.\(^{30}\)

\((h)\) **Early or expeditious dismissal mechanism**

68. In order to address concerns raised about frivolous or unmeritorious claims resulting in increased cost and duration, the Working Group may wish to consider as reform option effective early or expeditious dismissal mechanisms (or their introduction if not already existing).\(^{31}\)

\((i)\) **Developing principles on allocation of cost and security for costs**

69. The Working Group may wish to consider the following reform options: (i) clear and definitive rules on allocation of costs, with tribunals making costs orders on an interim basis so as to keep parties cost-conscious; (ii) urging tribunals to be more active in adjusting costs; (iii) identifying specific factors to be considered in allocating costs, such as outcome, the parties' conduct, the complexity of the issues; and the reasonableness of the costs claimed as well as the use of third-party funding; and (iv) introduction of clear rules or mechanisms on security for costs to ensure recovery of costs of respondent States.

\((j)\) **Others**

70. The Working Group may also wish to consider whether allowing counterclaims by respondent States, and setting a more streamlined procedure for post-award actions including interpretation, revision and annulment and introduction of stricter timelines, would have a positive impact on cost and duration of ISDS proceedings.

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\(^{30}\) Ibid.

\(^{31}\) Development of solutions modelled around Rule 41(5) of the ICSID Arbitration Rules could also be envisaged.
CAN INTERNATIONAL TRADE LAW RECOVER?

WTO DISPUTE SETTLEMENT: CAN WE GO BACK AGAIN?

Rachel Brewster*

The world’s twenty-year experiment with a rule-based international trading order is most likely ending. Trade wars are raging again for the first time in two decades as World Trade Organization (WTO) members unilaterally impose and counterimpose sanctions. In Geneva, the WTO Appellate Body, whose existence is essential to the functioning of the WTO Dispute Settlement Understanding (DSU), is on a trajectory to shut down in December 2020. For all the fireworks, however, many commentators retain an optimism that the recent events will be a passing phase and that the world will return to a more law-oriented trading system after the present crisis.

This essay is less sanguine and argues that recent events may have damaged the WTO irreparably. The present departure from enforcement norms is potentially devastating because it goes to the heart of what has provided the WTO with such influence in global economic affairs: the willingness of member countries to accept the WTO legal system as a binding constraint on state action, even when costly domestically. Having abandoned the DSU framework, will countries once again view the WTO rule-based system as mandatory? Or will the WTO become more like other global institutions whose ability to constrain member countries is modest, notwithstanding hard treaty obligations?

To illustrate why returning to a rule-of-law system will be so difficult, this essay describes the WTO enforcement norms and highlights why they are significant to WTO success. It then explains how the current American administration has violated these norms and how other WTO member countries have followed suit in response, leading to widespread disregard for the DSU framework. Finally, it analyzes how the precedent of opting out of the DSU framework may have changed actors’ beliefs about whether abiding by the DSU is obligatory and beneficial in the long-term. Once these beliefs have shifted, the political costs of returning to a rule-based system rise, and the likelihood of further violations increases. In short, a world of more power-based bargaining may be returning, and the value of the WTO to all countries will be greatly diminished.

WTO Enforcement Norms

The strong WTO legal system is unique among global institutions. Often called the WTO’s crown jewel, the DSU establishes a rule-based adjudicatory process with compulsory jurisdiction over all WTO member countries, allowing it to impose economic and other sanctions on violating members. The DSU framework is intended to ensure that member countries abide by their WTO commitments and to provide a binding means of settling disputes. The legal challenge is to ensure that members comply with WTO decisions and that compliance is enforced by the WTO.

1 For an overview of the various sanctions and counter-sanctions, see Chad Bown & Melina Kolb, Trump’s Trade War: An Up-To-Date Guide, Peterson Inst. for Int’l. Econ. (Sept. 24, 2018).

2 Even under the current rule-based system, economic power is still relevant at the WTO. Both countries’ willingness to bring cases and their ability to bear economic sanctions will depend on their market size. Nonetheless, compared to the pre-WTO General Agreement on Tariff and Trade system, the dispute settlement system is more rule-based because it relies on legal argument, not market power, to resolve trade disputes. See generally John H. Jackson, The World Trading System (2d ed. 1997).

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a broad jurisdictional scope over almost all of the WTO Agreements, a right of appeal to the seven-member Appellate Body, and procedures for assessing damages and authorizing retaliation (if a member country maintains its breach of substantive trade rules). However, the influence of the WTO legal system is equally due to the near perfect record of WTO member country compliance with the DSU framework. Not only do the WTO Agreements call for binding dispute resolution, but member countries have followed these rules faithfully, not acting outside of the DSU until recently. It is this acceptance of a constraint by member countries—and the beliefs of subnational actors that these constraints are unavoidable—that has made WTO adjudication such a force in international affairs.

WTO enforcement norms do not require WTO member countries to always comply with substantive trade rules. Instead, WTO enforcement norms provide a framework that structures how WTO members address allegations of noncompliance with trade rules. In fact, many of the enforcement norms address circumstances where the respondent country does not ultimately bring its policies into compliance with WTO substantive rules. Thus, even as WTO members did not invariably comply with the WTO substantive rules, compliance with the enforcement norms—the rule-of-law framework that addresses trade policy—was nearly perfect until 2016.

The WTO norms that have effectively governed trade disputes for two decades involve three major principles: acceptance of multilateral adjudication, a prohibition on counterretaliation, and the regulation of remedies.

**Acceptance of Multilateral Adjudication**

A core principle of the WTO is that its members must not take any actions regarding alleged breaches of trade rules without going through the WTO dispute settlement system. This means that complaining countries cannot impose sanctions (called “retaliation” or “rebalancing”) until the multilateral adjudicatory system has completed its work. As an example, in the 1990s and early 2000s, the United States maintained that the European Union’s ban on beef treated with growth hormones was a breach of trade rules. Following WTO enforcement norms, the United States waited until it successfully challenged the European Union’s policy before it imposed sanctions. This is particularly notable since, under the General Agreement on Tariffs and Trade 1947 system, the United States had imposed unilateral retaliation for more mild EU restrictions on beef.

Similarly, WTO norms require complaining countries not to impose any sanctions if they lose their cases in disputes settlement. For instance, in an early WTO case, the United States lost its claim against Japan regarding alleged unfair trading practices in the photographic film industry. Although many influential legislators and

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3 In previous work, I have referred to this as the difference between breaching trade rules (first order rules) and violating WTO enforcement rules (second order rules). It is possible to breach trade rules but still remain within the WTO’s enforcement framework. See Rachel Brewster, *Pricing Compliance: When Formal Remedies Displace Reputational Sanctions*, 54 Harv. Int’l L.J. 259, 300–01 (2013).

4 This principle is embodied in Article 23 of the DSU, committing member countries to multilateral adjudication of disputes. See *Understanding on Rules and Procedures Governing the Settlement of Disputes* art. 23, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401 [hereinafter DSU]. While the DSU has a number of rules and procedures, this rule is part of the fundamental bargain of the WTO system—that the United States would forgo unilateral sanctioning and accept multilateral adjudication of trade disputes if the system were legally binding and capable of authorizing retaliation. See Panel Report, *United States—Sections 301–310 of the Trade Act of 1974*, WT/DS152/R (adopted Feb. 28, 2000) (describing how Art. 23 of the DSU is a core principle of the WTO dispute settlement system).

5 The DSU permits arbitration outside of the WTO system if both parties agree. See DSU, *supra* note 4, art. 25. Parties are also encouraged to settle claims without WTO adjudication. Id., art. 3(7).


industry groups urged the Clinton administration to impose unilateral sanctions on Japan to force its government to negotiate, the United States accepted the decision and dropped its complaint.8

Prohibition on Counterretaliation

If a respondent state has lost its case but maintains its breach of trade rules, it must accept retaliation—most often in the form of higher tariffs—and cannot threaten counterretaliation. This aspect of the WTO enforcement norms is critical to preventing trade wars by limiting the right to retaliate to successful complainants. For example, when the United States successfully challenged the EU hormone-beef ban, the European Union refused to change its policy but nonetheless accepted the right of the United States to raise tariffs on EU goods so long as it was in breach of trade rules.9 Similarly, when Brazil successfully challenged American cotton subsidies, the United States agreed to compensate Brazil, paying US$147 million annually for several years, instead of threatening counterretaliation.10

Regulating Remedies

Member countries must accept the WTO’s authority to determine the appropriate level of retaliation. Complaining countries cannot impose additional economic sanctions to increase the pressure on recalcitrant respondents.11 This principle prevents the escalation of trade disputes by placing limits on retaliation and provides clarity on the price of substantive noncompliance. Returning again to the EU’s ban on hormone-beef, American sanctions were not sufficient to change the EU’s policy, but the United States did not increase its retaliation above WTO-authorized levels to pry open European markets.

In sum, WTO members’ acceptance of these three principles of dispute settlement provided the foundation for the rule-based trading order. Although governments do not always comply with WTO substantive law, countries’ commitment (until recently) to these enforcement norms provided a stable and beneficial basis for international economic relations.

The Breakdown in Norms

Recent practice by the United States represents a dramatic departure from major economies’ past respect and careful cultivation of WTO enforcement norms. The U.S. actions have additionally had follow-on effects with other global economic powers, including the European Union, China, Canada, and others. There are at least three ways in which American policies have violated WTO enforcement norms and prompted other countries to similarly abandon these norms: Section 301 actions, Section 232 actions, and the block on the Appellate Body appointments.

Section 301 Actions

In June 2018, the U.S. government imposed unilateral sanctions against China for allegedly engaging in unfair trade practices with regards to intellectual property and state subsidies. The United States filed claims at the WTO regarding some of these allegations, but it left the DSU framework by immediately imposing sanctions on Chinese products (initially US$50 billion in June 2018, but increased to US$250 billion in September 2018). This is the U.S. government’s first use of Section 301 sanctions outside of the WTO framework since the WTO’s creation.

The American action created a situation where the Chinese government had to decide whether to respond quickly or wait for WTO adjudication. Unsurprisingly, given the unilateral nature of the American action, China responded immediately and unilaterally as well, and also applied sanctions without making use of the multilateral system.

Both the American and the Chinese actions violate the principle of multilateral adjudication of trade disputes and the principle that the WTO should determine the remedy (if any). The countries’ disregard of these rules has created the most dramatic and rapidly escalating trade war since the end of the Cold War.

Section 232 Actions

The United States has also imposed tariffs on aluminum and steel imports from WTO members, in the name of national security. The American claims of national security justifications for these goods strain credulity, and the tariffs have imposed unexpected economic costs on military allies and adversaries alike. The European Union filed a complaint at the WTO, but also declared that it will treat these tariffs as safeguards, a domestic measure designed to respond to a surge of imports. By reclassifying the tariffs as safeguards, the European Union claims that it can adopt compensatory measures—through higher tariffs—immediately. Although the EU’s unilateral measure is an understandable attempt to react in real time to the United States’ very broad national security claim, it also violates the WTO enforcement norms that these matters should be subject to multilateral adjudication. Other states, such as Mexico and Canada, have similarly adopted unilateral responses.

Block on Appellate Body Members

Although the U.S. block on the appointment or reappointment of Appellate Body members is not a breach of any rules or procedures embodied in the DSU, the action represents a direct attack on the functioning of the WTO enforcement system. Unless disputing parties agree to a process, without Appellate Body members, the DSU cannot function because it cannot provide the appeal to which WTO countries are entitled under the DSU framework. This means that the dispute cannot be resolved because the case cannot be forwarded to the Dispute Settlement Body, the entire WTO membership sitting in its dispute settlement role, for adoption. The United States thereby

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12 See Chad P. Bown et al., Trump and China Formalize Tariffs on $260 Billion of Imports and Look Ahead to Next Phase, Peterson Inst. for Int’l Econ. (Sept. 20, 2018).
13 See Bown & Kolb, supra note 1.
14 Id. Like the United States, China has filed a case but did not wait for WTO adjudication to counterretaliate.
15 Jennifer A. Hillman, Trump Tariffs Threaten National Security, N.Y. Times (June 1, 2018).
16 The Dispute Settlement Body adopts Appellate Body reports by reverse consensus: the report is adopted unless there is a consensus against adoption. This has never happened in practice. Instead of going through the DSU process, WTO members could alternatively agree to arbitration or to waive appeals on an ad hoc basis, but respondent states are unlikely to accept these alternatives.
effectively is forcing other WTO members out of the multilateral adjudication system as well—in most cases, with no alternative dispute settlement system. As former WTO Appellate Body member Jennifer Hillman has noted:

[W]hat everyone expects is that no one will wait for an appeals decision if there is not an appellate body division that can hear the appeal . . . . No country is likely to wait like that. So they start then to take a unilateral action—to go ahead to retaliate or other unilateral action against the country with whom they had the dispute. And the concern is that then that country says, “that action was not lawful” . . . and you end up with the possibility of a mini-trade war in each and every dispute that comes before the WTO dispute settlement system.17

These three trade actions have significantly undermined enforcement norms. The United States and other WTO members have eschewed multilateral dispute settlement, have engaged in counterretaliation, and have imposed escalating trade sanctions. Together with the block on Appellate Body member appointments, these actions represent a rejection of the existing enforcement system.

Are We Heading Toward a Power-Based Future?

The departure of WTO member countries en masse from WTO dispute resolution does not bode well for the return to near perfect compliance with WTO enforcement norms. Until 2016, the system functioned as a mandatory and binding legal system, even though the WTO never had the power to prevent unilateralism. Nonetheless, member countries abided by the WTO’s enforcement norms and created one of the most effective rule-based legal systems in international law.

Going forward, it will be hard for countries to credibly commit to returning to a mandatory rule-of-law system in good times and bad. First, the precedent of widespread departures from WTO enforcement norms provides national leaders with more freedom in crafting strategies to allegations of WTO breaches. Many complaining countries may no longer wait for the WTO adjudicative process to play out and may respond immediately to other countries’ alleged breaches. In addition, respondent countries may resist dispute settlement and start threatening counterretaliation if complaining countries impose sanctions. The events of the last two years also change the optics of such actions: these strategies seem less like an egregious violation of international law and more like a reasonably available policy option. Furthermore, domestic constituencies may now have less sympathy for claims that WTO rules pose a real constraint on national leaders, thus raising the already high political costs of abiding by WTO rules and procedures.

Second, emerging economies, which have greater long-term concerns about whether the WTO rules are in their national interests, may use the precedent of recent events to resist the application of WTO rules. Countries such as China, Brazil, and India may wish to push back on WTO intellectual property rules or rules that limit a country’s ability to use subsidies broadly. These countries can use the recent precedent to justify departures from WTO enforcement norms and force a return to power-based negotiations on these issues.18 Such threats may materialize more in future years as the economic power of emerging economies grows.

If the WTO system is not able to return to a rule-of-law system, then the value of the WTO agreements and, perhaps more importantly, the value of the WTO as a forum to resolve trade issues without threats will be notably weakened. The meaning of WTO rules will depend on the disputing countries’ interpretations and the relative power of each country to enforce its view. This creates uncertainty for countries trying to maintain the maximum

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17 See Trade Talks, America May Be Doing Away with Dispute Settlement, Episode 60 (Oct. 28, 2018).
level of regulatory discretion in trade policy and yet comply with WTO rules, as well as for private industry trying to make investments for the next decade. More importantly, it will make WTO law apply only to those who do not have the power to resist other country’s interpretations.

The path ahead seems like a much rockier road than the last two decades, with the prospect of protracted trade wars and uncertain trade law. The WTO’s ability to be an important constraint on states will be substantially weakened. Although the WTO will continue to operate, its influence is most likely to wane as the international trade system returns to more unilateral adjudication and remedies.
THREE APPROACHES TO FIXING THE WORLD TRADE ORGANIZATION’S APPELLATE BODY: THE GOOD, THE BAD AND THE UGLY?

By Jennifer Hillman, Professor, Georgetown University Law Center*

The basic rule book for international trade consists of the legal texts agreed to by the countries that set up the World Trade Organization (WTO) along with specific provisions of its predecessor, the General Agreement on Tariffs and Trade (GATT). At the heart of that rules-based system has been a dispute settlement process by which countries resolve any disputes they have about whether another country has violated those rules or otherwise negated the benefit of the bargain between countries. Now the very existence of that dispute settlement system is threatened by a decision of the Trump Administration to block the appointment of any new members to the dispute settlement system’s highest court, its Appellate Body. Under the WTO rules, the Appellate Body is supposed to be comprised of seven people who serve a four-year term and who may be reappointed once to a second four-year term.1 However, the Appellate Body is now

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down to just three members due to the United States’ blockage of any process to replace those whose terms have expired—and three is the bare minimum number of members necessary to rule on an appeal. Moreover, the terms of two of those three remaining members will expire in December, 2019, leaving the Appellate Body unable to complete any appeals.\(^2\)

In the absence of a functioning Appellate Body, the WTO’s highly regarded dispute settlement system could grind to a halt. Under the rules of the Dispute Settlement Understanding (DSU), countries that win a case at the panel stage are not entitled to seek the rewards of that victory while an appeal is pending. As such, any country that loses a case could forestall any outcome by appealing the decision, knowing that the Appellate Body lacks the requisite quorum of three members to hear their appeal. It is hard to see why countries would be willing to wait in an endless queue for their appeal to be completed; instead most are likely to take matters into their own hands by engaging in unilateral retaliation, which will only invite further retaliation by the country that filed the appeal in the first place. As the Deputy Director General of the WTO, Alan Wolff put it, the United States’ blockage of any process to appoint new members to the Appellate Body risks turning every individual trade dispute into a “mini-trade war.”\(^3\)

**Context Matters**

In considering what needs to be done to fix the Appellate Body and when, the context in which this crisis is occurring is important.

First, it must be remembered that the United States’ decision to join—and indeed to lead the effort to create—a binding dispute settlement system for the trading system occurred at a unique moment in history. The negotiations establishing the WTO and its dispute settlement system occurred in the late 1980s and early 1990s—arguably the high-water mark for multilateralism and multilateral rules.\(^4\) It was created in the wake of the collapse of Communism and the building

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1. Article 17 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (“DSU”), Annex 2, Marrakesh Agreement Establishing the World Trade Organization, 1867 U.N.T.S. 154, provides that the Appellate Body shall be “comprised of [seven] persons of recognized authority, with demonstrated expertise in law, international trade and the subject matter of the covered agreements generally”; and that each person shall serve on the Appellate Body “for a four-year term, and each person may be reappointed once.”

2. DSU Article 17.1 states that the Appellate Body “shall be composed of seven persons, three of whom shall serve on any one case.” However, beginning in the spring of 2017, the United States objected to the commencement of the traditional process for selecting new members to replace those whose terms had expired, and in September 2018, objected to the reappointment of one other member, leaving the Appellate Body with only three members. While the Appellate Body will formally be without the required three members to hear appeals in December 2019, it may run short of members for specific appeals even sooner than that should any of the remaining three members become ill or have a conflict of interest or the appearance of a conflict based on their past experiences prior to joining the Appellate Body.


4. During the late 1980s and 1990s, for example, the Maastricht and Amsterdam treaties formally binding together the countries of Europe into the European Union (EU) were completed in 1993 and 1997. The Montreal Protocol on Substances that Deplete the Ozone Layer—or chlorofluorocarbons, came into force on January 1, 1989. The International Convention on the Law of the Sea established its International Tribunal in 1996. International courts
of a united Europe, at a time of much work in the academic community, led by John Jackson and his critical 1990 book *Restructuring the GATT*, to provide the intellectual underpinnings for a trade organization with a binding set of rules and a system for adjudicating them at its central core. 5 Second, it was a time in the United States of considerable frustration among the trade insiders at the lack of an ability to hold countries—particularly those in the EU—to their commitments under the then existing General Agreement on Tariffs and Trade (GATT). 6 Under the rules of GATT, if a country did not want a particular dispute to be discussed at all, it could block the creation of a panel to consider it. If a country allowed the dispute to be heard but did not like the outcome, it could block the adoption of the panel report, thereby preventing the report from creating an obligation to comply. As a result, there was a clamoring among the trade cognoscenti for a more binding trade-rules system. Third, the WTO’s Dispute Settlement Understanding (DSU) was, in the end, rolled up into a much broader package of new texts (“Results of the Uruguay Round of Multilateral Trade Negotiations”) providing market access and rules on everything from trade in services, to agriculture to intellectual property that had never before been included, such that even those members of Congress who might otherwise be reluctant to agree to effectively submit the United States to the jurisdiction of an international “court” found their qualms about dispute settlement outweighed by the gains in market access and new disciplines elsewhere. 7 It is hard to imagine such a confluence of events and incentives coming together again for decades, if ever. Therefore, if the Appellate Body and with it the WTO’s binding, two-stage dispute settlement system, cannot be restored soon, it is not likely to come back.

Second, while there may be little support among many in Congress for the Trump Administration’s “national security” tariffs on steel and aluminum—and there will be downright opposition if tariffs are imposed on cars or car parts—there are very few champions in the US were flourishing too, with the UN creating a number of international tribunals, including the International Criminal Tribunal for the Former Yugoslavia, established in 1993, the International Criminal Tribunal for Rwanda, established in November 1994, the Special Court for Sierra Leone in January of 2002, followed by a joint UN-Cambodian government court, the Extraordinary Chamber of Cambodia in June 2003. The free-standing Caribbean Court of Justice got underway in 2001 while the African Court of Human and Peoples Rights protocol was adopted in 1998. 5 See Robert Howse, The House That Jackson Built: Restructuring the GATT System, 20(2) Mich. J. Intl. L., 107 (1999), available at https://repository.law.umich.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1407&context=mjil.

6 The U.S. believed that a directive of the European Communities to ban the use of hormones in livestock production and meat sold in the EU, was in violation of the Agreement on Technical Barriers to Trade (TBT Agreement). When the EU rejected the proposal to establish a Technical Expert Group to address questions of a technical nature, the U.S. suggested the establishment of a panel to determine if the EU was circumventing its obligations through the use of product and process methods rather than changing product characteristics. The EU rejected this proposal for establishment of a panel.

7 Based on concerns over sovereignty, the United States has not submitted to the general jurisdiction of the International Court of Justice, or the Inter-American Court of Human Rights, or the International Tribunal for the Law of the Sea. Recently, National Security Adviser John Bolton stated that the United States will not join, co-operate or provide assistance to the International Criminal Court. See John Bolton Threatens ICC with US Sanctions, BBC News, September 11, 2018, available at https://www.bbc.com/news/world-us-canada-45474864.
Congress for the Appellate Body. If the Appellate Body crisis is to be solved, it is not likely to be at the behest of members of Congress or other political forces in Washington coming to the rescue.

Third, the United States’ concerns over the functioning of the Appellate Body did not begin with election of Donald Trump and they will not end with Donald Trump. Many of the current concerns have been raised for more than a decade with virtually no response in Geneva. Any solution that is worked out is going to have to demonstrate that the rest of the world is hearing what the US is saying—even if they don’t always agree with the US’ claims.

What can be done to break the impasse? I suggest three options—borrowing the title from Sergio Leone's classic western movie, The Good, the Bad and the Ugly—but recognize at the outset that beauty is in the eyes of the beholder—so what I may call ugly may appear to be good to others. What is critical is not sorting out the best approach; rather, the imperative is to break the log-jam before it is too late.

**The Good—A Separate System for Trade Remedies**

While no one knows for certain exactly what the United States seeks in terms of changes to the Appellate Body, it is clear that the lion’s share of its complaints stem from decisions by the

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10 The U.S. Ambassador to the WTO, Dennis Shea, recently stated that there is nothing to negotiate or change with respect to the WTO Appellate Body, since all the US wants is for the Appellate Body to apply the rules as they were written when the WTO was created in 1995. Alternatively, Amb. Shea has said that the US concerns are those that have been articulated at recent meetings of the WTO’s Dispute Settlement Body. As those meetings, the United States raised the following concerns:

1) that Appellate Body members should not be allowed to “hold-over” to finish an appeal they began working on before their term as an Appellate Body member expired, a practice which had been engaged in pursuant
Appellate Body relating to trade remedy decisions—challenges to anti-dumping, anti-subsidy or safeguard measures. Whether it is the series of disputes in which the Appellate Body outlawed the previously long-standing practice of “zeroing” in the calculation of anti-dumping margins, or the decision to read into the WTO’s Safeguards Agreement a requirement that safeguards can only be imposed if there is evidence that the increase in imports occurred as a result of “unforeseen developments,” or the decision to determine that the entities that are capable of providing subsidies—“governments or public bodies” are only those entities which engage in “governmental functions”—it is clear that the decisions that are at the heart of the United States’ substantive concerns are those in the trade remedy arena.

In addition, developing country members have long-term concerns over the application of the trade remedy rules, including their perception that some countries resort to trade remedies as “tools to capture all.” As such, a separate process for appeals may satisfy their concerns as well.

Therefore, one approach might be to treat appeals of trade remedy decisions differently—either by creating a specialized Appellate Body chamber to hear them or by eliminating or at least temporarily freezing appeals from panel decisions in trade remedy cases.

A. Special Appellate Body for Trade Remedies

One option would be to create a special Appellate Body to hear only appeals of trade remedy decisions. This special appellate institution—call it the Rules Appellate Body—could be made up of members chosen in large part because of a strong background in trade remedy law. The selection process for members and the procedures of this Rules Appellate Body could largely mirror those of the current Appellate Body—and given that about half of all WTO disputes have been over trade remedy matters, the workload of this Rules Appellate Body and of the existing Appellate Body would be about even, so having complimentary bodies of equal size would make sense. Having two bodies evenly splitting the work load would also assist both bodies to more readily complete their work in the 90-day time frame outlined for appeals in the DSU rules. The Rules Appellate Body could similarly be staffed by a secretariat that also has deep expertise in trade remedy law. Decisions coming from this Rules Appellate Body would be subject to the same reverse consensus process of adoption by the WTO’s Dispute Settlement Body (DSB) and compliance with the decisions would similarly be subject to the same oversight by the DSB as appeals under the current system (DSU Articles 21 and 22).

A variation on this theme could be to simply add two or four additional members to the existing Appellate Body who have deep trade remedy expertise and insist that any three-member division hearing an appeal of a trade remedy case would have to be made up of at least two of these trade-remedy expert Appellate Body members.

If this proposal is pursued formally, the Members would need to go through a negotiation process for amendment to the Dispute Settlement Understanding (DSU) (Understanding on Rules and Procedures Governing the Settlement of Disputes, Annex 2 of the Multilateral Trade Agreements). According to Article X:8 of the Marrakesh Agreement Establishing the World Trade Organization ("WTO Agreement"), such an amendment needs to be decided by consensus. As such, work would need to begin immediately to work out a package set of amendments to set up this new process and to seek appointments both to the Rules Appellate Body and to fill the four vacancies on the existing Appellate Body. Members may also be able to develop related practices on a voluntary basis, similar to the process launched by Canada in July 2016. Members would also need to resolve whether appeals from “adverse effects” (as opposed to countervailing duty)

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12 Article X:8 states that “Any Member of the WTO may initiate a proposal to amend the provisions [of the DSU] by submitting such proposal to the Ministerial Conference. The decision to approve [such amendments] shall be by consensus . . . and shall take effect for all Members upon approval by the Ministerial Conference.”

cases challenging subsidies would be heard by the Rules Appellate Body or the existing Appellate Body.

B. Moratorium on Appeals from Trade Remedy Panel Decisions

A second approach to trade remedy disputes would be to establish a moratorium on appeals from panel decisions—or even just to amend the rules to make panel decisions on trade remedy matters final. The theory behind such an approach is two-fold. First, panels examining trade remedy decisions are already playing an appellate role and therefore don’t need a second or third level of review. Every trade remedy measure that comes before the WTO’s dispute settlement system must be based on an investigation conducted by the investigating authorities in each country—so there is already a factual record that has been compiled and an existing decision that applies the law—including the WTO rules—to those facts to reach a conclusion that trade remedies are justified in the particular case at issue. As such, it may be appropriate to allow the panel’s decision to sit in the shoes of an appellate report, and not subject such panel reports to further review.

The second reason for a “no appeals of trade remedy panel reports” approach is that most of the controversial decisions of the Appellate Body have been in the trade remedy area, so eliminating appeal rights in this limited arena may suggest a major enough change to break the current impasse over Appellate Body appointments. If so, it would allow the process to move forward, to keep the Appellate Body up and running for all non-trade remedy appeals and would maintain the current consensus-based approach to the appointment of Appellate Body members.

A temporary moratorium on appeals of trade remedy panel reports could be implemented through a DSB resolution noting that for the period of the moratorium, Article 17.1 of the DSU (“the Appellate Body shall hear appeals from panel cases”) is interpreted to put a hold on appeals from trade remedy panels. If the Members prefer a permanent end to trade remedy appeals, an amendment to Article 17.1 would most likely be necessary.14

Obviously, those who fundamentally disagree with the United States’ criticisms of the Appellate Body and its trade remedy decisions are more likely to put this approach into the category of bad

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14 A less desirable option for implementing the “no appeals of trade remedy panels” might be for the Ministerial Conference and/or the General Council to adopt a definitive interpretation of Article 17.1 of the DSU, pursuant to Article IX.2 of the Agreement Establishing the World Trade Organization. The phrase “shall hear appeals” from DSU Article 17.1 would be found not to cover all appeals through an interpretation that “shall hear appeals” means “shall hear appeals from matters not claiming violations of the WTO’s Agreement on Safeguards, or the Agreement on Subsidies and Countervailing Measures or the Agreement Interpreting Article VI of the GATT (Anti-dumping Agreement).” As noted above, Members would have to determine whether all subsidy disputes would be subject to this “no appeal” approach, or only those involving countervailing duty investigations. Given that the rationale for staying or eliminating appeals in trade remedy cases is based on the existence of a factual and legal record developed by Investigating Authorities in each country, it is logical to limit the “no appeals” approach to countervailing duty investigations, as most countries do not have comparable investigative records for “adverse effects” subsidy claims.
or even ugly. But the reason it starts out as a “good” option is that it represents a significant enough departure from the current system to serve as a catalyst for breaking the gridlock.

The Bad: Arbitration under Article 25 of the DSU Instead of Appeals to the Appellate Body

The second approach—The Bad—is to use the existing language in DSU Article 25 to effectively continue appeals using an arbitration process. Because this arbitration option is already in the rules, moving to arbitration in lieu of appeals to the Appellate Body may be the only option available to the Members that does not require a change to the DSU rules themselves or a consensus decision by the DSB. One approach that has been suggested to put Article 25 into action would work as follows: 1) the parties to a dispute would agree before the panel ruling is known to arbitrate any appeal to that decision; 2) the arbitration could be conducted much like appeals are today—the parties could, for example, choose to adopt the Appellate Body Working Procedures as their own, and could ask to appoint current or former appellate body members to be their arbitrators; 3) the current secretariat of the Appellate Body could serve as the staff to the arbitration process, just as it does in providing support for arbitrations over the amount of time countries are given to comply with rulings (RPT) and the amount of retaliation that is permitted; 4) the arbitrators would apply the substantive and procedural rules of the WTO Agreements; 5) parties could agree to allow third parties in the panel proceedings to participate in an appeal-arbitration; 6) because an arbitration would not suspend the adoption of a panel report, the complainant would need to suspend the panel proceedings under DSU Article 12.12, so the panel report would not be adopted as such, but could be attached to and incorporated into the arbitrator’s award; and 7) the arbitrator’s award, including the final panel report, could be circulated to all WTO members as a WT/DS document.

The upside to this arbitration-appeal approach is that it is already in the rules and could be adopted without the need for consensus among WTO members.

So why is it “bad”? First, going to Article 25 arbitration for all appeals means giving up on the Appellate Body. If this road is taken, it is highly unlikely that there will be sufficient will among WTO Members to restore the Appellate Body and with it, the notion of having a binding two-stage process. Unless the arbitration-appeal process proves overly cumbersome or unworkable, it will likely remain the only option for those willing to use it.

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16 In Saving the WTO’s Appeals Process, Cato Institute, October 12, 2018, available at https://www.cato.org/blog/saving-wtos-appeals-process, former Appellate Body Chair James Bacchus similarly argues that arbitration under Art. 25 presents an opportunity for Members to engage in arbitration as a means of dispute settlement and allows significant leeway to Members to select arbitrators and procedures, including replicating the current DSU rules, albeit without US participation.
Second, it requires the agreement of the parties in each and every dispute to go to this arbitration-appeal process, so countries would have no guarantee that the United States (or others) would necessarily agree to an arbitration-appeal in a given dispute. Particularly for smaller countries, there is considerable concern about their ability to hold larger countries like the United States to their commitments in the absence of an Appellate Body. Moreover, the losing party in a given dispute could still file a notice of a formal appeal and thereby stall indefinitely the adoption of the panel report. As a result, it may not serve the most crucial need in the system—to stop all disputes from becoming mini-trade wars.

Third, the decisions of an arbitration panel would not be formally adopted by the DSB. While the approach outlined above would allow the attachment of a panel report to an arbitration award and would allow that package of the award plus the panel report to be circulated to all Members, it would not be formally adopted by the DSB. As such, the arbitration-appeals would always sit somewhat outside the binding dispute settlement system. While the rules provide that arbitration awards under Article 25 can be subject to the surveillance of the DSB (DSU Articles 21 and 22 apply mutatis mutandis), it is not certain exactly what the DSB can do to enforce an unadopted panel report/arbitration appeal.

The Ugly: Fix the Procedural Matters Readily Fixable, Run the Selection Process and then Appoint New Members by Vote

The third approach—The Ugly—would be a multistep process that starts with fixing a number of the procedural or more fixable of the issues that the United States has been raising. All of these were discussed by scholars in some detail17 and were addressed in a proposal recently put forward at the WTO by the European Union, joined by China, Canada, India, Norway, New Zealand, Switzerland, Australia, Korea, Iceland, Singapore, and Mexico.18 The fixes in the EU paper include:


1) 90-days for appeals—the proposal would amend Art 17.5 of the DSU to require consultation between the parties and the Appellate Body to seek parties’ agreement on any extension of the 90 day period; in the absence of an agreement for a time extension, options to limit the scope of the appeal, or to put page limits on the submissions, or to limit the length of the Appellate Body Report would be worked out by the parties and the Appellate Body, along with the possibility of issuing the report in one of the three official languages of the WTO, with translation to be done outside the 90-day window;

2) clarifying and limiting the ability of outgoing Appellate Body members to hold over to finish an appeal that started before the expiration of their term to only those appeals in which the hearing has been completed;²⁰

3) modifying or clarifying DSU Article 17.12 that requires the AB to “address” each issue raised on appeal to make it clear that “address” means addressing issues only to the extent necessary to resolve the dispute;

4) clarifying that municipal law is an issue of fact, not an issue of law, and therefore is not one of the issues that falls to the Appellate Body for interpretation; and

5) establishing an annual process for meetings between the Appellate Body and the WTO Members to allow Members to express concerns about any particular Appellate Body approaches, systemic issues or trends in the jurisprudence.

The hope would be that these could be fixed through a single amendment to Article 17 of the DSU, with the EU proposal calling for adoption of such an amendment by the General Council as soon as possible. Following the adoption of these changes (or any combination of them or other similar changes), Members should push for a swift process to appoint four new members of the Appellate Body and to begin shortly thereafter a process to replace the two AB members whose second/final term ends on December 10, 2019. If at that point the United States were to join the consensus to move forward, this plan would leapfrog over the bad and the good to become the beautiful. It would be a win-win for all. The United States could rightfully claim that its pressure resulted in significant changes to address each of the concerns it has raised at the DSB since the spring of 2017,²⁰ the other Members would benefit from changes that should make the dispute

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²⁰ An alternative fix to the “hold over/Rule 15” concern was set forth in a Georgetown Law paper, suggesting that the amendment to the holdover rule to appeals in which the hearing has been completed should be accompanied by incentives for the appointment process to proceed before vacancies occur. “TRANSITION ON THE WTO APPELLATE BODY: A PAIR OF REFORMS?” https://georgetown.app.box.com/s/jwcvliz2thwtv3dhgdne0nkfk3vlpv3sf

²⁰ See Annex A for a summary and links to all US statements to the DSB involving the AB selection process since 2017.

settlement system more efficient for all but done in a manner that does not detract from the rights of any Member, and the WTO’s binding two-stage dispute settlement system would be back to working at full-speed.

If, however, the United States were not willing to move forward, despite having its concerns addressed through the changes noted above, then the Members would need to move to appoint Appellate Body members over the United States’ objection. To do so, the Chair of the DSB should begin the normal consultation process for the selection of Appellate Body members, beginning with convening the Selection Committee—which consists of the Chair of the DSB, the Director General of the WTO, and the chairs of the General Council, Committee on Trade in Goods, Committee on Trade in Services and TRIPS Council. All Members would be invited to interview the candidates themselves and to convey their preferences to the Selection Committee. Based on those preferences and its own interviews of the candidates, the Selection Committee would then recommend a slate of four members to fill the four vacancies on the Appellate Body.

If at that point the United States blocks action on the recommended slate of nominees, then the time would have come for the Members to appoint the recommended slate, by vote if necessary. Failure to do so would effectively mean allowing one Member to deny all other Members their right of access to the already-agreed upon Appellate Body.

While the DSB rules state that decisions of the DSB shall be taken by consensus (DSU Article 2.4), the vote would be an appointment rather than a decision under Article 2 and would be done in furtherance of the requirement in Article 17.2 that the DSB “shall appoint persons to serve on the Appellate Body.” The vote would be simply and solely to appoint the slate of recommended

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21 World Trade Organization, Establishment of the Appellate Body - Recommendations by the Preparatory Committee for the WTO approved by the Dispute Settlement Body on 10 February 1995, WTO Doc. WT/DSB/1. The selection process noted above, taken pursuant to recommendations of the WTO Preparatory Committee, have been followed over the entire life of the Appellate Body and used successfully to appoint each of the 27 present and former members of the Appellate Body. There is no reason to depart from this well-settled process.

22 Note that at this point, nominations to fill the vacancies created by the expiration of the term of Ricardo Hernandez Ramirez (term expired June, 2017) and Peter van den Bossche (term expired December, 2017) have been submitted to the WTO. An additional process would likely be necessary for candidates to replace the terms of Hyun Chong Kim of South Korea (resigned August 1, 2018) and Shree Baboo Chekitan Servansing of Mauritius (first term expired September 30, 2018 with United States blocking reappointment for a second term).

23 Professor Ernst-Ulrich Petersmann makes the point that the United States’ unilateral blocking of a DSB consensus is inconsistent with the legal duty of all WTO members to maintain the Appellate Body as legally prescribed in Art. 17 of the DSU (“being ‘composed of seven persons’, with vacancies being ‘filled as they arise’”), is inconsistent with DSU Art 3.10 (good faith) and amounts to illegal de facto amendments to the DSU, thereby justifying—and legally requiring—majority decisions by the WTO Ministerial Conference or General Council to maintain the AB. Prof. Ernst – Ulrich Petersmann, Proposals by panel member, Conférence sur la réforme de l’OMC, November 15, 2018,
nominees. As such, it should not raise concerns that the WTO has departed from the consensus-based approach to decision making nor should it set a precedent for voting to make changes in the underlying rules of the WTO itself. Moreover, a vote to appoint members to the Appellate Body should be seen as an action by the WTO Members to fulfill the obligation placed on them as members of the DSB under Article 17.2 —“the DSB shall appoint persons to serve on the Appellate Body. . . vacancies shall be filled as they arise.” In addition, the vote would only occur after efforts to improve the DSU while meeting the United States’ concerns were taken. As such, the good faith of the Members voting to ensure the continued operation of the two-stage binding dispute settlement system would be clear.

There is no doubt that going down the road of appointing members to the Appellate Body will be controversial. Already, the United States has signaled that it will take a “decision” of the DSB to launch the selection process and that it views appointments as “decisions” of the DSB, which means, that for the United States, both the commencement of the selection process and the appointment itself are subject to the DSB’s consensus rule—“where the rules and procedures of this Understanding provide for the DSB to take a decision, it shall do so by consensus.” (DSU Article 2.4). There are no provisions in the DSU establishing a voting process. Instead, the rules regarding voting are contained in Article IX of the WTO Agreement, which provide that: 1) where a decision cannot be arrived at by consensus, the matter shall be decided by voting, 2) that each Member of the WTO has one vote, 3) that votes can be taken at meetings of the Ministerial Conference and the General Council, and 4) that matters (with some specific exceptions such as definitive interpretations of existing text) shall be decided by majority vote. (WTO Agreement Article IX.1).

It is important to note that in the 22 years of the WTO’s existence, the Members have never chosen to vote on any matter, preferring to stick with the GATT/WTO’s traditional consensus-based decision-making process. If and when such voting occurs, it will be done in a meeting of the General Council (or at a Ministerial Conference), not in the Dispute Settlement Body. While all Members of the WTO are members of both the General Council and the Dispute Settlement Body, the General Council and the Dispute Settlement Body have different, but overlapping, available at https://www.tresor.economie.gouv.fr/Articles/4c69c305-4f37-45f5-aa28-09a6aab19768/files/398e28fd-73d7-42bc-85fd-9267bb0289c5.

24 Id. As Professor Petersmann states “such majority decisions [to complete the Appellate Body selection process] necessary for preventing the illegal destruction of the WTO AB system do not set a precedent for future WTO majority voting on discretionary, political issues.”


26 The General Council is the WTO’s highest-level decision-making body, meeting regularly to carry out the functions of the WTO. It has representatives (usually ambassadors or equivalent) from all member governments and has the authority to act on behalf of the ministerial conference which only meets about every two years. The General Council also meets, under different rules, as the Dispute Settlement Body and as the Trade Policy Review Body. https://www.wto.org/english/thewto_e/gcounc_e/gcounce.htm.
mandates, with the General Council sitting as the Dispute Settlement Body when the matters before it fall under the rules of the Dispute Settlement Understanding.\(^{27}\) This mandate has evolved into the Dispute Settlement Body sitting on its own, often with different Member representatives (typically its dispute settlement specialists).\(^{28}\) There is, however, precedent for dispute settlement issues to come before the General Council.\(^{29}\) And while most of the discussion over the blockage of the appointment process has occurred in the Dispute Settlement Body, China has raised concerns about the selection of new Appellate Body Members in the General Council.\(^{30}\)

Moreover, as WTO Agreement Article XVI. 3 makes clear, to the extent that there is a conflict between the WTO Agreement rules (which do provide for voting) and the DSU rules (which do not provide for voting), the WTO Agreement rules prevail in the event of a conflict between the two.\(^{31}\) Here, the conflict stems from the United States’ use of the consensus rule in the DSU to unilaterally terminate the existence of the Appellate Body, thereby jeopardizing the functioning of the dispute settlement system, while the rules of the WTO Agreement mandate that “the WTO shall administer the Understanding on Rules and Procedures Governing the Settlement of Disputes.”\(^{32}\) It is that responsibility to administer the rules of the DSU that gives the WTO and its Members the right to use the voting procedures in Article IX of the WTO Agreement if necessary to break the impasse over the appointment of members to the Appellate Body. In addition, the provisions in Article IX.2 (for authoritative interpretation by three-fourths majority vote) could be used if necessary to confirm the interpretation that there is a collective duty under Article 17.2 of the DSU (“the DSB shall appoint . . . Vacancies shall be filled as they arise”) to fill the vacancies on the Appellate Body.

In addition, problems in simply getting the appointments on the agenda may add further complications. A simple proposal requesting a General Council decision (by vote if necessary) to appoint the recommended slate of nominees may face obstacles even at the step of placing the item on the agenda. According to the Rules of Procedure for Sessions of the Ministerial Council, WTO Agreement Article IV.3 provides that the DS may have its own chairman and its rules of procedure.

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\(^{27}\) Article IV of the WTO Agreement provides that the General Council (composed of representatives of all Members) shall meet in the intervals in between the Ministerial Conferences and shall carry out: 1) the functions of the Ministerial Conference, 2) the additional functions assigned to it by the WTO Agreement, and 3) shall convene to “discharge the responsibilities of the Dispute Settlement Body provided for in the Dispute Settlement Understanding.” Art. IV.3.

\(^{28}\) WTO Agreement Article IV.3 provides that the DSB may have its own chairman and its rules of procedure.

\(^{29}\) For example, the issue of the acceptance and treatment of amicus curiae submissions was debated in General Council in 2001. World Trade Organization, General Council – Minutes of the Meeting dated November 22, 2001, WTO Doc. WT/GC/M/60.

\(^{30}\) China raised the Appellate Body selection process at the May 8, 2018 General Council meeting. World Trade Organization, General Council – Minutes of the Meeting dated May 8, 2018, WTO Doc. WT/GC/M/172.

\(^{31}\) Marrakesh Agreement Establishing the World Trade Organization, 1867 U.N.T.S. 154, art. XVI:3. Article XVI provides: “3. In the event of a conflict between a provision of this Agreement [WTO Agreement] and a provision of any of the Multilateral Trade Agreements [which includes the DSU as Annex 2], the provision of this Agreement shall prevail to the extent of the conflict.”

Conference and Meetings of the General Council (WT/L/161), any Member can propose items for inclusion in the provisional agenda in advance of the Ministerial Conference session or the General Council meeting. However, because the first item of business at each session shall be the consideration and approval of the agenda, even if a Member can place the appointment of Appellate Body members on the provisional agenda, there might not be consensus for the adoption of the agenda, raising further issues about whether Members would be willing to break another consensus rule—that agendas are set by consensus—in order to ensure the survival of the Appellate Body.33

Why is this potentially beautiful outcome considered “ugly”? If the process resulted in a vote to appoint Appellate Body Members, it will indeed be ugly, for at least the following reasons:

1) going to voting—even for the limited purpose of appointing Appellate Body members—puts Members in the difficult position of choosing between abandoning the preferred consensus approach versus the obligation to fill seats on the Appellate Body and potentially raises the concern that other more substantive issues will soon follow as matters subject to voting;

2) the United States may declare any Appellate Body members appointed by this process to be illegitimate and that it therefore refuses to participate in the appeals process or to abide by the decisions of the Appellate Body;

3) even though the vote would allow the Appellate Body and WTO’s two-stage dispute settlement system to remain in place, an Appellate Body that is not viewed as legitimate in the eyes of all Members would remain a diminished one.

Conclusion

I put forward these good, bad and ugly options because I believe the situation is grave. I would regard any one of these options as preferable to doing nothing and letting the system die. So I urge everyone to rearrange these options according to your own sense of what is good and what is ugly—but understand that doing nothing is worse than even the most unsightly solution.

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33 For example, India recently objected to including investment facilitation on agenda of the General Council meeting in 2017. As a result, the meeting was reconvened eight days later with a modified title on the item to emphasize that it is for informal dialogues on investment facilitation and not the launch of formal negotiations. This has often been the process in the past—to work out a consensus on a modified agenda. It is not clear whether such modifications would satisfy the United States if it remains opposed to any process that would lead to the appointment of members to the Appellate Body.
### Annex A

**Concerns Expressed before the WTO’s Dispute Settlement Body by the United States Regarding the Function of the Appellate Body -- 2017 to Present**

<table>
<thead>
<tr>
<th>Date of DSB Meeting</th>
<th>Block appointment or reappointment process</th>
<th>Concern/s Expressed by United States</th>
<th>Full text of US Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>19-Apr-17</td>
<td>US stated that it looks forward to consulting with the Chair and the Members on the appointments</td>
<td>No concern expressed on the AB or the relevant rules</td>
<td><a href="https://geneva.usmission.gov/wp-content/uploads/sites/290/Apr19.DSBStmt_as-delivered.fin_public.pdf">https://geneva.usmission.gov/wp-content/uploads/sites/290/Apr19.DSBStmt_as-delivered.fin_public.pdf</a></td>
</tr>
</tbody>
</table>
Possible reform of investor-State dispute settlement (ISDS)

Submission from the European Union

This note reproduces a submission received from the European Union in preparation for the thirty-fifth session of Working Group III. The submission is reproduced as an annex to this note in the form in which it was received by the Secretariat (in Arabic, Chinese, English, French, Russian and Spanish).
Annex

20 November 2017

The identification and consideration of concerns as regards investor to state dispute settlement

1. Introduction

1. This paper is intended as a contribution to the discussions in Working Group III of the United Nations Commission on International Trade (UNCITRAL). The aim of the paper is to identify and consider concerns as regards the current system of investor to state dispute settlement (ISDS) in line with the first stage of the mandate given to Working Group III by the UNCITRAL Commission. Consideration of what reforms might be desirable is for the second stage of discussions and is not addressed in this paper.

2. The Note by the UNCITRAL Secretariat, "Possible reform of investor-State dispute settlement (ISDS)" of 18 September 2017 lists a number of concerns which have been identified regarding ISDS (para 19 et seq.). The present paper builds on and responds to that paper. In particular, it suggests that a further and complementary way of thinking about the concerns with the ISDS system is to consider the framework in which the current system of ISDS operates. Considering the system as a whole provides a way of identifying concerns because it permits the existing system of dispute settlement to be compared and contrasted to other systems with similar attributes. Consequently, this paper first examines the key attributes and characteristics of the investment treaty regime (section 2). It then briefly looks, in a comparative manner, at how disputes in regimes with comparable characteristics to the investment regime are managed (section 3). Thereafter, it looks at the factors influencing the design of the current system of ISDS (section 4) before turning, on the basis of the analysis in these previous sections, to identify a number of concerns which merit further consideration (section 5).

2. Key attributes of the investment treaty regime

3. The key attributes of the current investment regime stem from two fundamental features. First, the regime is a public international law regime. Second, it resembles public law in that it is largely concerned with the treatment of investors and hence the relationship between individual actors and the state.

4. The international investment regime is made up of a large number of international treaties. These are instruments of public international law, concluded between public international law actors acting in their sovereign capacity. In these agreements, states grant the power to bring claims to enforce these international treaties to natural or legal persons (investors). However, that does not take away the public international law nature of these agreements, agreed, as they are, between

1 A/CN.9/WG.III/WP.142.
two sovereigns. As treaties, these agreements are also meant to be interpreted in accordance with public international law. This includes the rules on interpreting treaties and other rules, such as the rules on state responsibility.

5. These public international law treaties deal with the sovereign capacity of states to regulate, by providing certain protections which are enforceable by investors. This creates a situation similar to public or constitutional law, in which individuals are protected from acts of the state and can act to enforce those protections. It is important to recall that the state is acting in its sovereign capacity, both in approving these treaties and as regards the acts challenged. Investment treaty obligations apply to any acts that can be attributed to a state, be it legislation passed by a parliament or an individual decision taken by a local council. In the event that a state is found not to have respected these obligations it must make reparations. Such reparations typically take the form of monetary compensation, implying a charge on the budget of a state.

6. Framed by these two key features, i.e. the public international law basis of the treaties and the public law nature of the relationship, one can identify a number of characteristics of the international investment regime which are relevant for thinking about the present system and assessing concerns. These can be enumerated as follows:

   a) A constitutional/administrative law component: the obligations set down in the investment treaties are intended to protect investors from certain (limited) state conduct. Hence applying the obligations implies striking a balance between the right to exercise sovereign authority and the duty to protect individuals, typical of constitutional/administrative law determinations;

   b) A unidirectional system: the investor initiates the case against the state because the investor accepts the standing offer to arbitrate provided in the treaties;

   c) A vertical relationship: disputes predominantly concern foreign investors bringing cases against host states that arise from the vertical, regulatory relationship between those actors due to the fact that the investor enters into the host state territory and its economic and legal order;

   d) A repeat function: the treaties in question potentially will give rise to multiple disputes over a potentially extended period of time. This is to be distinguished from legal instruments establishing one-off contractual arrangements;

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3 Ibid, at 63-68.
e) A determinacy component: the substantive obligations are indeterminate in the sense that they set down general, high level standards intended to apply in multiple different fact patterns, much like constitutional law provisions; and,

f) A predictability/consistency function: given the general formulation of investment protection standards and conscious of the repeat function stakeholders (governments, investors, civil society) look at precedents in order to understand how obligations in the treaties are being or should be interpreted. This occurs both within the same treaty and across treaties, given the relatively high degree of homogeneity of the treaties. This means the adjudicative role is key in elaborating and further refining the precise meaning of the substantive obligations.

3. Comparative analysis

7. Disputes flowing from systems with the characteristics identified above frequently lead to the creation of permanent bodies with full-time and tenured adjudicators to adjudicate disputes. Permanent adjudicatory bodies offer a number of advantages for adjudicating disputes in regimes which display these characteristics. These advantages operate in multiple and overlapping ways. Permanent bodies, by their very permanency, deliver predictability and consistency and manage the fact that multiple disputes arise, since they can elaborate and refine the understanding of a particular set of norms over time and ensure their effective and consistent application. This is particular relevant when the norms are relatively indeterminate. When appointing adjudicators in a permanent setting, thought is given to a long-term approach. States have an interest that public actions can be taken and at the same time individual interests protected and they know that the balance between these interests is to be maintained in the long term. Permanent bodies with full-time adjudicators also free the adjudicators from the need to be remunerated from other sources and typically provide some form of tenure. This prevents the adjudicators from coming under pressure to take short-term considerations into account and ensures that there are no concerns as to their impartiality.

8. It can be observed, both on the international and domestic level, that disputes in other regimes involving the characteristics enumerated above for the investment regime are normally settled before standing bodies. The members of these adjudicative bodies are composed of full time adjudicators who are appointed by states, associated with a high degree of independence and impartiality. Frequently, decisions of these standing bodies are subject to review via appeal in order to ensure correctness and greater predictability.

9. At the international level, examples include the European Convention on Human Rights with the European Court of Human Rights and the Inter-American Convention on Human Rights with the Inter-American Court of Human Rights. The legal regimes applied by these courts share many of the characteristics identified above as regards the investment regime.\(^5\) Both of these bodies have permanent, standing courts with full time adjudicators appointed by the treaty parties. Although it does not have jurisdiction on claims advanced by individuals, the WTO also deals

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\(^5\) There are of course also significant differences, such as the nature of the remedies or the relationship to domestic litigation.
with the review of state action. These claims are heard within a structure that permits for appellate review by adjudicators appointed by the treaty parties.

10. At the domestic level, legal regimes with similar characteristics to the investment regime are also typically provided with permanent bodies for adjudication. It is a recognisable feature in domestic legal systems throughout the world that public or administrative law disputes are dealt with by standing permanent courts with independent judges that are positioned within a hierarchy that permits appellate review.

11. These examples are useful, not necessarily in all their details and features, but in showing that when creating or developing regimes with comparable characteristics to the investment regime, countries have consistently created permanent standing bodies. The next section briefly recalls the nature of the existing regime before the paper turns to consider the concerns arising within the existing regime in the light of the characteristics enumerated in section 2.

4. The current dispute settlement mechanisms for the investment regime

12. As of the 1960s the overall approach to the regulation of foreign investment has been characterised by 1) the emergence of international arbitration as a common means of settling investment disputes and 2) the increasing recognition by treaty law of the ability of investors to enforce the treaties directly against host states. The ICSID Convention, concluded in 1965 and currently binding for 161 States, represented and continues to represent a significant advance in the development of international investment law.

13. The ICSID Convention uses a model of dispute settlement based on arbitration. Tribunals are appointed by disputing parties and composed on an ad hoc basis to hear a particular dispute. Awards can be annulled on certain limited grounds by an ad hoc annulment committee. Other ISDS takes place on the basis of rules originally created for commercial arbitration, such as the UNCITRAL Arbitration Rules.

14. The ICSID Convention was conceived before the large body of investment treaties came into existence. Of the 2667 currently in force only 63 were in place in 1970 (the ICSID Convention entered into force on 14 October 1966). The drafters therefore did not have in mind that the system of dispute settlement contained in the ICSID Convention would be used, as it currently is, primarily for treaty dispute settlement. Indeed, they envisaged it would primarily be used for investment contract dispute settlement. The drafters of ICSID estimated that around 90% of cases would be under investment contracts and concessions and not under investment treaties. This can be understood to have motivated the key design choices made in the ICSID Convention.

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6 Source: UNCTAD Investment Policy Hub.
8 See, J Pauwelyn, "At the Edge of Chaos? Foreign Investment Law as a Complex Adaptive System, How It Emerged and How It Can Be Reformed," ICSID Review, Vol. 29, No. 2 (2014) pp. 372-418, in particular pp 401-402 quoting Professor Lowenfeld (a member of the US Delegation negotiating ICSID) who wrote: "None of the discussions at the consultative meetings [in preparation of the ICSID Convention], or so far as I know in the contemporary writing and legislative consideration, addressed
15. Indeed, it was only from the 1970s onwards that states started to include provisions permitting investors to themselves enforce the treaties, in part at least on the suggestion of ICSID. This reflected the deliberate choice of states to remove treaty disputes from the state-to-state level, permitting the investor to enforce the agreement without the need to persuade its home state to espouse the claim.

16. The first cases brought at ICSID were based on arbitral clauses in investment contracts or domestic legislation on the promotion and protection of foreign investments. The AAPL dispute from 1990 was the first case where foreign investor's treaty claims were permitted on the understanding that the parties' consent to ICSID arbitration was "perfected" by the investor accepting the host state's offer to arbitrate in the treaty.  

17. The AAPL dispute initiated an increase in treaty based cases, buttressed by the changing practice of states in inserting ISDS clauses. More than 70% of ICSID cases have in fact been brought under investment treaties and only 1% exclusively under investment contracts, as illustrated in Graph 1. below.

Graph 1. Instruments of consent in ICSID arbitrations (1976-2016).

18. The growth of cases has come in the 1990s and in particular in the last two decades, as demonstrated in Graph 2. below.

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The possibility that a host state in a bilateral treaty could give its consent to arbitrate with investors from the other state without reference to a particular investment agreement or dispute. I know that I did not mention that possibility in my testimony before the US Congress, and neither did anyone else."


19. The extensive network of investment treaties has given rise to a substantial and ever-growing investment arbitration case-law. The rising number of investment treaty-based cases has led to questioning of the current system of investment dispute settlement.

5. Concerns with the current dispute settlement mechanisms for the investment regime

20. When the main attributes of the investment treaty regime are set against the structure of the system of arbitration for investment disputes, a number of concerns can be identified within the existing system. These concerns coincide with those identified in the Secretariat paper but also arise at a systemic level or result from the nature of the system. These concerns take on heightened significance with the knowledge of the relatively high and sustained level of cases. These concerns can be identified as follows:

a) The ad hoc system impacts consistency and predictability

21. The ad hoc nature of the system impacts consistency and predictability. The ad hoc constitution of arbitral tribunals potentially influences outcomes, inasmuch as arbitrators are repeat players, or are seeking to be repeat players, in a system where the adjudicators need to be appointed afresh for each dispute. When considered at a systemic level, this can be considered as likely to lead to more fact-specific outcomes.\(^{11}\) This does not enhance the stability and consistency of the system

\(^{11}\) See Todd Tucker, "Inside the Black Box: Collegial Patterns on Investment Tribunals" (2016) 7(1) J Intl Disp Settlement 183–204.
and hence the ability of stakeholders, be they businesses, governments or civil society actors to seek guidance on previous cases to try to determine how the rules will be applied in a particular set of circumstances.

22. There are a number of examples of inconsistent arbitral decisions on core aspects of the traditional investment protection provisions. The questions raised in those conflicting cases concern general concepts and functions of the substantive investment rules that are repeatedly raised in many disputes where consistent responses would be desirable.

23. One example is the ongoing saga on the applicability of the most-favoured nation (MFN) clauses to procedural matters (i.e. dispute resolution). While some tribunals have held that the MFN clause extends to dispute settlement provisions contained in treaties between the respondent State and third States, other tribunals have reached the opposite conclusion. This issue continues to be raised in many cases. An example is APR Energy and others v. Australia where the claimants are seeking to import a dispute resolution clause into a treaty that contains no consent to arbitration.

24. In relation to the interpretation of the scope and effect of the umbrella clause, some tribunals have held that the clause would have the effect that breaches of certain contractual commitments would amount to breaches of the investment treaty, whereas others have denied this effect for ordinary commercial contracts.

25. Other examples include several arbitral decisions taken in the aftermath of the Argentine financial and economic crisis of 2001-2002 in relation to the necessity defence under Article XI of the US-Argentina BIT. For instance, while the Enron tribunal interpreted this provision by reference to the very strict test for "necessity" as a circumstance precluding wrongfulness, the Continental Casualty tribunal interpreted the rule by reference to the less stringent test for "necessary" state measures developed under the law of the World Trade Organization.

26. Counsel would not be acting with due diligence if they did not exploit every possibility to bring an argument which might be of aid to their clients. The ad hoc system creates incentives to run these arguments given there is no structure creating and enforcing consistency. The system

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12 See for instance Emilio Augustín Maffezini v. Kingdom of Spain, ICSID Case No. ARB/97/7, Decision of the Tribunal on Objections to Jurisdiction, para. 64; Siemens v. Argentina, ICSID Case No. ARB/02/8, Decision on Jurisdiction, para. 103; Gas Natural v. Argentina, ICSID Case No. ARB/03/10, Decision of the Tribunal on Preliminary Questions on Jurisdiction, paras. 31 and 49; Suez, Sociedad General de Aguas de Barcelona S.A., and InterAguas Servicios Integrales del Agua S.A. v. Argentina, ICSID Case No. ARB/03/17, Decision on Jurisdiction, paras. 53-66.


14 Power Rental Asset Co Two LLC (AssetCo), Power Rental Op Co Australia LLC (OpCo), APR Energy LLC v. the Government of Australia, UNCITRAL.

15 SGS Société Générale de Surveillance s.a. (SGS) v. Republic of the Philippines, ICSID Case No. ARB/02/6, Decision of the Tribunal on Objections to Jurisdiction, para. 128.

16 SGS Société Générale de Surveillance s.a. v. Islamic Republic of Pakistan, ICSID Case No. ARB/01/13, Decision on Jurisdiction, para. 166.

17 Enron Creditors Recovery Corp. & Ponderosa Assets, L.P. v. Argentine Republic, ICSID Case No. ARB/01/3, Award, paras. 322-345.

18 Continental Casualty Co. v. Argentine Republic, ICSID Case No. ARB/03/9, Award, paras. 189-230.
therefore in and of itself creates additional costs. This is in addition to the obvious difficulty which arises in terms of consistency and predictability. The repeat nature of the regime and the relative indeterminate nature of obligations heighten the importance of these consistency and predictability concerns.

b) Significant concerns of perception

27. It is a core feature of the domestic and international adjudicative systems mentioned earlier, that, in the words of a Chief Justice of the English Courts, "justice should not only be done, but should manifestly and undoubtedly be seen to be done." That statement is an expression of the decisive move away from ad hoc systems for public matters in all legal systems, led by the thinking of Jeremy Bentham, Voltaire and Alexander Hamilton. The ad hoc nature of the investor-state arbitration wherein the arbitrators, by definition, have other activities creates significant perception problems. These perception problems derive from the fact that the professional and/or personal interests of the persons involved in the system might be perceived to have an effect on the outcomes of the disputes. Whilst the detailed reality and the complex interactions between arbitrators themselves and the actors which appoint them undoubtedly paints a more complex picture, the combination of the unidirectional nature of the system and the importance of perception, of justice being seen to be done, raises concerns.

c) The limited systemic checks on correctness and consistency

28. Another concern regarding the existing system is the limited possibility for a systemic check for correctness and consistency. Under the ICSID system, annulment is only available to correct a very limited set of errors. Article 52 of the ICSID Convention only provides for annulment in limited circumstances. These do not touch upon the substantive correctness of the award. Similarly, domestic arbitration laws or the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards limit the grounds on which recognition and enforcement of an award can be refused.

29. This means that awards can be legally incorrect but the system does not allow for them to be corrected. In CMS v Argentina, for example, the Annulment Committee said:

"Throughout its consideration of the Award, the Committee has identified a series of errors and defects. The Award contained manifest errors of law. It suffered from lacunae and elisions. All this has been identified and underlined by the Committee. However the Committee is conscious that it exercises its jurisdiction under a narrow and limited mandate conferred by Article 52 of the ICSID Convention. The scope of this mandate

21 See Article 52(1) ICSID-Convention ("Either party may request annulment of the award by an application in writing addressed to the Secretary-General on one or more of the following grounds:(a) that the Tribunal was not properly constituted;(b) that the Tribunal has manifestly exceeded its powers;(c) that there was corruption on the part of a member of the Tribunal;(d) that there has been a serious departure from a fundamental rule of procedure; or(e) that the award has failed to state the reasons on which its based.").
allows annulment as an option only when certain specific conditions exist. As stated already (paragraph 136 above), in these circumstances the Committee cannot simply substitute its own view of the law and its own appreciation of the facts for those of the Tribunal.”

30. This problem of ensuring correctness compounds the other features of the existing regime leading to lack of consistency and predictability mentioned above. The significance of this is again linked to the repeat function of potential disputes and the relative level of determinacy. It is notable that constitutional and supreme courts function to interpret general and relatively indeterminate norms, fleshing them out and clarifying them over time. These often have important effects on legitimising and stabilising understandings of the underlying substantive rules. An example of this is the WTO Appellate Body, which with a number of foundational reports in the late 1990s and early 2000s effectively calibrated the balance between the free trade obligations of the WTO Agreements and the ability of WTO Members to regulate.

d) Nature of appointment of adjudicators

31. When states appoint adjudicators ex ante (before particular disputes arise), they act in their capacity as treaty parties and have an incentive to balance their interests, ensuring the selection of fair and balanced adjudicators that they would be happy to live with whether a future case is brought by their investors or against them as respondents. In arbitration, however, the choice of arbitrator is made not in advance but ex post (i.e. at the time a dispute has arisen), which means that investors and state respondents make decisions about arbitrators with a view to best serving their interests in that particular case. This leads them to focus on arbitrators who are already known in the system and who are considered as having a predisposition towards one or other side (being perceived as investor or state-friendly). On the one hand, that is a natural reaction to the paradigm in which the disputing parties operate as that represents the safest option in the circumstances. On the other, however, it means that parties are looking at appointment to the dispute primarily in their capacity as disputing party and not in their capacity as sovereigns, where their long term interests lies in providing for adjudicative bodies that faithfully interpret and apply the underlying substantive provisions. This is heightened by the repeat nature of potential disputes, the relative indeterminacy, the vertical relationship and both the public international law and public law features of the system.

32. In addition to encouraging the appointment of predisposed (i.e. perceived as investor or state friendly) arbitrators and a small number of repeat players, one of the problems with this approach is that it leads to a continued high concentration of persons who have gained their experience as arbitrators primarily in the field of commercial arbitration involving disputes of "private law" rather than public international law disputes. Such persons often are professionally less familiar

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22 CMS Gas Transmission Company v. Argentine Republic (ICSID Case No. ARB/01/8), Annulment Decision, para. 158.
with public international law (investment treaties are of course a field of public international law) and public law (which is important because the cases concern the actions of states in their sovereign capacity). Finally, the ad hoc appointment system also impacts on the regional and gender diversity of the individuals chosen to sit as arbitrators, with the system leading to relatively limited diversity on both fronts.

e) Significant costs

33. As already noted, a problem with the system is the manner in which it generates costs.\(^25\) This comes from the lack of consistency and predictability inherent in the system where diligent counsel will run arguments which might have been dismissed in another case because it is always possible that another tribunal will accept them. Costs are also generated by the need to identify and then appoint arbitrators. Moreover, the disputing parties themselves bear the burden of the costs of the arbitrator's fees and the fees of the arbitral institutions.

34. These elements combine with the already significant costs of litigating a dispute, in particular in hiring specialised counsel, and the lengthy nature of litigation to make the overall costs of bringing a claim under the existing system potentially prohibitive for a significant number of smaller and medium sized investors.

f) Lack of transparency

35. The existing system, being largely based on or derived from commercial arbitration has historically not regarded transparency as being a necessary component of dispute settlement. This has meant that information is not always provided to the public on investment disputes. Whilst significant steps have been taken to improve this situation, through the amendments of the ICSID Arbitration Rules to provide for certain levels of transparency, to the adoption of the UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration and the United Nations Convention on Transparency in Treaty-based Investor-State Arbitration (the "Mauritius Convention on Transparency") to more regular acceptance by disputing parties of the desirability of transparency, this remains a problem with the existing system.

6. Conclusion

36. There are significant concerns with the existing ISDS system. These can be identified as:

- the lack of consistency and predictability flowing from the ad-hoc nature of the system;

- significant concerns arising from the perception generated by the system;

- limited systemic checks on correctness and consistency in the absence of an effective appeal mechanism;

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- the nature of the appointment process impacting the outputs of the adjudicative process;

- significant costs; and,

- a lack of transparency.

37. These concerns are systemic in nature. That is they derive from the interplay of multiple elements of the current system, but above all the ad hoc nature of the tribunals and the lack of appellate review. As demonstrated above, the contemporary investment regime is strongly characterised by repeat disputes, relative indeterminacy and vertical relationships in a context of public international law and public law situations. A comparison shows that the international community and states individually have typically chosen to create or develop permanent standing bodies to adjudicate disputes in the context of such regimes.

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International trade law is making headlines in the United States and around the world in a manner unprecedented in the last two decades. The United States’ escalating trade war with China, its combative relationship with European trading partners, its forced renegotiation of the North American Free Trade Agreement (NAFTA), and its block on the appointment and re-appointment of Appellate Body members at the World Trade Organization (WTO) have all vaulted trade politics into the spotlight from its once quiet existence.

The crisis in trade law may be thought to be yet another example of the Trump administration’s iconoclastic approach to foreign relations that will fade as Trump’s tenure in power ends. But the damage done by the Trump administration’s actions in international trade will be long-lasting and, even if repairable, costly to unwind. Although many observers are heartened by the conclusion of a new NAFTA agreement with only minor changes—buoyed both by the idea that international economic order is resilient to the Trump administration’s tactics and the possibility that the administration may settle its aggressive demands for relatively small modifications¹—that essay argues that such optimism is misplaced. In all likelihood, the Trump administration’s trade policies will not be a passing concern.

The Trump administration’s attacks on the WTO, in particular, represent a shock to the norms and understandings essential to the agreement, not just a strike against certain trading partners or discrete policies. This shock has weakened the foundations of the multilateral trading system and will impose significant costs on the United States for decades to come. Specifically, the

Trump administration’s trade policies give China a path to rewrite global trade rules. China is and will be increasingly important to the future of global trade because of its expanding market size, but the Trump administration’s actions have weakened international institutions that would have provided a globally-supported set of constraints to channel this increased power.

This essay considers whether we may be entering a post-WTO era for international trade law. The WTO may continue to exist, but it will cease to provide a meaningful check on State action. Over the last two decades, WTO law and dispute settlement have been powerful forces in international economic relations. This may no longer be the case. Such a transformation will be costly to the United States in both the short and long-term if WTO rules, which generally benefit the American economic model, are no longer dominant and enforceable.

An alternative outcome is possible. If countries respond to the present moment by returning to and reinforcing multilateral norms and negotiations, then the present shock could be a spur to reignite commitments to a rule-based multilateral system. This would require a turn away from bilateral negotiations and the present American insistence on power-based dispute resolution.

This essay begins by reviewing the Trump administration’s strategy attacking the WTO. The essay goes on to explain why this strategy undermines the institution’s core norms and principles; it is not simply a continuation of existing disagreements within the WTO’s membership. The essay next turns to the consequences of a weakened WTO, particularly the precedent this sets for emerging powers to simply disregard the institution’s rules in their efforts to reshape trade relations. The essay concludes by very briefly considering what would be necessary to restore faith in the WTO and reinvigorate its relevance going forward.

I. THE WTO AND THE TRUMP ADMINISTRATION’S TRADE POLICY

Until recently, trade law was a very stable—perhaps even boring—area of international law. The WTO was the preeminent international trade regime for over two decades with its near-global membership. In addition, the WTO’s dispute settlement system was one of the most widely respected international legal systems in existence due to its large caseload, compulsory jurisdiction, high levels of compliance, and authoritative seven-member Appellate Body. The organization was not without problems—most notably its inability to conclude a new round of trade negotiations—but, on the whole, observers considered the WTO to be a model of global governance and a well-functioning institution. Indeed, many commentators had marveled that the WTO had managed to withstand the global economic shocks of the Great Recession without member

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2. For an overview of the Appellate Body’s structure and functions, see Gregory Shaffer et al., *The Extensive (but Fragile) Authority of the WTO Appellate Body*, 79 L. & CONTEMP. PROBS. 237 (2016).

countries breaching their commitments and imposing new barriers to trade.\textsuperscript{4}

The election of Donald Trump called into question this confidence in the robustness of the WTO. Trump had campaigned on an anti-international trade platform and was skeptical of American international commitments more generally. The shock that has subsequently come from the Trump administration has overcome traditional Republican support for freer trade policies as well as the popular wisdom that the economic costs of upending the WTO system were too great for any government to consider seriously.

The Trump administration’s attack on the WTO has been a three-pronged strategy: (1) an offensive against the WTO’s Appellate Body; (2) a return to unilateral adjudication and remediation of trade disputes; and (3) an interpretation of the WTO’s national security exception that would permit economic concerns to qualify. Each part of the attack on the WTO is worthy of its own essay, but this section will only provide a brief summary. In the following section, I analyze the impact of these policies on the future of the WTO.

The first part of the Trump administration’s strategy to undermine the WTO began with its block on confirming Appellate Body members. In these matters, the WTO membership acts by consensus, which is defined as no WTO member formally objecting.\textsuperscript{5} Now, the United States’ policy is to object formally to all motions to nominate or renew the term of Appellate Body members. This block will close down the body by December 2019 (and with it, the entire dispute settlement system) by depriving it of the necessary personnel to adjudicate cases.\textsuperscript{6} A former Appellate Body member, Ricardo Ramírez-Hernández, has termed this the Appellate Body’s “[death] through asphyxiation.”\textsuperscript{7} Although previous U.S. administrations had refused to re-nominate some American Appellate Body members and even blocked the reappointment of a South Korean Appellate Body member,\textsuperscript{8} the Trump administration’s policy of blocking all Appellate Body nominees, regardless of judicial philosophy, is a categorical


\textsuperscript{5} Understanding on Rules and Procedures Governing the Settlement of Disputes art. 2(4) n.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401 [hereinafter DSU] (“The DSB shall be deemed to have decided by consensus on a matter submitted for its consideration, if no Member, present at the meeting of the DSB when the decision is taken, formally objects to the proposed decision.”).

\textsuperscript{6} As of October 1, 2018, there are only three remaining Appellate Body Members and two of the Members’ terms expire in December 2019. \textit{See Dispute Settlement – Appellate Body Members}, \textit{World Trade Org.}, http://www.wto.org/english/tratop_e/dispu_e/ab members descr_e.htm (last visited Oct. 27, 2018). For more on the Appellate Body crisis, see Bryce Baschuk, \textit{WTO Appellate Body Crisis Reaches New Phase}, 35 Int’l Trade Rep. (BNA) No. 25 (June 21, 2018). Shutting down the Appellate Body could end any effective dispute settlement within the WTO because members have the right to an appeal to the Appellate Body. \textit{See DSU} art. 16(4). Thus, the WTO’s Dispute Settlement Body cannot adopt the panel decision, when one party appeals, if the Appellate Body has not ruled on the case.


change. The policy seeks to end the dispute resolution process altogether, rather than addressing more narrow objections to the trajectory of WTO jurisprudence. The United States’ block on Appellate Body nominations is a direct assault on the idea that disputes should be resolved through a neutral interpretation of trade law rather than more negotiated, economic-power-based solution.9 Without a dispute settlement system, international trade law would return to a GATT-era type system where panels would issue legal opinions but most significant trade disputes were resolved through negotiations, and where the meaning and operation of the law were largely determined through power politics.

Second, the Trump administration began unilaterally imposing trade sanctions against China for its intellectual property policies, which it has deemed to be unfair trade practices.10 These so-called Section 301 sanctions have escalated over the last several months as China has responded by imposing its own sanctions on American imports.11 The use of Section 301 sanctions represents a rejection of one of the WTO’s fundamental due process principles—the commitment to the multilateral resolution of disputes through neutral adjudication. The core of the WTO law is not just a system of trade rules but a dispute settlement system; international trade law rather than more negotiated, economic-power-based solution represents a rejection of one of the WTO’s fundamental due process principles to raise tariffs on European goods and only applied sanctions to the level authorized. The resort to unilateral trade measures is a dramatic departure from past American administrations, who have carefully followed WTO due process rules to maintain the power and legitimacy of the system.13 It also represents a full-throated


13. The United States has not applied trade sanctions to WTO members for alleged breaches of WTO law without WTO authorization. For instance, in the United States dispute with the European Union on the European ban on beef from hormone-treated cattle, the United States waited for WTO authorization to raise tariffs on European goods and only applied sanctions to the level authorized. See 2 CHARAN DEVEREAUX ET AL., CASE STUDIES IN US TRADE NEGOTIATION: RESOLVING DISPUTES 72-73 (2006). This is particularly notable given that the United States had unilaterally retaliated against the EU’s
rejection of the WTO’s rule of law norms and a forceful return to the unilateralism that WTO structures were designed to prevent.

Third, the Trump administration has used national security to justify a series of tariff measures on steel and aluminum imports.\textsuperscript{14} It is currently considering similar actions on automobiles.\textsuperscript{15} The General Agreement on Tariffs and Trade contains a narrow exception to protect “essential security interests taken in time of war or other emergency in international relations.”\textsuperscript{16} WTO members have historically been quite restrained in claiming national security concerns, recognizing that broad national security claims could be misused to provide economic protection to industries.\textsuperscript{17} For instance, when the George W. Bush administration imposed tariffs to protect the American steel industry, that administration did not claim a national security justification but applied the tariff as a safeguard.\textsuperscript{18} In fact, the United States has not used a national security justification for tariffs in the entire history of the WTO.\textsuperscript{19}

By claiming national security as a justification for these trade measures, the Trump administration is maintaining that its measures are beyond the jurisdiction of the WTO to judge. Commerce Secretary Wilbur Ross has argued that national security concerns are justified to keep an important industry healthy, stating, “National security is broadly defined to include the economy, to include the impact on employment, to include a very big variety of things . . . . Economic security is military security. And without economic security, you can’t have military security.”\textsuperscript{20} This claim is very broad and would mean that large sections of a nation’s economy could be considered within the exception’s scope

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\textsuperscript{14} Proclamation No. 9,704, 83 Fed. Reg. 11,619 (Mar. 8, 2018); Proclamation No. 9,705, 83 Fed. Reg. 11,625 (Mar. 8, 2018).


\textsuperscript{18} The Bush administration lifted these tariffs after the WTO dispute resolution system ruled that the tariffs were not legal, although it did not cite the WTO ruling in its public statements about why the tariffs were lifted. Richard W. Stevenson & Elizabeth Becker, After 21 Months, Bush Lifts Tariffs on Steel Imports, N.Y. TIMES (Dec. 5, 2003), http://www.nytimes.com/2003/12/05/us/after-21-months-bush-lifts-tariff-on-steel-imports.html.

\textsuperscript{19} Bown, supra note 17 (noting that the United States has not claimed a national security justification for trade measures in over 30 years).

and thus freed from WTO rules.\textsuperscript{21} Again, this political move—asserting that large swaths of the national economic policy are exempt from the WTO—is another rejection of multilateral authority over trade policy.\textsuperscript{22}

Together, these three policies represent a U.S. strategy of rejecting the WTO’s bindings as legitimate, attempting to undermine the WTO’s rule of law system, and embracing a return to unilateralism and power-based bargaining. This is a categorical departure from past trade disputes among WTO members, where countries engaged in many protracted battles over the meaning and application of WTO rules but reliably stayed within the institution’s framework for resolving disputes.\textsuperscript{23} By rejecting the WTO’s mandate to constrain a State’s trade policy, and actively attempting to shut down the dispute settlement system, the Trump administration has undermined the WTO’s authority as a legitimate constraint on member countries and weakened its influence in transnational relations.

Eventually the Trump administration will end. But even if many of the policies of the current administration end with it, the effects of the current administration’s actions in the trade realm will be hard to unwind. The next section addresses whether and how these policies will affect the future of global trade law and norms in the long term. It focuses on future leverage that the Trump administration’s policies provide toward China’s effort to rewrite trade law and trade institutions.

\section*{II. The Consequences of Undermining WTO Norms}

One of the primary effects of the current attack on the WTO will be to increase China’s bargaining power in the near future. China was already bound to have more negotiating power in international economic law as the size of its internal market continues to grow dramatically.\textsuperscript{24} This is a natural and probably inevitable result of China’s economic development. Nonetheless, China’s growing economic power had been cabinéd into a solid institutional structure of

\begin{enumerate}
\item The WTO’s success was in large part found in the fact that member countries abided by the process norms of the system—not acting unilaterally and accepting multilateral legal decisions—even if they did not always abide by all of the WTO’s substantive rules. See Rachel Brewster, \textit{Pricing Compliance: When Formal Remedies Displace Reputational Sanctions}, 54 \textit{Harv. Int’l L.J.} 259, 300-01 (2013) (discussing how WTO members may have breached trade rules but did not violate the WTO framework for resolving allegations of breach).
\item Bargaining power in trade negotiations is linked to market size because countries offer greater access to their market as leverage for getting greater access to other countries’ markets. The greater a country’s internal market, the greater its bargaining power all else being equal. Richard H. Steinberg, \textit{In the Shadow of Law or Power? Consensus-Based Bargaining and Outcomes in the GATT/WTO}, 56 \textit{Int’l Org.} 339, 347-48 (2002).
\end{enumerate}
longstanding and well-respected trade rules and institutions. China’s decision to enter the WTO in 2001 under the WTO’s most complex and demanding accession agreement reflects the importance of the WTO to accessing global markets.\textsuperscript{25} China understood that fuller inclusion within the global economic system demanded acceptance of key institutional structures and rules.\textsuperscript{26} WTO law and processes were not ideal for China’s model of development,\textsuperscript{27} but China could not start negotiations from a blank slate. The United States, the European Union, Japan, and other developed economies had a first mover advantage in setting up their preferred substantive rules (including rules on intellectual property and state subsidies) and institutionalizing these principles into a strong rule-of-law dispute settlement system.\textsuperscript{28} These structures—both the laws and process norms of the WTO—established an economic order that would channel and constrain China’s increasing economic power.

The current shock has ruptured the existing economic order and has provided the Chinese government with numerous means to challenge the WTO system and demand greater policy accommodations going forward. A post-WTO era may be beginning. At the most obvious level, the Chinese government can simply copy the Trump administration’s precedent to disregard trade rules that it does not like. In trade disputes with regional partners, it can impose unilateral sanctions and demand bilateral negotiations to resolve its concerns. Similarly, the Chinese government could forbid entry into whole sectors of its economy by claiming broad national security rationales and rejecting WTO jurisdiction over these claims. It too can block Appellate Body members whose interpretations of trade law do not match Chinese interests, and it can threaten to shut the system down if its preferred substantive interpretations are not met.

At a broader level, the current shock has undone the binding of the international economic law system. The pre-2016 WTO was multilateral and consensus-oriented (to its detriment in new negotiations).\textsuperscript{29} The substantive rules and process norms were “sticky” because they were long-standing, widely observed, and generally respected.\textsuperscript{30} The system demanded that countries address their concerns with trade partners’ policies and challenges to other


\textsuperscript{26} See id. at 333-39.

\textsuperscript{27} For instance, China’s model of development has focused on interconnected state-owned enterprises, making the WTO’s anti-subsidy rules and domestic trade remedy laws are far from optimal for China. See Mark Wu, The “China, Inc.” Challenge to Global Trade Governance, 57 HARV. INT’L L.J. 261, 269-84 (2016) (examining how state-owned enterprises are part of China’s economic model).

\textsuperscript{28} Trade agreements often begin with a smaller, more homogenous group of countries that can agree to deeper substantive rules and then offer membership to other States. For a general theory of this effect, see George W. Downs et al., Managing the Evolution of Multilateralism, 52 INT’L ORG. 397 (1998). The Trans-Pacific Partnership was often described as a similar sequential agreement structure: Pacific countries (except China) would negotiate deeper free trade rules in the first stage with the expectation that China would need to accede to the agreement at a later stage. See Daniel C.K. Chow, How the United States Uses the Trans-Pacific Partnership to Contain China in International Trade, 17 CHI. J. INT’L L. 370 (2016).


\textsuperscript{30} See Shaffer et al., supra note 2, at 256-67.
members’ compliance with trade law in a multilateral forum that emphasized the power of law and minimized power considerations, even if it did not eliminate power imbalances. The Trump administration’s rejection of these multilateral norms in favor of bilateral, power-based bargaining has minimized the WTO’s influence over China as it becomes a major economic power.

As its market power increases, the Chinese government can demand that trade negotiations and dispute resolution proceed outside of the WTO framework. The norms against such a blatantly WTO-illegal move were previously strong enough that it would have been costly for China and engendered significant pushback from other WTO members. Now, however, the clear American precedent for such actions lowers the costs to China of adopting such a policy and may increase the expected benefits by adopting such a strategy. It may even enable China to push the world towards a post-WTO order with less formal institutions that might better serve China’s economic interests. Instead of facing a stable and united international order, China enters the global economy as a full economic power with the global system in disarray. Opportunities now abound for China to reshape global trade rules and processes.

Thus far, the Chinese government has indicated willingness to support the WTO’s substantive rules and institutional structure. It has criticized the United States for its intransigence on Appellate Body member confirmations and has argued that the United States’ return to unilateralism is illegitimate. However, it is unclear how extensive the Chinese government’s commitment to the WTO is, given the economic advantages to alternative systems. For instance, for China, a post-WTO world that includes more flexibility on intellectual property and subsidies may be preferable to the current WTO regime. This is particularly true if the plans to “save the WTO” from the United States involve more onerous economic demands on China. For instance, the EU’s proposal to revitalize the WTO includes greater intellectual property restrictions, which would distribute more of the gains from trade away from China and developing countries. Japan and the EU are also trying to engage the United States by pushing forward a joint proposal targeting Chinese state-owned enterprises and threatening WTO-

31. JOHN H. JACKSON, THE WORLD TRADING SYSTEM 109-12, 133-37 (2d ed. 1997). Market size, and thus economic power, still is relevant at the WTO. For instance, the United States has been able to resist complying with some Appellate Body decisions because it has a greater ability to bear economic retaliation than smaller States do. Nonetheless, compared to the pre-WTO GATT system, the dispute settlement system is more rule-based and minimizes power imbalances in adjudication. See Brewster, supra note 12, at 257-60.


33. See European Commission Directorate-General for Trade, WTO – EU’s Proposal for Modernization, at 6, WK 8329/2018 INIT (July 5, 2018) (discussing expanding rules regarding investment and intellectual property). Intellectual property rules distribute more of the gains from trade for IP-heavy goods to more developed states and away from consumers of these goods. See, e.g., Jagdish Bhagwati, Afterword: The Question of Linkage, 96 AM. J. INT’L L. 126, 127 (2002) (stating that high intellectual property rules “incorporated into international trade rules . . . facilitate[,] even enforce[,] with the aid of trade sanctions, what is in the main a payment by the poor countries (which consume intellectual property) to the rich countries (which produce it)”).
imposed fines for subsidies. These new proposals are being offered while the Chinese government continues the battle to be recognized as a market-economy, a status that China believes it is entitled to under its accession agreement.

The future relevance of the WTO may very well lie with the Chinese government’s assessment of whether the WTO is a useful structure to legitimize China’s economic rise to an economic superpower, or whether the WTO is a hurdle to China’s growth and strategic economic interests. China would not have to exit the WTO to create a post-WTO economic order. Rather, China could remain formally a member, but follow the Trump administration’s lead by acting outside of WTO rules and demanding bilateral negotiations to resolve disputes when it suits China’s interests.

III. CONCLUSION

The current crisis in international trade law is unlikely to dissipate with the end of the Trump administration’s tenure in power. The attack on the legitimacy and authority of the WTO has shaken the institution’s ability to be relevant in international economic relations. The world’s twenty-year experience with a multilateral and rule-based international trade system may well be at a close.

The sunset of the WTO’s relevance is not inevitable. The shock of the Trump administration’s unilateralist policies may lead to backlash. Such a backlash could make member countries—including the next American administration—willing to recommit to multilateralism in a manner that they were previously reluctant to consider. Crisis can result in political support for institutional reform and revitalization as well as decay. Much of the work needed to restore faith in multilateralism involves state restraint—not making unilateral threats, not demanding bilateral negotiations, and not refusing to engage multilateral processes. But the exercise of state restraint will not be enough. Rather, a public, positive, and credible demonstration of support for the WTO would be necessary to rebuild the confidence in the organization.

One action that would be credible and public would be a change to the selection of Appellate Body members that gives them more independence. The European Commission has already suggested expanding Appellate Body member terms to 6-8 years without renewal (instead of 4 years, renewable once). In addition, WTO member countries could prevent one or two powerful...
States from blocking Appellate Body members by basing the selection of new judges on a consensus-minus-one or consensus-minus-two model, such that no individual member (or its close ally) could shut down the dispute resolution system again. Such an institutional innovation would strengthen WTO processes as well as provide a credible demonstration of member countries’ recommitment to multilateralism going forward.

Baschuk, *European Plan for Extending WTO Appellate Terms Panned by U.S.*, Int’l Trade Daily (BNA) No. 194 (Oct. 5, 2018). The European Commission also calls for increasing the number of Appellate Body members from seven to nine. European Commission Directorate-General for Trade, supra note 33, at 18, at 17. This would further insulate the Appellate Body from attempts to limits its power by blocking reappointments.
Revitalizing the WTO

Settling Trade Disputes in a Turbulent Multipolar World
Revitalizing the WTO:
Settling Trade Disputes in a Turbulent Multipolar World

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Bertelsmann Stiftung High-Level Board of Experts on the Future of Global Trade Governance

In the light of rising threats to the multilateral trading system, the Bertelsmann Stiftung has set up a High-Level Board of Experts on the Future of Global Trade Governance. Composed of seasoned trade diplomats and distinguished experts, it is identifying feasible options for reinvigorating the World Trade Organization (WTO). To inform the Board’s ongoing discussions, Bertelsmann Stiftung has commissioned additional research. This paper by Robert McDougall reflects on the current controversies around the WTO Dispute Settlement Body which it views as an opportunity to reflect on the design of dispute resolution at the WTO and potentially modify its functioning. It reflects the author’s views which are not necessarily those of the Board.

Further information on the High-Level Board of Experts and its work can be found on futuretradegovernance.org and ged-project.de.
Executive Summary

Despite growing consensus on the need to update the trade rules and strengthen the World Trade Organization, there is little agreement on which reforms are necessary. While some place priority on resolving the impasse over appointments to the Appellate Body, other reforms to the dispute settlement mechanism may be more important to respond to the challenges facing judicialized dispute settlement of trade disputes in the WTO. The changing balance of economic power, ageing trade rules and a backlash against globalization make it difficult to achieve legitimate outcomes through win-lose adjudication. Increasing demand, a potential for a chill on ongoing negotiations and an imbalance between the political and adjudicative functions of the WTO exacerbate these challenges. Resolving the impasse over the Appellate Body will not, on its own, resolve the more profound legitimacy crisis facing the trading system. Members should instead focus on pursuing broader improvements to the dispute settlement mechanism to ensure that it remains fit-for-purpose in the service of trade cooperation in a turbulent multipolar world.

Introduction

The deepening crisis in the multilateral trading system reflects a growing disconnect between the existing rules and the political, economic and technological realities they are meant to govern. The resulting erosion of confidence in the fairness of the trade rules threatens the functioning of the World Trade Organization (WTO). While governments have been slow to respond to the changing global economic dynamics, recent political shocks have forced a recognition that current approaches to trade cooperation are not working as well as they could. At their recent gathering in Buenos Aires, G20 Leaders acknowledged that the trading system is “currently falling short of its objectives” and that “there is room for improvement”. They supported the “necessary reform of the WTO to improve its functioning”.

While there may be general agreement on the need to improve the trading system, there is less agreement on what constitutes “necessary reform”. In an important contribution to this question, the High-Level Report on “Revitalizing Multilateral Governance at the WTO” called first for revitalizing the mechanisms of trade cooperation in order to lay the foundation for the more difficult task of updating the substantive rules. The Report also highlighted the importance of effective conflict resolution, but acknowledged a number of important challenges facing the WTO dispute settlement mechanism, not least of which is the ongoing impasse over filling vacancies on the Appellate Body.

Some WTO members propose to treat the crisis over the Appellate Body as the top priority in WTO reform efforts. However, the weakening of the dispute settlement system is only a symptom, and not the cause, of disruption in the rules-based trading system. As current tensions illustrate, effective trade cooperation, and trade peace, depends on more than the availability of enforceable dispute settlement. Insisting on first restoring the capacity to engage in win-lose adjudication over the existing rules will therefore not resolve these tensions and indeed may even impede efforts to find solutions to them. Instead, efforts to strengthen the dispute settlement function of the WTO should start with a broader evaluation of its operation in order to identify reforms that address the more fundamental challenges to its effectiveness.

The Judicialization of Dispute Settlement at the WTO

The dispute settlement mechanism that emerged with the WTO capped a long period of incremental legalization and judicialization of cooperation on trade. There is no doubt that judicialized dispute settlement helps to de-
politician trade relations by delegating the resolution of disputes to impartial third parties and providing binding enforcement mechanisms. In the process, it mitigates (although does not completely eliminate) power asymmetries between states and brings greater clarity and coherence to the meaning of trade commitments. Importantly, since trade cooperation occurs in the “shadow of the law”, these effects are felt far beyond the specific disputes brought before it, contributing to the security and predictability of the rules-based trading system.

In its short life, the WTO dispute settlement mechanism has exceeded expectations. It is frequently celebrated as the “jewel in the crown” of the WTO and as one of the most prolific and successful systems of international adjudication in history. Due in part to this success, it has taken on an increasing share of the responsibility for the maintenance of trade cooperation, a burden that has been magnified by the relative underperformance of the negotiating function. However, the disproportionate centrality of judicialized dispute settlement to the trading system exposes it to a number of external and internal challenges. These will need to be addressed as part of efforts to strengthen the dispute settlement function and revitalise rules-based cooperation on trade.

**External Challenges to Effective Dispute Settlement**

The first set of challenges arise from the fundamental changes to the context in which trade cooperation and dispute settlement occur. The WTO was founded in a moment of optimism about global integration and growing acceptance of both market-oriented models of economic development and the legalisation of international trade relations. The trade rules that were codified in the WTO reflected this historical convergence. However, the context has changed in a number of interconnected ways that have diminished the effectiveness of WTO adjudication.

First, the trade rules have failed to keep pace with changing realities. The effect of the structural transformation of the global economy and technological change have modified the value of certain concessions and upset the existing balance of rights and obligations. As the balance of economic power shifts and negotiations over new rules stall, some WTO members may be tempted to pursue their market access objectives through adjudication, whereas others may seek to avoid the enforcement of rules they consider no longer reflect underlying economic realities (e.g., the “non-market economy” disputes). With waning consensus on whether the existing rules contain “reciprocal and mutually advantageous arrangements”, it becomes increasingly difficult for adjudication in certain areas to provide outcomes that will be accepted as legitimate by all parties.

Second, the disruption and economic insecurity caused by these changes in the global economy have led to political upheaval in some countries and a backlash against both globalisation and multilateralism. The resurgence of nationalism has led some to reassert sovereignty as the most important institution in international relations. At least some of the discontent reflects a lack of trust that the existing rules provide for an equitable distribution of the benefits of trade and a concern that certain dispute settlement outcomes may have contributed to this disequilibrium. Domestic political pressures simultaneously increase the willingness to take unilateral trade-distorting measures and decrease the willingness to abide by the findings of international tribunals on the conformity of those measures to the trade rules.

Third, emerging multi-polarity and the associated geo-political rivalry between the United States and China cause some to see the level of economic interdependence fostered by the trade rules as a liability. The equation of economic security with national security and the resulting pressure to “decouple” the two economies

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5 WTO, “WTO disputes reach 400 mark”,. 6 November 2009 (quoting WTO Director General, Pascal Lamy), online: <https://www.wto.org/english/news_e/pres09_e/pr578_e.htm>.
7 Preamble of the GATT, online: <https://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm>.
undermines the voluntary restraint traditionally in effect against taking measures and pursuing legal disputes that could undermine the integrity of the rules-based trading system. There are now sixteen dispute proceedings in the WTO that involve national security justifications for trade-distorting measures.\(^\text{11}\) Regardless of the legal merit of each side’s claims, these proceedings will not resolve the underlying tensions and may even further erode respect for the existing rules and institutions.

**Internal Challenges to Effective Dispute Settlement**

The WTO dispute settlement mechanism also faces a number of challenges that are internal to its operation. The innovations adopted in the Dispute Settlement Understanding\(^\text{12}\) (in particular reverse consensus and appellate review) overcame the weakness of dispute settlement under the GATT and have contributed significantly to the success of the WTO. However, the unprecedented degree of judicialization in the multilateral trading system may have had several unforeseen, and unforeseeable, consequences for cooperation on trade.

First, even prior to the impasse over the Appellate Body, the dispute settlement mechanism was increasingly struggling to deliver results within the prescribed time periods,\(^\text{13}\) which increases the risk of opportunist trade-distorting measures. Worsening delays are likely attributable to a combination of rising demand, the changing nature of disputes and the techniques employed by increasingly sophisticated parties. While rising demand is often presented as evidence of the system’s success,\(^\text{14}\) it may also reflect a growing emphasis on win-lose adjudication at the expense of other conciliatory, and often more timely, approaches to resolving trade irritants. Moreover, there is some evidence that much of the demand is from a sub-set of WTO members bringing repeat disputes over a narrow range of issues.\(^\text{15}\) The combination of a cultural shift toward adversarial dispute resolution and the dominance of a few repeat members raises concerns about whether the system is as inclusive and accessible as it could be.\(^\text{16}\)

Second, while judicialized dispute settlement is effective in resolving disputes over the existing rules, its effect on efforts to advance cooperation in new areas is unclear.\(^\text{17}\) The dispute settlement mechanism, and the parties that take their disputes before it, seem committed to address all issues and clarify all obligations. Similarly, the regular WTO bodies seem to be increasingly reluctant to document or codify the results of their deliberations for fear that these might have unintended effects on the interpretation of their existing obligations. Some members may even be tempted to pursue adjudication rather than negotiations in the hope that they can achieve their objectives without the compromises and trade-offs inherent in a negotiation.\(^\text{19}\)

Third, while the design and architecture of the WTO legal framework reserves the ultimate authority over the interpretation of WTO commitments to members,\(^\text{20}\) in practice WTO adjudicators have nearly unchecked

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\(^{11}\) Summary of the DSB meeting of 21 November 2018, *supra* note 3.


\(^{18}\) Article 17.12 of the DSU provides that the “Appellate Body shall address each of the issues raised in accordance with paragraph 6 during the appellate proceeding”.


\(^{20}\) Article IX:2 of the Marrakesh Agreement reserves to WTO members the “exclusive authority to adopt interpretations” of the obligations contained in the WTO agreements. Article 3.9 of the DSU acknowledges the hierarchy of "authoritative interpretations" over the results of dispute settlement.
autonomy to affect the meaning of WTO rights and obligations. Indeed, the decision of the United States to block appointments to the Appellate Body is motivated in part by grievances, some of them longstanding, about how the tribunal has exercised this autonomy. While there may be a good faith disagreement among members about whether the Appellate Body has discharged its mandate with sufficient circumspection, there is no question that the unintended imbalance between the political and adjudicative bodies of the WTO threatens the legitimacy of the dispute settlement mechanism.

Dispute Settlement in the Service of Trade Cooperation

Despite its procedural pretexts and systemic justifications, the impasse over the Appellate Body is a symptom of a more profound legitimacy crisis in the trading system. The combination of the changing balance of economic power, ageing trade rules, and scepticism about whether the benefits of globalisation have been distributed equally present considerable challenges for continued rules-based cooperation on trade. The WTO dispute settlement mechanism cannot, on its own, resolve any of these issues. Indeed, efforts to prioritise the restoration of the Appellate Body may only distract from, and in the worst case even become an obstacle to, more fundamental reforms to the rules and institutions of international trade.

Contrary to the concerns expressed by some, the incapacitation of the Appellate Body does not “threaten the survival of the WTO” and will not make the existing rules “count for little”. It will not even bring about the collapse of the entire dispute settlement mechanism, which is about more than its appeal and enforcement mechanisms. Of course, strengthening the dispute settlement function of the WTO, including compulsory, impartial and enforceable third-party adjudication, should be an important outcome of the reform effort. But simply restoring the appellate function will be insufficient to adapt it to the changed context and overcome some of its current limitations.

Instead, the dispute settlement mechanism should be evaluated for its contribution to overcoming problems in trade cooperation. Recourse to adjudication reflects a failure to resolve cooperation problems by other means and should normally be considered a last resort. However, a system that places a disproportionate emphasis on win-lose adjudication relieves members of the responsibility, and in some circumstances deprives them of the opportunity, to pursue more timely and conciliatory resolution of their trade disputes. As part of efforts to restore trust in the benefits of rules-based trade, reform of the dispute settlement mechanism should focus on restoring the “proper balance” between the political and adjudicative functions of the WTO.

Restoring Balance Between the Political and Adjudicative Functions

There is increasing acknowledgement that updating the trade rules and strengthening the WTO may require new forms of flexibility for both the content of commitments and the legal frameworks within which they are codified. Likewise for the dispute settlement mechanism, it may be necessary to introduce greater flexibility to address the challenges to its legitimacy and restore balance in its operations. This rebalancing could be accomplished by

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26 Revitalizing Multilateral Governance, supra note 2.
strengthening the capacity for political decision-making on the one hand while reducing the emphasis on win-lose adjudication on the other.

On the political side of the ledger, in addition to improving the negotiating function to modernize the rules, there could be more opportunity and greater responsibility for political cooperation to resolve trade disputes and clarify the meaning of trade commitments. This could be accomplished by providing better safety values for politically sensitive disputes, through diversion to political bodies or, during the current trade tensions, a moratorium of certain kinds of disputes. Strengthening the deliberative function of the regular WTO committees would also help. More systemically, the exclusive but as yet unused authority of members to adopt “authoritative interpretations” of their WTO commitments could be better operationalised. For example, procedures could be developed that regularise the deliberation and adoption of negotiated interpretations, either to proactively clarify ambiguous WTO provisions or to override or disallow dispute settlement findings that exceed what is acceptable to members.

On the dispute settlement side of the ledger, there could be a reduction of the reliance on, and the consequences of, compulsory adjudication. For starters, the opportunities for mediation and conciliation could be improved to place more emphasis on reconciling interests rather than determining legal right and wrong. As the experience in dispute settlement under the WTO has already shown, there are some disputes that simply cannot be resolved through adjudication. In cases where adjudication becomes necessary, the scope of adjudication could be narrowed and the procedures streamlined to make them more timely and accessible. Finally, to mitigate the risk of a chill on ongoing negotiations and committee deliberations, some categories of information and some types of deliberations could be declared inadmissible in dispute settlement proceedings. Most of these changes can be implemented through “authoritative interpretations” adopted by the General Council of the WTO.

The pending incapacitation of the Appellate Body is serious and concerning but is not itself fatal to rules-based trade cooperation or even necessarily to the WTO’s capacity to settle trade disputes. Given the lack of confidence among some members that the current rules provide a framework for balanced and reciprocal trade relations, it is not yet clear whether the dispute settlement mechanism can even be fully restored separately from an update of those rules. If the Appellate Body does become incapacitated, members can use “no-appeal agreements” during an interim period to reserve access to the enforcement function of the WTO. More importantly though, members should also be thinking about broader improvements to the dispute settlement mechanism to ensure that it remains fit-for-purpose in the service of trade cooperation in a turbulent multipolar world.

28 Communication from Canada, “Strengthening and modernizing the WTO: Discussion paper”, JOB/GC/201, 24 September 2018 [Strengthening the WTO], online: <http://bit.ly/wto-job-gc-201>. For example, a political agreement could exclude from dispute settlement, or suspend ongoing disputes related to, issues that are unlikely to be resolved through legal proceedings, such as those currently related to national security and non-market economy status or similar to those raised in the US—Helms Burton dispute (DS38).
30 Adjudicative Bodies, supra note 26.
31 One example of such an interpretation in a different context is the “Notes of Interpretation of Certain Chapter 11 Provisions”, adopted by the NAFTA Free Trade Commission on 31 July 2001 to “clarify and reaffirm the meaning of certain of [the] provisions” of NAFTA Chapter Eleven, online: <http://www.sice.oas.org/tpd/nafta/commission/ch11understanding_e.asp>.
32 Inclusive Dispute Settlement, supra note 16.
33 Strengthening the WTO, supra note 28.
36 Impasse in the DSB, supra note 25.
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Unit I: The Syntax and Grammar of International Trade Law

Case Law: US–Section 301

United States – Sections 301-310 of the Trade Act of 1974

Editors’ Note: This case interests us since it explicitly raises the question as to the overall objectives of the WTO. It involves an alleged conflict between United States statutes on trade remedies and the Dispute Settlement Understanding (“DSU”) – part of the interlocking Agreements comprising the WTO, which lays out rules and procedures governing the settlement of trade disputes. When you read this report you should ask yourself why the panel engaged in an examination of the overall objectives of the WTO.

Summary of facts

Excerpt from Dispute Settlement Commentary of Section 301 on the subscriber page of www.worldtradelaw.net.

This dispute concerns U.S. legislation that authorizes certain actions by the United States Trade Representative (“USTR”) in response to trade barriers imposed by other countries. While this legislation is known commonly as "Section 301," the entire measure at issue actually spans Sections 301-310 of the Trade Act of 1974 (codified at 19 U.S.C. §2411 et seq.).

The operation of the Section 301 provisions is as follows. First, Section 302 authorizes the USTR to initiate investigations of acts, policies or practices of other countries that are "unreasonable or discriminatory" and burden or restrict U.S. commerce. It also requires the USTR to request consultations with the country concerned. Section 303 then requires that if no mutually acceptable resolution is reached within a certain time period, the USTR must request proceedings under the formal dispute settlement procedures of the trade agreement at issue.

In turn, Section 304(a) requires that the USTR make a determination under the trade agreement at issue as to whether U.S. rights are being denied on or before the earlier of "(i) the date that is 30 days after the date on which the dispute settlement procedure is concluded, or (ii) the date that is 18 months after the date on which the investigation is initiated." Moreover, it requires that if the USTR's determination is affirmative (i.e., if the USTR determines that U.S. rights are being denied), the USTR must, at the same time, determine what action it will take under Section 301, which authorizes the USTR to take remedial action, including the suspension or withdrawal of concessions or the imposition of duties or other import restrictions. However, with regard to investigations involving alleged violations of the WTO Agreement, the following rules apply. If the DSB adopts rulings favorable to the United States on a measure that was originally investigated under these Section 301 provisions, then, under Section 304(a), where the responding Member agrees to implement the DSB's ruling within a reasonable time, the USTR can determine that U.S. rights are being denied, but that "satisfactory measures" are being taken that justify the termination of the Section 301 investigation.

Section 306(a) then requires the USTR to "monitor" the implementation of measures undertaken by a foreign government to provide a satisfactory resolution of a matter subject to dispute settlement. Under Section 306(b), if, on the basis of that monitoring, the USTR "considers" that a foreign country is not satisfactorily implementing the measure undertaken to reach a satisfactory resolution, then the USTR is required to reach a determination under Section 304(a) as to what
further action it will take under Section 301(a). In this situation, Section 305(a)(1) requires that, subject to the specific direction by the President of the United States, the USTR must implement the action it determines necessary under Section 304(a) "by no later than … 30 days after the date on which such determination is made." Section 305(a)(2)(A), however, permits the USTR to delay, by no more than 180 days, any action under Section 301 if the USTR determines "that substantial progress is being made, or that a delay is necessary or desirable to obtain U.S. rights or satisfactory solution with respect to the acts, policies, or practices that are the subject of the action." (Paras. 2.1-2.20)

The European Communities argued that Sections 304(a)(2)(A) and 306(b) are inconsistent with DSU Article 23.2(a), and that Sections 306(b) and 305(a) are inconsistent with DSU Article 23.2(c). Moreover, it claimed that Section 306(b) violates GATT Articles I, II, III, VIII and XI.

Panel Report, WT/DS152/R, 22 December 1999
Panel: Hawes, Johannessen, Weiler

http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds152_e.htm

(...)

VII. Findings

(...)  

(a) The dual nature of obligations under Article 23 of the DSU

7.35. Article 23 of the DSU deals, as its title indicates, with the "Strengthening of the Multilateral System". Its overall design is to prevent WTO Members from unilaterally resolving their disputes in respect of WTO rights and obligations. It does so by obligating Members to follow the multilateral rules and procedures of the DSU.

7.36. Article 23.1 provides as follows:

"Strengthening of the Multilateral System

When Members seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements, they shall have recourse to, and abide by, the rules and procedures of this Understanding" (emphasis added).

7.37. Article 23.2 specifies three elements that need to be respected as part of the multilateral DSU dispute settlement process. It provides as follows:

"In such cases [referred to in Article 23.1, i.e. when Members seek the redress of WTO inconsistencies], Members shall:

(a) not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any
objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding, and shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under this Understanding;

(b) follow the procedures set forth in Article 21 to determine the reasonable period of time for the Member concerned to implement the recommendations and rulings; and

(c) follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time”.

(...) 

(c) "... the ordinary meaning ... in the light of [the treaty's] object and purpose"

7.71. What are the objects and purposes of the DSU, and the WTO more generally, that are relevant to a construction of Article 23? The most relevant in our view are those which relate to the creation of market conditions conducive to individual economic activity in national and global markets and to the provision of a secure and predictable multilateral trading system.

7.72. Under the doctrine of direct effect, which has been found to exist most notably in the legal order of the EC but also in certain free trade area agreements, obligations addressed to States are construed as creating legally enforceable rights and obligations for individuals. Neither the GATT nor the WTO has so far been interpreted by GATT/WTO institutions as a legal order producing direct effect. 661 Following this approach, the GATT/WTO did not create a new legal order the subjects of which comprise both contracting parties or Members and their nationals.

7.73. However, it would be entirely wrong to consider that the position of individuals is of no relevance to the GATT/WTO legal matrix. Many of the benefits to Members which are meant to flow as a result of the acceptance of various disciplines under the GATT/WTO depend on the activity of individual economic operators in the national and global market places. The purpose

661 We make this statement as a matter of fact, without implying any judgment on the issue. We note that whether there are circumstances where obligations in any of the WTO agreements addressed to Members would create rights for individuals which national courts must protect, remains an open question, in particular in respect of obligations following the exhaustion of DSU procedures in a specific dispute (see Eeckhout, P., The Domestic Legal Status of the WTO Agreement: Interconnecting Legal Systems, Common Market Law Review, 1997, p. 11; Berkey, J., The European Court of Justice and Direct Effect for the GATT: A Question Worth Revisiting, European Journal of International Law, 1998, p. 626). The fact that WTO institutions have not to date construed any obligations as producing direct effect does not necessarily preclude that in the legal system of any given Member, following internal constitutional principles, some obligations will be found to give rights to individuals. Our statement of fact does not prejudge any decisions by national courts on this issue.
of many of these disciplines, indeed one of the primary objects of the GATT/WTO as a whole, is to produce certain market conditions which would allow this individual activity to flourish.

7.74. The very first Preamble to the WTO Agreement states that Members recognise "that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services". 662

7.75. Providing security and predictability to the multilateral trading system is another central object and purpose of the system which could be instrumental to achieving the broad objectives of the Preamble. Of all WTO disciplines, the DSU is one of the most important instruments to protect the security and predictability of the multilateral trading system and through it that of the market-place and its different operators. DSU provisions must, thus, be interpreted in the light of this object and purpose and in a manner which would most effectively enhance it. In this respect we are referring not only to preambular language but also to positive law provisions in the DSU itself. Article 3.2 of the DSU provides:

"The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system. The Members recognize that it serves to preserve the rights and obligations of Members under the covered agreements …". 663

7.76. The security and predictability in question are of "the multilateral trading system". The multilateral trading system is, per force, composed not only of States but also, indeed mostly, of individual economic operators. The lack of security and predictability affects mostly these individual operators.

662 See also similar language in the second preambles to GATT 1947 and GATS. The TRIPS Agreement addresses even more explicitly the interests of individual operators, obligating WTO Members to protect the intellectual property rights of nationals of all other WTO Members. Creating market conditions so that the activity of economic operators can flourish is also reflected in the object of many WTO agreements, for example, in the non-discrimination principles in GATT, GATS and TRIPS and the market access provisions in both GATT and GATS.

663 The importance of security and predictability as an object and purpose of the WTO has been recognized as well in many panel and Appellate Body reports. See the Appellate Body report on Japan – Alcoholic Beverages, op. cit., p. 31 ("WTO rules are reliable, comprehensible and enforceable. WTO rules are not so rigid or so inflexible as not to leave room for reasoned judgements in confronting the endless and ever-changing ebb and flow of real facts in real cases in the real world. They will serve the multilateral trading system best if they are interpreted with that in mind. In that way, we will achieve the 'security and predictability' sought for the multilateral trading system by the Members of the WTO through the establishment of the dispute settlement system"). It has also been referred to under the TRIPS Agreement. In the Appellate Body Report on India – Patents (US), op. cit., it was found, at para. 58, that "India is obliged, by Article 70.8(a), to provide a legal mechanism for the filing of mailbox applications that provides a sound legal basis to preserve both the novelty of the inventions and the priority of the applications as of the relevant filing and priority dates" (italics added). See also the WTO Panel Report on Argentina – Textiles and Apparel (US), op. cit., para. 6.29 and the GATT Panel Reports on United States Manufacturing Clause, adopted 15/16 May 1984, BISD 31S/74, para. 39; Japan – Measures on Imports of Leather ("Japan – Leather"), adopted 15/16 May 1984, BISD 31S/94, para. 55; EEC – Imports of Newsprint, adopted November 20 1984, BISD 31S/114, para. 52; Norway – Restrictions on Imports of Apples and Pears, adopted 22 June 1989, BISD 36S/306, para. 5.6.
7.77. Trade is conducted most often and increasingly by private operators. It is through improved conditions for these private operators that Members benefit from WTO disciplines. The denial of benefits to a Member which flows from a breach is often indirect and results from the impact of the breach on the marketplace and the activities of individuals within it. Sections 301-310 themselves recognize this nexus. One of the principal triggers for US action to vindicate US rights under covered agreements is the impact alleged breaches have had on, and the complaint emanating from, individual economic operators.

7.78. It may, thus, be convenient in the GATT/WTO legal order to speak not of the principle of direct effect but of the principle of indirect effect.

7.79. Apart from this name-of-convenience, there is nothing novel or radical in our analysis. We have already seen that it is rooted in the language of the WTO itself. It also represents a GATT/WTO orthodoxy confirmed in a variety of ways over the years including panel and Appellate Body reports as well as the practice of Members.

7.80 Consider, first, the overall obligation of Members concerning their internal legislation. Under traditional public international law a State cannot rely on its domestic law as a justification for non-performance. Equally, however, under traditional public international law, legislation under which an eventual violation could, or even would, subsequently take place, does not normally in and of itself engage State responsibility. If, say, a State undertakes not to expropriate property of foreign nationals without appropriate compensation, its State responsibility would normally be engaged only at the moment foreign property had actually been expropriated in a given instance. And yet, even in the GATT, prior to the enactment of Article XVI:4 of the WTO Agreement explicitly referring to measures of a general nature, legislation as such independent from its application in specific instances was considered to constitute a violation. This is confirmed by numerous adopted GATT panel reports and is also agreed upon by both parties to this dispute. Why is it, then, that legislation as such was found to be inconsistent with GATT rules? If no specific application is at issue – if, for example, no specific discrimination has yet been made – what is it that constitutes the violation?

7.81 Indirect impact on individuals is, surely, one of the principal reasons. In treaties which concern only the relations between States, State responsibility is incurred only when an actual violation takes place. By contrast, in a treaty the benefits of which depend in part on the activity of individual operators the legislation itself may be construed as a breach, since the mere existence of legislation could have an appreciable "chilling effect" on the economic activities of individuals.

7.82 Thus, Article III:2 of GATT 1947, for example, would not, on its face, seem to prohibit legislation independently from its application to specific products. However, in light of the object and purpose of the GATT, it was read in GATT jurisprudence as a promise by contracting parties not only that they would abstain from actually imposing discriminatory taxes, but also that they would not enact legislation with that effect.

7.83 It is commonplace that domestic law in force imposing discriminatory taxation on imported products would, in and of itself, violate Article III irrespective of proof of actual discrimination in a specific case. Furthermore, a domestic law which exposed imported products to future discrimination was recognized by some GATT panels to constitute, by itself, a violation of

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664 See Article 27 of the Vienna Convention.
665 A change in the relative competitive opportunities caused by a measure of general application as such, to the detriment of imported products and in favour of domestically produced products, is the decisive criterion.
Article III, even before the law came into force.\textsuperscript{666} Finally, and most tellingly, even where there was no certainty but only a risk under the domestic law that the tax would be discriminatory, certain GATT panels found that the law violated the obligation in Article III.\textsuperscript{667} A similar approach was followed in respect of Article II of GATT 1994 by the WTO panel on \textit{Argentina – Textiles and Apparel (US)} when it found that the very change in system from \textit{ad valorem} to specific duties was a breach of Argentina's \textit{ad valorem} tariff binding even though such change only brought about the potential of the tariff binding being exceeded depending on the price of the imported product.\textsuperscript{668}

\begin{itemize}
\item In the Panel Report on \textit{US – Superfund} (op. cit., paras. 5.2.1 and 5.2.2) tax legislation as such was found to violate GATT obligations even though the legislation had not yet entered into effect. See also the Panel Report on \textit{US - Malt Beverages} (op. cit., paras. 5.39, 5.57, 5.60 and 5.69) where the legislation imposing the tax discrimination was, for example, not being enforced by the authorities.
\item See Panel Report on \textit{US – Tobacco}, op. cit., para. 96:
\begin{quote}
"The Panel noted that an internal regulation which merely exposed imported products to a risk of discrimination had previously been recognized by a GATT panel to constitute, by itself, a form of discrimination, and therefore less favourable treatment within the meaning of Article III. The Panel agreed with this analysis of risk of discrimination as enunciated by this earlier panel".
\end{quote}
A footnote to this paragraph refers to the Panel Report on \textit{EEC - Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal Feed Protein}, adopted 25 January 1990, BISD 37S/86, para. 141, which reads as follows:
\begin{quote}
"Having made this finding the Panel examined whether a purchase regulation which does not necessarily discriminate against imported products but is capable of doing so is consistent with Article III:4. The Panel noted that the exposure of a particular imported product to a \textit{risk} of discrimination constitutes, by itself, a form of discrimination. The Panel therefore concluded that purchase regulations creating such a risk must be considered to be according less favourable treatment within the meaning of Article III:4. The Panel found for these reasons that the payments to processors of Community oilseeds are inconsistent with Article III:4".
\end{quote}
\item Op. cit., paras. 6.45-6.47, in particular para. 6.46: "In the present dispute we consider that the competitive relationship of the parties was changed unilaterally by Argentina because its mandatory measure clearly has the potential to violate its bindings, thus undermining the security and the predictability of the WTO system" (emphasis added). This was confirmed by the Appellate Body (op. cit., para. 53):
\begin{quote}
"In the light of this analysis, we may generalize that under the Argentine system, whether the amount of the DIEM [a regime of Minimum Specific Import Duties] is determined by applying 35 per cent, or a rate less than 35 per cent, to the representative international price, there will remain the possibility of a price that is sufficiently low to produce an \textit{ad valorem} equivalent of the DIEM that is greater than 35 per cent. In other words, the structure and design of the Argentine system is such that for any DIEM, no matter what \textit{ad valorem} rate is used as the multiplier of the representative international price, the possibility remains that there is a "break-even" price below which the \textit{ad valorem} equivalent of the customs duty collected is in excess of the bound \textit{ad valorem} rate of 35 per cent".
\end{quote}
\end{itemize}

On that basis, the Appellate Body found that the application of a type of duty different from the type provided for in a Member's Schedule is inconsistent with Article II:1(b), first sentence, of the GATT 1994. In this respect, see also the Panel Report on \textit{United States – Standards for Reformulated and Conventional}
The rationale in all types of cases has always been the negative effect on economic operators created by such domestic laws. An individual would simply shift his or her trading patterns – buy domestic products, for example, instead of imports – so as to avoid the would-be taxes announced in the legislation or even the mere risk of discriminatory taxation. Such risk or threat, when real, was found to affect the relative competitive opportunities between imported and domestic products because it could, in and of itself, bring about a shift in consumption from imported to domestic products: This shift would be caused by, for example, an increase in the cost of imported products and a negative impact on economic planning and investment to the detriment of those products. This rationale was paraphrased in the Superfund case as follows:

"to protect expectations of the contracting parties as to the competitive relationship between their products and those of the other contracting parties. Both articles [GATT Articles III and XI] are not only to protect current trade but also to create the predictability needed to plan future trade".

Doing so, the panel in Superfund referred to the reasoning in the Japanese Measures on Imports of Leather case. There the panel found that an import quota constituted a violation of Article XI of GATT even though the quota had not been filled. It did so on the following grounds:

"the existence of a quantitative restriction should be presumed to cause nullification or impairment not only because of any effect it had had on the volume of trade but also for other reasons e.g. it would lead to increased transaction costs and would create uncertainties which could affect investment plans".

In this sense, Article III:2 is not only a promise not to discriminate in a specific case, but is also designed to give certain guarantees to the market place and the operators within it that discriminatory taxes will not be imposed. For the reasons given above, any ambivalence in GATT panel jurisprudence as to whether a risk of discrimination can constitute a violation should, in our view, be resolved in favour of our reading.

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669 Op. cit., para. 5.2.2.
670 Panel Report on Japan – Leather, op. cit., para. 55. In this respect, see also Panel Report on US – Malt Beverages (op. cit., para. 5.60), where legislation was found to constitute a GATT violation even though it was not being enforced, for the following reason:

"Even if Massachusetts may not currently be using its police powers to enforce this mandatory legislation, the measure continues to be mandatory legislation which may influence the decisions of economic operators. Hence, a non-enforcement of a mandatory law in respect of imported products does not ensure that imported beer and wine are not treated less favourably than like domestic products to which the law does not apply" (emphasis added).

671 As a result, we do not consider that the general statements made in certain GATT panels are correct in respect of all WTO obligations and in all circumstances, for example, the statement in Panel Report on EEC – Parts and Components (op. cit., para. 5.25) that “[u]nder the provisions of the [GATT] which Japan claims have been violated by the EEC contracting parties are to avoid certain measures; but these provisions do not establish the obligation to avoid legislation under which the executive authorities may possibly impose such measures” and in Panel Report on Thai – Cigarettes (op. cit., para. 84), the statement
7.86. Similarly, Article 23 too has to be interpreted in the light of these principles which encapsulate such a central object and purpose of the WTO. It may have been plausible if one considered a strict Member-Member matrix to insist that the obligations in Article 23 do not apply to legislation that threatens unilateral determinations but does not actually mandate them. It is not, however, plausible to construe Article 23 in this way if one interprets it in the light of the indirect effect such legislation has on individuals and the market-place, the protection of which is one of the principal objects and purposes of the WTO.

7.87 To be sure, in the cases referred to above, whether the risk materialized or not depended on certain market factors such as fluctuating reference prices on which the taxation of the imported product was based by virtue of the domestic legislation. In this case, whether the risk materializes depends on a decision of a government agency. From the perspective of the individual economic operator, however, this makes little difference. Indeed, it may be more difficult to predict the outcome of discretionary government action than to predict market conditions, thereby exacerbating the negative economic impact of the type of domestic law under examination here.

7.88. When a Member imposes unilateral measures in violation of Article 23 in a specific dispute, serious damage is created both to other Members and the market-place. However, in our view, the creation of damage is not confined to actual conduct in specific cases. A law reserving the right for unilateral measures to be taken contrary to DSU rules and procedures, may — as is the case here — constitute an ongoing threat and produce a "chilling effect" causing serious damage in a variety of ways.

7.89. First, there is the damage caused directly to another Member. Members faced with a threat of unilateral action, especially when it emanates from an economically powerful Member, may in effect be forced to give in to the demands imposed by the Member exerting the threat, even before DSU procedures have been activated. To put it differently, merely carrying a big stick is, in many cases, as effective a means to having one's way as actually using the stick. The threat alone of conduct prohibited by the WTO would enable the Member concerned to exert undue leverage on other Members. It would disrupt the very stability and equilibrium which multilateral dispute resolution was meant to foster and consequently establish, namely equal protection of both large and small, powerful and less powerful Members through the consistent application of a set of rules and procedures.672

7.90. Second, there is the damage caused to the market-place itself. The mere fact of having legislation the statutory language of which permits conduct which is WTO prohibited — namely, the imposition of unilateral measures against other Members with which it is locked in a trade dispute — may in and of itself prompt economic operators to change their commercial behaviour in a way that distorts trade. Economic operators may be afraid, say, to continue ongoing trade with, or investment in, the industries or products threatened by unilateral measures. Existing trade may also be distorted because economic operators may feel a need to take out extra insurance to allow for the illegal possibility that the legislation contemplates, thus reducing the relative competitive opportunity of their products on the market. Other operators may be deterred from trading with such a Member altogether, distorting potential trade. The damage thus caused to the market-place may actually increase when national legislation empowers individual economic operators to trigger unilateral State action, as is the case in the US which allows individual petitioners to request the USTR to initiate an investigation under Sections 301-310.

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672 In this respect, see the statements made by third parties to this dispute in Section V of our Report.
This in itself is not illegal. But the ability conferred upon economic operators to threaten their foreign competitors with the triggering of a State procedure which includes the possibility of illegal unilateral action is another matter. It may affect their competitive economic relationship and deny certain commercial advantages that foreign competitors would otherwise have. The threat of unilateral action can be as damaging on the market-place as the action itself.

7.91. In conclusion, the risk of discrimination was found in GATT jurisprudence to constitute a violation of Article III of GATT – because of the "chilling effect" it has on economic operators. The risk of a unilateral determination of inconsistency as found in the statutory language of Section 304 itself has an equally apparent "chilling effect" on both Members and the market-place even if it is not quite certain that such a determination would be made. The point is that neither other Members nor, in particular, individuals can be reasonably certain that it will not be made.

Whereas States which are part of the international legal system may expect their treaty partners to assume good faith fulfillment of treaty obligations on their behalf, the same assumption cannot be made as regards individuals.

7.92. It is a circumspect use of the teleological method to choose that interpretation of Article 23 of the DSU that provides this certainty and eliminates the undesired "chilling effects" which run against the object and purpose of the WTO Agreement.

(...)
OFFICE of the UNITED STATES TRADE REPRESENTATIVE
EXECUTIVE OFFICE OF THE PRESIDENT

FINDINGS OF THE INVESTIGATION INTO
CHINA’S ACTS, POLICIES, AND PRACTICES
RELATED TO TECHNOLOGY TRANSFER,
INTELLECTUAL PROPERTY, AND INNOVATION
UNDER SECTION 301 OF THE TRADE ACT OF 1974

March 22, 2018
## Abbreviations and Acronyms

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<tr>
<th>Acronym</th>
<th>Definition</th>
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<tbody>
<tr>
<td>3PLA</td>
<td>People’s Liberation Army, Third Department</td>
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<tr>
<td>4WD</td>
<td>four-wheel drive</td>
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<tr>
<td>AAFA</td>
<td>American Apparel &amp; Footwear Association</td>
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<td>ABA</td>
<td>American Bar Association</td>
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<td>ABC</td>
<td>Agriculture Bank of China</td>
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<td>ABPIA</td>
<td>American Bridal &amp; Prom Industry Association</td>
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<td>ACC</td>
<td>American Chemistry Council</td>
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<td>AEI</td>
<td>American Enterprise Institute</td>
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<td>AGIC</td>
<td>Asia-Germany Industrial Promotion Capital</td>
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<td>AI</td>
<td>artificial intelligence</td>
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<td>AmCham</td>
<td>American Chamber of Commerce Shanghai</td>
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<td>AML</td>
<td>Anti-Monopoly Law</td>
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<td>AMSC</td>
<td>American Superconductor Corporation</td>
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<tr>
<td>APEC</td>
<td>Asia-Pacific Economic Cooperation</td>
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<td>APT</td>
<td>advanced persistent threat</td>
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<tr>
<td>AQSIQ</td>
<td>Administration of Quality Supervision, Inspection and Quarantine</td>
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<tr>
<td>ATI</td>
<td>Allegheny Technologies, Inc</td>
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<tr>
<td>AVIC</td>
<td>Aviation Industry Corporation of China</td>
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<tr>
<td>AVICEM</td>
<td>ACIF Electromechanical Systems Co., Ltd</td>
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<tr>
<td>AWD</td>
<td>all-wheel drive</td>
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<tr>
<td>BCM</td>
<td>Bank of Communications</td>
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<tr>
<td>BEA</td>
<td>U.S. Bureau of Economic Analysis</td>
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<tr>
<td>BGI</td>
<td>Shenzhen Beijing Genomics Institute</td>
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<td>BLO</td>
<td>Biotechnology Innovation Organization</td>
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<tr>
<td>BIS</td>
<td>Bureau of Industry and Security</td>
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<td>BoC</td>
<td>Bank of China</td>
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<td>BRI</td>
<td>Belt and Road Initiative</td>
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<tr>
<td>BRIC</td>
<td>Brazil, Russia, India, and China</td>
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<tr>
<td>C&amp;C</td>
<td>command-and-control</td>
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<tr>
<td>CAAC</td>
<td>Civil Aviation Administration of China</td>
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<td>CAIGA</td>
<td>China Aviation Industry General Aircraft Co.</td>
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<td>CAST</td>
<td>China Association of Science and Technology</td>
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<td>CCCB</td>
<td>China Construction Bank Corporation</td>
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<tr>
<td>CCC</td>
<td>China Compulsory Certification</td>
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<td>CCCME</td>
<td>China Chamber of Commerce for Import &amp; Export of Machinery and Electronic Products</td>
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<tr>
<td>COIC</td>
<td>China Chamber of International Commerce</td>
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<td>CCP</td>
<td>Chinese Communist Party</td>
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<td>CCXR</td>
<td>China Chengxin Securities Rating Company</td>
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<td>CDB</td>
<td>China Development Bank</td>
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<tr>
<td>CFIUS</td>
<td>Committee on Foreign Investment in the United States</td>
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<td>CG</td>
<td>Complete Genomics</td>
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<td>CGCC</td>
<td>China General Chamber of Commerce</td>
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<td>CIC</td>
<td>China Investment Corporation</td>
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<tr>
<td>CIGS</td>
<td>copper indium gallium selenide</td>
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<td>CIPL</td>
<td>China Intellectual Property Law Society</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>CJV</td>
<td>contractual joint venture</td>
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<tr>
<td>CMG</td>
<td>Continental Motors Group Limited</td>
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<td>CMOS</td>
<td>complementary metal-oxide semiconductor</td>
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<tr>
<td>CNOOC</td>
<td>China National Offshore Oil Corporation</td>
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<td>CNY</td>
<td>Chinese yuan</td>
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<tr>
<td>COMAC</td>
<td>Commercial Aircraft Corporation of China, Ltd</td>
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<td>CompTIA</td>
<td>Computing Technology Industry Association</td>
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<tr>
<td>CPPCC</td>
<td>Chinese People’s Political Consultative Conference</td>
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<tr>
<td>CSI</td>
<td>Coalition of Services Industries</td>
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<tr>
<td>CSIS</td>
<td>Center for Strategic and International Studies</td>
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<td>CSP</td>
<td>cloud service providers</td>
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<tr>
<td>CTA</td>
<td>Consumer Technology Association</td>
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<tr>
<td>DHH</td>
<td>DHH Washington Law Office</td>
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<tr>
<td>DHS</td>
<td>U.S. Department of Homeland Security</td>
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<tr>
<td>DOJ</td>
<td>U.S. Department of Justice</td>
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<tr>
<td>DRC</td>
<td>Development and Reform Commission</td>
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<tr>
<td>EJV</td>
<td>equity joint venture</td>
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<td>EXIM</td>
<td>China Export-Import Bank</td>
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<tr>
<td>FADEC</td>
<td>full authority digital engine control</td>
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<tr>
<td>FAW</td>
<td>First Automotive Workers</td>
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<tr>
<td>FDI</td>
<td>foreign direct investment</td>
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<tr>
<td>FIE</td>
<td>foreign-invested entities</td>
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<tr>
<td>FYP</td>
<td>Five-Year Plan for National Economic and Social Development</td>
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<tr>
<td>GA</td>
<td>general aviation</td>
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<tr>
<td>GAC</td>
<td>General Administration of Customs</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<td>GMO</td>
<td>genetically modified organism</td>
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<tr>
<td>HNA</td>
<td>Hainan Airlines</td>
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<tr>
<td>IaaS</td>
<td>infrastructure as a service</td>
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<tr>
<td>IAM</td>
<td>International Association of Machinists and Aerospace Workers</td>
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<tr>
<td>IATA</td>
<td>International Air Transport Association</td>
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<tr>
<td>IC</td>
<td>integrated circuit</td>
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<tr>
<td>ICBC</td>
<td>Industrial and Commercial Bank of China</td>
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<tr>
<td>ICT</td>
<td>information and communications technology</td>
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<tr>
<td>ICTSD</td>
<td>International Center for Trade and Sustainable Development</td>
</tr>
<tr>
<td>IDAR</td>
<td>introduce, digest, absorb, and re-innovate</td>
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<tr>
<td>IDC</td>
<td>internet data center</td>
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<tr>
<td>IDDS</td>
<td>innovation-driven development strategy</td>
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<tr>
<td>IGBT</td>
<td>insulated-gate bipolar transistors</td>
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<tr>
<td>IGCC</td>
<td>University of California Institute on Global Conflict and Cooperation</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>iML</td>
<td>Integrated Memory Logic Limited</td>
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<tr>
<td>IP</td>
<td>intellectual property</td>
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<tr>
<td>IPIRA</td>
<td>Intellectual Property and Industry Research Alliances</td>
</tr>
<tr>
<td>ISS</td>
<td>Imaging Solutions and Services</td>
</tr>
<tr>
<td>ISSI</td>
<td>Integrated Silicon Solutions, Inc.</td>
</tr>
<tr>
<td>IT</td>
<td>information technology</td>
</tr>
<tr>
<td>ITAR</td>
<td>International Traffic in Arms Regulations</td>
</tr>
<tr>
<td>ITI</td>
<td>Information Technology Industry Council</td>
</tr>
<tr>
<td>Acronym</td>
<td>Description</td>
</tr>
<tr>
<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>ITIF</td>
<td>Information Technology &amp; Innovation Foundation</td>
</tr>
<tr>
<td>JCCT</td>
<td>U.S.-China Joint Commission on Commerce and Trade</td>
</tr>
<tr>
<td>JV</td>
<td>joint venture</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>merger and acquisitions</td>
</tr>
<tr>
<td>MCF</td>
<td>military-civil fusion</td>
</tr>
<tr>
<td>MCM</td>
<td>multi-chip module</td>
</tr>
<tr>
<td>MEMA</td>
<td>Motor &amp; Equipment Manufacturers Association</td>
</tr>
<tr>
<td>MEMS</td>
<td>micro-electromechanical systems</td>
</tr>
<tr>
<td>MERICS</td>
<td>Mercator Institute for China Studies</td>
</tr>
<tr>
<td>METI</td>
<td>Ministry of Economy, Trade, and Industry</td>
</tr>
<tr>
<td>MIIT</td>
<td>Ministry of Industry and Information Technology</td>
</tr>
<tr>
<td>MLP</td>
<td>National Medium- and Long-Term Plan for the Development of Science and Technology</td>
</tr>
<tr>
<td>MLPS</td>
<td>Multi-level Protection Scheme</td>
</tr>
<tr>
<td>MLR</td>
<td>Ministry of Land and Resources of the People’s Republic of China</td>
</tr>
<tr>
<td>MNE</td>
<td>multinational enterprise</td>
</tr>
<tr>
<td>MOA</td>
<td>Ministry of Agriculture of the People’s Republic of China</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance of the People’s Republic of China</td>
</tr>
<tr>
<td>MOFCOM</td>
<td>Ministry of Commerce of the People’s Republic of China</td>
</tr>
<tr>
<td>MOST</td>
<td>Ministry of Science and Technology of the People’s Republic of China</td>
</tr>
<tr>
<td>MPS</td>
<td>managed print services</td>
</tr>
<tr>
<td>MRO</td>
<td>maintenance, repair, and overhaul</td>
</tr>
<tr>
<td>MSS</td>
<td>China’s Ministry of State Security</td>
</tr>
<tr>
<td>MW</td>
<td>megawatt</td>
</tr>
<tr>
<td>NAM</td>
<td>National Association of Manufacturers</td>
</tr>
<tr>
<td>NBC</td>
<td>National Bureau of Statistics of the People’s Republic of China</td>
</tr>
<tr>
<td>NDRC</td>
<td>National Development and Reform Commission</td>
</tr>
<tr>
<td>NEA</td>
<td>National Energy Administration</td>
</tr>
<tr>
<td>NEV</td>
<td>new-energy vehicle</td>
</tr>
<tr>
<td>NFTC</td>
<td>National Foreign Trade Council</td>
</tr>
<tr>
<td>NHI</td>
<td>Northern Heavy Industries Group</td>
</tr>
<tr>
<td>NPC</td>
<td>National People’s Congress (China)</td>
</tr>
<tr>
<td>NTE</td>
<td>National Trade Estimate</td>
</tr>
<tr>
<td>OCTG</td>
<td>oil country tubular goods</td>
</tr>
<tr>
<td>ODI</td>
<td>overseas direct investment</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OFDI</td>
<td>outbound foreign direct investment</td>
</tr>
<tr>
<td>PaaS</td>
<td>computer platform as a service</td>
</tr>
<tr>
<td>PBOC</td>
<td>People’s Bank of China</td>
</tr>
<tr>
<td>PERC</td>
<td>Passivated Emitter Rear Contact</td>
</tr>
<tr>
<td>PLA</td>
<td>China’s People’s Liberation Army</td>
</tr>
<tr>
<td>PMA</td>
<td>parts manufacturing and authorization</td>
</tr>
<tr>
<td>PMDD</td>
<td>Permanent-Magnet Direct Drive</td>
</tr>
<tr>
<td>PPD-28</td>
<td>Presidential Policy Directive 28</td>
</tr>
<tr>
<td>PPP</td>
<td>private-public partnership</td>
</tr>
<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
</tr>
<tr>
<td>PWM</td>
<td>pulse width modulation</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research and development</td>
</tr>
<tr>
<td>RMB</td>
<td>renminbi (official currency of China)</td>
</tr>
<tr>
<td>S&amp;ED</td>
<td>U.S.-China Strategic &amp; Economic Dialogue</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Form</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------</td>
</tr>
<tr>
<td>S&amp;T</td>
<td>science and technology</td>
</tr>
<tr>
<td>SaaS</td>
<td>computer software as a service</td>
</tr>
<tr>
<td>SAFE</td>
<td>State Administration of Foreign Exchange</td>
</tr>
<tr>
<td>SAIC</td>
<td>State Administration of Industry Commerce</td>
</tr>
<tr>
<td>SASAC</td>
<td>State-owned Assets Supervision and Administration Commission</td>
</tr>
<tr>
<td>SASTIND</td>
<td>State Administration for Science, Technology, and Industry for National Defense</td>
</tr>
<tr>
<td>SAT</td>
<td>State Administration of Taxes</td>
</tr>
<tr>
<td>SEI</td>
<td>strategic and emerging industries</td>
</tr>
<tr>
<td>SIA</td>
<td>Semiconductor Industry Association</td>
</tr>
<tr>
<td>SIGINT</td>
<td>Signals intelligence</td>
</tr>
<tr>
<td>SIPO</td>
<td>State Intellectual Property Office</td>
</tr>
<tr>
<td>SMIC</td>
<td>Semiconductor Manufacturing International Corporation</td>
</tr>
<tr>
<td>SNPTC</td>
<td>State Nuclear Power Technology Corporation</td>
</tr>
<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
</tr>
<tr>
<td>SSLP</td>
<td>seamless standard line pipes</td>
</tr>
<tr>
<td>TIA</td>
<td>Telecommunications Industry Association</td>
</tr>
<tr>
<td>TIER</td>
<td>Regulations of the PRC on Administration of Import and Export Technologies</td>
</tr>
<tr>
<td>TRB</td>
<td>technical reconnaissance bureau</td>
</tr>
<tr>
<td>TRIPS</td>
<td>Trade-Related Aspects of Intellectual Property Rights</td>
</tr>
<tr>
<td>UAV</td>
<td>unmanned aerial vehicle</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>USC</td>
<td>United States Constitution</td>
</tr>
<tr>
<td>USCBC</td>
<td>U.S.-China Business Council</td>
</tr>
<tr>
<td>USCIB</td>
<td>U.S. Council for International Business</td>
</tr>
<tr>
<td>USD</td>
<td>U.S. dollars</td>
</tr>
<tr>
<td>USITC</td>
<td>U.S. International Trade Commission</td>
</tr>
<tr>
<td>USPTO</td>
<td>U.S. Patent and Trademark Office</td>
</tr>
<tr>
<td>USW</td>
<td>United Steel Workers</td>
</tr>
<tr>
<td>UT</td>
<td>United Turbine</td>
</tr>
<tr>
<td>VAT</td>
<td>value-added tax</td>
</tr>
<tr>
<td>VC</td>
<td>venture capital</td>
</tr>
<tr>
<td>WFOE</td>
<td>wholly foreign-owned entity</td>
</tr>
<tr>
<td>WIPO</td>
<td>UN’s World Intellectual Property Organization</td>
</tr>
<tr>
<td>WNA</td>
<td>World Nuclear Association</td>
</tr>
<tr>
<td>ZGC</td>
<td>Zhongguancun</td>
</tr>
</tbody>
</table>
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3. Leveraging “International Innovation Resources” Through Engagement with Silicon Valley

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1. The Chinese Government’s Extensive Cyber Activities
2. The United States Department of Justice Indicted Chinese Government Hackers in May 2014
3. China’s Institutional Framework Supports Cyber Intrusions into U.S. Commercial Networks
4. China’s Recent Cyber Intrusion Activities Against U.S. Commercial Networks


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1. Measures Purportedly Related to National Security or Cybersecurity
2. Inadequate Intellectual Property Protection
3. China’s Anti-Monopoly Law
4. China’s Standardization Law
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B. Conclusion
I. Overview

A. Core Elements of Section 301

This investigation has been brought under Section 301 of the Trade Act of 1974, as amended (the Trade Act).\(^1\) Section 301 is a key enforcement tool that may be used to address a wide variety of unfair acts, policies, and practices of U.S. trading partners. Section 301 sets out three categories of acts, policies, or practices of a foreign country that are potentially actionable: (i) trade agreement violations; (ii) acts, policies or practices that are unjustifiable (defined as those that are inconsistent with U.S. international legal rights) and that burden or restrict U.S. Commerce; and (iii) acts, policies or practices that are unreasonable or discriminatory and that burden or restrict U.S. Commerce.\(^2\) The third category of conduct is most relevant to this investigation.

Section 301 defines “discriminatory” to “include, when appropriate, any act, policy, and practice which denies national or most-favored nation treatment to United States goods, service, or investment.”\(^3\) An “unreasonable” act, policy, or practice is one that “while not necessarily in violation of, or inconsistent with, the international legal rights of the United States is otherwise unfair and inequitable.”\(^4\) The statute further provides that in determining if a foreign country’s practices are unreasonable, reciprocal opportunities to those denied U.S. firms “shall be taken into account, to the extent appropriate.”\(^5\)

If the USTR determines that the Section 301 investigation “involves a trade agreement,” and if that trade agreement includes formal dispute settlement procedures, USTR may pursue the investigation through consultations and dispute settlement under the trade agreement. Otherwise, USTR will conduct the investigation without recourse to formal dispute settlement.

Moreover, if the USTR determines that the act, policy, or practice falls within any of the three categories of actionable conduct under Section 301, the USTR must also determine what action, if any, to take.\(^6\) For example, if the USTR determines that an act, policy or practice is unreasonable or discriminatory and that it burdens or restricts U.S. commerce,

The Trade Representative shall take all appropriate and feasible action authorized under [Section 301(c)], subject to the specific direction, if any, of the President regarding any such action, and all other appropriate and feasible action within the power of the President that the President may

---

1 Unless otherwise specified, “Section 301” refers generally to Chapter 1 of Title III of the Trade Act of 1974 (codified as amended in 19 U.S.C. §§ 2411-2417). Furthermore, for ease of reference, full citations are used throughout this report.
6 For example, in 2014, USTR determined that action against Ukraine was not appropriate due to the political situation. See Notice of Determination in Section 301 Investigation of Ukraine, 79 Fed. Reg. 14,326-27 (Mar. 13, 2014).
I. Overview

direct the Trade Representative to take under this subsection, to obtain the elimination of that act, policy, or practice.\(^7\)

Actions specifically authorized under Section 301(c) include: (i) suspending, withdrawing or preventing the application of benefits of trade agreement concessions; (ii) imposing duties, fees, or other import restrictions on the goods or services of the foreign country for such time as deemed appropriate; (iii) withdrawing or suspending preferential duty treatment under a preference program; (iv) entering into binding agreements that commit the foreign country to eliminate or phase out the offending conduct or to provide compensatory trade benefits; or (v) restricting or denying the issuance of service sector authorizations, which are federal permits or other authorizations needed to supply services in some sectors in the United States.\(^8\) In addition to these specifically enumerated actions, the USTR may take any actions that are “within the President’s power with respect to trade in goods or services, or with respect to any other area of pertinent relations with the foreign country.”\(^9\)

B. Background to the Investigation

On August 14, 2017, the President issued a Memorandum to the Trade Representative stating inter alia that:

China has implemented laws, policies, and practices and has taken actions related to intellectual property, innovation, and technology that may encourage or require the transfer of American technology and intellectual property to enterprises in China or that may otherwise negatively affect American economic interests. These laws, policies, practices, and actions may inhibit United States exports, deprive United States citizens of fair remuneration for their innovations, divert American jobs to workers in China, contribute to our trade deficit with China, and otherwise undermine American manufacturing, services, and innovation.\(^10\)

The President instructed USTR to determine under Section 301 whether to investigate China’s law, policies, practices, or actions that may be unreasonable or discriminatory and that may be harming American intellectual property rights, innovation, or technology development.\(^11\)

Concerns about a wide range of unfair practices of the Chinese government (and the Chinese Communist Party (CCP)) related to technology transfer, intellectual property, and innovation are longstanding. USTR has pursued these issues multilaterally, for example, through the WTO dispute settlement process and in WTO committees, and bilaterally through the annual Special 301 review. These issues also have been raised in bilateral dialogues with China, including the U.S.-China Joint Commission on Commerce and Trade (JCCT) and U.S.-China Strategic & Economic Dialogue (S&ED), to attempt to address some of the U.S. concerns.

\(^7\) 19 U.S.C. § 2411(b).
\(^8\) In cases in which USTR determines that import restrictions are the appropriate action, preference must be given to the imposition of duties over other forms of action. 19 U.S.C. §§ 2411(c).
\(^11\) Id.
I.  Overview

1.  Initiation of the Investigation

USTR initiated this investigation on August 18, 2017 after consultation with the interagency Section 301 committee and private sector advisory committees. On that same date, USTR also requested consultations with the Government of China. China’s Minister of Commerce responded to this letter on August 28, opposing the initiation of a Section 301 investigation.

The Federal Register Notice described the focus of the investigation as follows:

First, the Chinese government reportedly uses a variety of tools, including opaque and discretionary administrative approval processes, joint venture requirements, foreign equity limitations, procurements, and other mechanisms to regulate or intervene in U.S. companies’ operations in China, in order to require or pressure the transfer of technologies and intellectual property to Chinese companies. Moreover, many U.S. companies report facing vague and unwritten rules, as well as local rules that diverge from national ones, which are applied in a selective and non-transparent manner by Chinese government officials to pressure technology transfer.

Second, the Chinese government’s acts, policies and practices reportedly deprive U.S. companies of the ability to set market-based terms in licensing and other technology-related negotiations with Chinese companies and undermine U.S. companies’ control over their technology in China. For example, the Regulations on Technology Import and Export Administration mandate particular terms for indemnities and ownership of technology improvements for imported technology, and other measures also impose non-market terms in licensing and technology contracts.

Third, the Chinese government reportedly directs and/or unfairly facilitates the systematic investment in, and/or acquisition of, U.S. companies and assets by Chinese companies to obtain cutting-edge technologies and intellectual property and generate large-scale technology transfer in industries deemed important by Chinese government industrial plans.

Fourth, the investigation will consider whether the Chinese government is conducting or supporting unauthorized intrusions into U.S. commercial computer networks or cyber-enabled theft of intellectual property, trade secrets, or confidential business information, and whether this conduct harms U.S. companies or provides competitive advantages to Chinese companies or commercial sectors.

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13 See Appendix A.
I. **Overview**

In addition to these four types of conduct, interested parties could submit for consideration information on other acts, policies and practices of China relating to technology transfer, intellectual property, and innovation for potential inclusion in this investigation or to be addressed through other applicable mechanisms.\(^1\)

The terms “technology” and “technology transfer” are key concepts in this investigation. They are defined in Box I.1.

<table>
<thead>
<tr>
<th>Box I.1: Technology and Technology Transfer Defined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology is defined broadly in this investigation to include knowledge and information needed to produce and deliver goods and services, as well as other methods and processes used to solve practical, technical or scientific problems. In addition to information protected by patents, copyrights, trademarks, trade secrets, and other types of intellectual property (IP) protections, the term also includes “know-how”, such as production processes, management techniques, expertise, and the knowledge of personnel.</td>
</tr>
<tr>
<td>Technology and innovation are critical factors in maintaining U.S. competitiveness in the global economy. Among all major economies, the United States has the highest concentration of knowledge- and technology-intensive industries as a share of total economic activity. And in high-tech manufacturing, the United States leads the world with a global share of production of 29 percent, followed by China at 27 percent.</td>
</tr>
<tr>
<td>Technology transfers made on voluntary and mutually-agreed terms, and without government interference or distortion, are critical to the U.S. economy. In fact, U.S. companies are global leaders in the transfer of technology through legal mechanisms such as trade in high-tech goods and services; the licensing of technology to companies and persons abroad; and foreign direct investment (FDI).</td>
</tr>
</tbody>
</table>


2. **China’s Bilateral Commitments to End its Technology Transfer Regime and to Refrain from State-Sponsored Cyber Intrusions and Theft**

In the bilateral relationship, China repeatedly has committed to eliminate aspects of its technology transfer regime. On at least eight occasions since 2010, the Chinese government has committed not to use technology transfer as a condition for market access and to permit technology transfer decisions to be negotiated independently by businesses. China has further committed not to pressure the disclosure of trade secrets in regulatory or administrative

\(^1\) See Appendix A.
proceedings. The evidence adduced in this investigation establishes that China’s technology transfer regime continues, notwithstanding repeated bilateral commitments and government statements, as summarized in Table I.1, below, and discussed in the remainder of this report.
## Table I.1 China’s Bilateral Commitments Relating to Technology Transfer, 2010 - 2016

<table>
<thead>
<tr>
<th>Year</th>
<th>Mechanism</th>
<th>Commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>S&amp;ED</td>
<td>China reaffirmed that the terms and conditions of technology transfer, production processes, and other proprietary information will be determined by individual enterprises.</td>
</tr>
<tr>
<td>2011</td>
<td>JCCT</td>
<td>China confirmed that it does not and will not maintain measures that mandate the transfer of technology in the New Energy Vehicles Sector. China further clarified that “mastery of core technology” does not require technology transfer for NEVs.</td>
</tr>
<tr>
<td>2012</td>
<td>S&amp;ED</td>
<td>China reaffirmed its commitment that technology transfer is to be decided by firms independently and not to be used by the Chinese government as a pre-condition for market access.</td>
</tr>
<tr>
<td>2012</td>
<td>Xi Visit Commitment</td>
<td>China reiterated that technology transfer and technological cooperation shall be decided by businesses independently and will not be used by the Chinese government as a pre-condition for market access.</td>
</tr>
<tr>
<td>2012</td>
<td>JCCT</td>
<td>China reaffirmed that technology transfer and technology cooperation are the autonomous decisions of enterprises. China committed that it would not make technology transfer a pre-condition for market access.</td>
</tr>
<tr>
<td>2014</td>
<td>JCCT</td>
<td>China committed that enterprises are free to base technology transfer decisions on business and market considerations, and are free to independently negotiate and decide whether and under what circumstances to assign or license intellectual property rights to affiliated or unaffiliated enterprises.</td>
</tr>
<tr>
<td>2014</td>
<td>JCCT</td>
<td>China confirmed that trade secrets submitted to the government in administrative or regulatory proceedings are to be protected from improper disclosure to the public and only disclosed to government officials in connection with their official duties in accordance with law.</td>
</tr>
<tr>
<td>2015</td>
<td>Xi Visit Commitment</td>
<td>China committed not to advance generally applicable policies or practices that require the transfer of intellectual property rights or technology as a condition of doing business in the Chinese market.</td>
</tr>
<tr>
<td>2015</td>
<td>Xi Visit Commitment</td>
<td>China committed to refrain from conducting or knowingly supporting cyber-enabled theft of intellectual property cyber-enabled theft of intellectual property, including trade secrets or other confidential business information, with the intent of providing competitive advantages to companies or commercial sectors.</td>
</tr>
<tr>
<td>2016</td>
<td>Xi Visit Commitment</td>
<td>China committed not to require the transfer of intellectual property rights or technology as a condition of doing business.</td>
</tr>
</tbody>
</table>

I. Overview

3. Input from the Public

USTR provided the public and interested persons with opportunities to present their views and perspectives on the issues highlighted in the *Federal Register Notice*, including through a public hearing on October 10, 2017. Witnesses with varied interests and perspectives testified and responded to questions from the interagency Section 301 committee including representatives of U.S. companies and workers, trade and professional associations, and think tanks, as well as law firms and representatives of trade and professional associations headquartered in China. Interested persons also filed approximately 70 written submissions in the public docket for this investigation.

As U.S. companies have stated for more than a decade, they fear that they will face retaliation or the loss of business opportunities if they come forward to complain about China’s unfair trade practices. Concerns about Chinese retaliation arose in this investigation as well. Multiple submissions noted the great reluctance of U.S. companies to share information on China’s technology transfer regime, given the importance of the China market to their businesses and the fact that Chinese government officials are “not shy about retaliating against critics.”

For example, a representative of the Commission on the Theft of American Intellectual Property testified at the hearing: “American companies are intimidated and reticent over the issue, especially in China. There they risk punishment by a powerful and opaque Chinese regulatory system.” In addition, according to the U.S. China Business Council, their member companies do not presently have “reliable channel[s] to report abuses and to appeal adverse decisions…without fear of retaliation.” Similarly, a representative of SolarWorld stated that “many other companies face the same issues of cyberhacking and technology theft that [it] has faced, but are unwilling to come forward publicly due to fear of lost sales or retaliation by China.”

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17 The following individuals participated in the public hearing: Richard Ellings, Commission on the Theft of American Intellectual Property; Stephen Ezell, Information Technology and Innovation Foundation; Erin Ennis, US-China Business Council; Owen Herrnstadt, International Association of Machinists and Aerospace Workers; Juergen Stein, SolarWorld; Daniel Patrick McGahn, American Superconductor Corporation; William Mansfield, ABRO Industries; Scott Partridge, American Bar Association Intellectual Property Law Section; Scott Kennedy, Center for Strategic and International Studies; Jin Haijun, China Intellectual Property Law Society; Chen Zhou and Liu Chao, China Chamber of International Commerce; XU Chen, China General Chamber of Commerce; John Tang, DHH Washington Law Office; Wang Guiqing, China Chamber of Commerce for Import and Export of Machinery and Export Products. See Appendix B.
19 U.S. CHINA BUSINESS COUNCIL [*hereinafter “USCBC”*], *Submission, Section 301 Hearing* 4 (Sept. 28, 2017); see also SOLARWORLD, *Submission, Section 301 Hearing* 2 (Oct. 20, 2017).
20 James Lewis, CENTER FOR STRATEGIC & INT’L STUDIES [*hereinafter “CSIS”*], *Submission, Section 301 Hearing* 6 (Sept. 27, 2017); see also Lee Branstetter, *Submission, Section 301 Hearing* 4 (Sept. 28, 2017); Stephen Zirschky, *Submission, Section 301 Hearing* 2 (Sept. 28, 2017).
21 USTR, *Hearing Transcript, Section 301 Hearing* 13 (Oct. 10, 2017); see also COMM’N. ON THE THEFT OF AM. IP [*hereinafter “IP Commission”*], *Submission, Section 301 Hearing* 8 (Sept. 28, 2017).
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Because USTR self-initiated this action, no particular company or group of companies was required to step forward and file a Section 301 petition to initiate this investigation. Moreover, in making this determination, USTR and the interagency Section 301 committee took into account not just investigation submissions and testimony but also public reports, scholarly articles, and other reliable information. In addition, business confidential information has been provided and considered as part of the record in this investigation, so that companies could share sensitive information without the threat of business loss or retaliation.

C. China’s Technology Drive

Official publications of the Chinese government and the CCP set out China’s ambitious technology-related industrial policies. These policies are driven in large part by China’s goals of dominating its domestic market and becoming a global leader in a wide range of technologies, especially advanced technologies. The industrial policies reflect a top-down, state-directed approach to technology development and are founded on concepts such as “indigenous innovation” and “re-innovation” of foreign technologies, among others. The Chinese government regards technology development as integral to its economic development and seeks to attain domestic dominance and global leadership in a wide range of technologies for economic and national security reasons.\(^\text{24}\) China accordingly seeks to reduce its dependence on technologies from other countries and move up the value chain, advancing from low-cost manufacturing to become a “global innovation power in science and technology.”\(^\text{25}\) In pursuit of this overarching objective, China has issued a large number of industrial policies, including more than 100 five-year plans, science and technology development plans, and sectoral plans over the last decade.\(^\text{26}\) Some of the most prominent industrial policies include the *National Medium- and Long-Term Science and Technology Development Plan Outline (2006-2020)* (MLP),\(^\text{27}\) the *State Council Decision on Accelerating and Cultivating the Development of Strategic Emerging Industries (SEI Decision)*\(^\text{28}\), and, more recently, the *Notice on Issuing “Made in China 2025” (Made in China 2025 Notice).*\(^\text{29}\)

The MLP, issued in 2005 and covering the period 2006 to 2020, is the seminal document articulating China’s long-term technology development strategy. The MLP recognizes the country’s “relatively weak indigenous innovation capacity,” its “weak core competitiveness of enterprises,” and the fact that the country’s high-technology industries “lag” those of more developed nations.\(^\text{30}\)

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\(^{24}\) See James Lewis, *Submission, Section 301 Hearing* 1 (Sept. 2017).


\(^{26}\) IGCC REPORT at 30.


\(^{28}\) *Decision on Accelerating the Cultivation and Development of Strategic Emerging Industries (State Council, Guo Fa [2010] No. 32, issued Oct. 10, 2010).*

\(^{29}\) *Notice on Issuing “Made in China 2025” (State Council, Guo Fa [2015] No. 28, issued May 8, 2015).*

\(^{30}\) *MLP §1.*
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As its focus, the MLP identifies 11 key sectors, and 68 priority areas within these sectors, for technology development.\(^{31}\) It also designates eight fields of “frontier technology,”\(^{32}\) within which 27 “breakthrough technologies” will be pursued, and highlights four major scientific research programs.\(^{33}\) The MLP also establishes the cross-cutting goal of reducing the rate of dependence on foreign technologies in the identified sectors to below 30% by the year 2020.\(^{34}\)

The MLP strategy for securing sought-after technology development includes several key elements, which continue to have a negative impact on U.S. and other foreign companies:

- A top-down national strategy, in which implementation requires the mobilization and participation of all sectors of society\(^{35}\) and the integration of civil and military resources;\(^{36}\)

- Prioritization of certain industries and technologies for development,\(^{37}\) particularly those that can advance “sustainable development,” “core competitiveness,” “public service,” and “national security” objectives.\(^{38}\)

- Leveraging state resources and regulatory systems;\(^{39}\)

- Import substitution to be achieved through “indigenous innovation,”\(^{40}\) and re-innovation based on assimilation and absorption of foreign technologies;\(^{41}\) and

- Promoting Chinese enterprises to become dominant in the domestic market\(^{42}\) and internationally competitive enterprises\(^{43}\) in key industries.

The MLP set in motion a web of policies and practices intended to drive innovation and re-innovation. For example, Section 8(2) of the MLP calls for “enhancing the absorption, digestion,

\(^{31}\) The sectors include energy, water and mineral resources, environment, agriculture, manufacturing, transportation, information and services, population and health, urbanization, public security and national defense.

\(^{32}\) The areas include biotech, information technology, advanced materials, advanced manufacturing, advanced energy technology, marine technology, laser technology and aerospace technology.

\(^{33}\) The fields include protein science, nanotechnology, quantum physics and developmental and reproductive science.

\(^{34}\) MLP § 2(2) ¶ 3, Guiding Directives, Development Targets, and Comprehensive Arrangements.

\(^{35}\) MLP § 2(1). (“In sum, we must make enhancing indigenous innovation capacity our national strategy, and implement it in all aspects of modernization construction and in every industry, sector and region.”). §8(5) also guides “all types of financial institutions and private funds to participate in science and technology development.”

\(^{36}\) MLP § 8(7).

\(^{37}\) MLP § 3 sets out the “Key Sectors and their Priority Issues.”

\(^{38}\) MLP § 3, Preamble.

\(^{39}\) MLP § 9.

\(^{40}\) MLP § 2(1).

\(^{41}\) MLP §§ 2(1), 8(2). The term “introduce” used throughout MLP refers to introduction of technology through foreign investment. This is made more explicit in the measures defining and discussing IDAR below.

\(^{42}\) MLP § 2(2) states dependence on foreign technology should be reduced to only 30% by 2020.

\(^{43}\) See IGCC REPORT at 157. See also MLP § 2.
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and re-innovation of introduced technology." Following the issuance of the MLP, China detailed these policies in the Several Supporting Policies for Implementing the “National Medium- and Long-Term Science and Technology Development Plan Outline (2006-2020)” (MLP Supporting Policies) and the Opinions on Encouraging Technology Introduction and Innovation and Promoting the Transformation of the Growth Mode in Foreign Trade (IDAR Opinions), which articulate the concept of Introducing, Digesting, Absorbing, and Re-innovating foreign intellectual property and technology (IDAR). The IDAR approach involves four steps, each of which hinges on close collaboration between the Chinese government and Chinese industry to take full advantage of foreign technologies:

- **Introduce:** Chinese companies should target and acquire foreign technology. Methods of “introducing” foreign technology that are specifically referenced include: technology transfer agreements, inbound investment, technology imports, establishing foreign R&D centers, outbound investment, and the collection of market intelligence by state entities for the benefit of Chinese companies. Technology to be “introduced” from overseas includes “major equipment that cannot yet be supplied domestically”, as well as “advanced design and manufacturing technology”; conversely, the government discourages imports of technologies for which China is already deemed to “possess domestic R&D capabilities.”

- **Digest:** Following the acquisition of foreign technology, the Chinese government should collaborate with China’s domestic industry to collect, analyze, and disseminate the information and technology that has been acquired.

- **Absorb:** The Chinese government and China’s domestic industry should collaborate to develop products using the technology that has been acquired. The Chinese government should provide financial assistance to develop products using technology obtained through IDAR, including foreign trade development funds, government procurement, and fiscal incentives. To absorb foreign technologies, authorities have established engineering research centers, enterprise-based technology centers, state laboratories, national technology transfer centers, and high-technology service centers.

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44 MLP §§ 2(1), 8(2).
47 English translation of Chinese term yinjin.
48 English translation of Chinese term xiaohua.
49 English translation of Chinese term xishou.
50 English translation of Chinese term zai chuangxin.
51 IDAR Opinions § 7-9, 11-12. See also IGCC REPORT at 118-119.
52 MLP Supporting Policies § 28, 29.
53 MLP Supporting Policies § 29.
54 IDAR Opinions § 7; MLP Supporting Policies § 31.
55 IDAR Opinions § 15, 18; MLP Supporting Policies § 30, 32.
56 IGCC REPORT at 118.
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- **Re-innovate:** At this stage, Chinese companies should “re-innovate” and improve upon the foreign technology. The ultimate objective is to develop new, home-grown products that are competitive internationally, so as to “allow enterprises to possess more indigenous intellectual property for core products and core technologies.”

The IDAR approach embraces a strong role for the Chinese government in guiding and assisting Chinese industry in technology development and has had profound implications, in particular, for the way in which China has sought to introduce foreign technologies into China over the last decade. It has spurred Chinese government ministries and government officials to pursue an array of aggressive implementing acts, policies, and practices, including those that are the subject of this investigation.

China has continued to emphasize the IDAR approach since it was first articulated in 2006 in broad-ranging five-year plans and technology development plans issued by China’s State Council, central government ministries and provincial and municipal governments, and the CCP. The IDAR approach also has been incorporated into numerous economic development plans for specific sectors, such as integrated circuits.

In 2010, the Chinese government announced another seminal technology development strategy, which calls for the accelerated development of seven so-called “strategic emerging industries” (SEIs): (1) energy efficient and environmental technologies, (2) next generation information technology, (3) biotechnology, (4) high-end equipment manufacturing, (5) new energy, (6) new materials, and (7) new energy vehicles. The 12th Five-year National Strategic Emerging Industries Development Plan (12th Five-year SEI Plan) subsequently recommended specific fiscal and taxation policy support and set a target for SEIs to account for 8% of China’s economy by 2015 and 15% by 2020. The 12th Five-year SEI Plan also aims to foster a group of Chinese enterprises – including state-owned enterprises – into “backbone enterprises” that can become

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57 IDAR Opinions § 5.
58 E.g., 12th Five-year Development Plan for the Integrated Circuit Industry (Ministry of Industry and Information Technology, published Feb. 24, 2012) § 3(1), ¶ 3: “Maintain innovation drivers. Combine implementation of national science and technology major special projects and megaprojects, using innovation in technologies, modes, mechanisms, and systems as the impetus to make breakthroughs in a group of shared core technologies. Strengthen introduce, digest, absorb, and re-innovate, to stride down the path of open-type innovation and internationalized development.” (emphasis added).
60 Notice on Issuing the 12th Five-year National Strategic Emerging Industries Development Plan (State Council, Guo Fa [2012] No. 28, issued July 9, 2012).
market leaders domestically and compete globally. The Chinese government later reaffirmed and refined this strategy in its 13th Five-year Strategic Emerging Industries Development Plan.

Notably, support for the IDAR strategy was reiterated in the CCP’s 2013 Third Plenum Decision released in connection with the Third Plenary Session of the 18th National Congress of the CCP. IDAR’s inclusion in the Third Plenum Decision is significant because the document was widely seen as setting forth the priorities of President Xi Jinping’s new administration with respect to China’s future economic development path. By reaffirming that China should “establish and perfect a mechanism to encourage original innovation, integrated innovation, and introduce, absorb, digest, and re-innovate,” the Third Plenum Decision signaled the CCP’s continued high-level support for the IDAR approach to technology innovation.

In 2015, the State Council released the Made in China 2025 Notice, which is China’s ten-year plan for targeting ten strategic advanced technology manufacturing industries for promotion and development: (1) advanced information technology; (2) robotics and automated machine tools; (3) aircraft and aircraft components; (4) maritime vessels and marine engineering equipment; (5) advanced rail equipment; (6) new energy vehicles; (7) electrical generation and transmission equipment; (8) agricultural machinery and equipment; (9) new materials; and (10) pharmaceuticals and advanced medical devices.

While the Made in China 2025 Notice references market-oriented principles, it closely resembles China’s other state-led, technology-related plans, such as the MLP, issued a decade earlier, in that it:

- Reaffirms the Chinese government’s central role in economic planning.

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61 For example, the 12th Five-year National Economic and Social Development Plan Outline (adopted by the NPC on Mar. 14, 2011) calls for the cultivation of a group of backbone enterprises within strategic emerging industries. Ch. 10, §2 “Fostering the Development of Strategic Emerging Industries”. The 12th Five-year SEI Plan further specifies that backbone enterprises are to have “relatively strong indigenous innovation capacity and a technological leadership effects.” § 2(3), “Guiding Thoughts, Fundamental Principles, and Development Targets”. At the sectoral level, the Guidelines for the Development and Promotion of the Integrated Circuit Industry (State Council, issued June 24, 2014) laud the fact that China has established “a group of backbone enterprises with significant international competitiveness.” § 1, ¶ 1. The Guiding Opinion on Promoting International Industrial Capacity and Equipment Manufacturing Cooperation (State Council, Guo Fa [2015] No. 30, issued May 13, 2015) provides that a “main target” of the policy is to “establish a group of backbone enterprises that possess international competitiveness and the ability to open up markets.” § 2(6).

62 Notice on Issuing the 13th Five-year National Strategic Emerging Industries Development Plan (State Council, Guo Fa [2016] No. 67, issued Nov. 29, 2016).

63 CCP Central Committee Decision on Several Major Issues for Comprehensively Deepening Reform (CCP Central Committee, issued Nov. 12, 2013) [hereinafter “Third Plenum Decision”].

64 Third Plenums have historically been used to announce major economic reforms, such as the adoption of reform and opening during the Third Plenary Session of the 11th National Congress of the CCP in 1978, and the endorsement of the socialist market economy following the 14th National Congress of the CCP in 1993.

65 Third Plenum Decision § 13.


67 Made in China 2025 Notice § 3(6).

68 Made in China 2025 Notice § 2(2).
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- Calls on all facets of society to mobilize behind the plan;\(^{69}\)
- Seeks technological breakthroughs in key areas for economic and security purposes;
- Promotes further civil-military integration and the two-way transfer and conversion of military and civilian technologies;\(^{70}\)
- Leverages state resources,\(^ {71}\) policy support,\(^ {72}\) and regulatory systems,\(^ {73}\)
- Continues to promote import substitution and rely on indigenous products to meet growing demand in China;\(^ {74}\)
- Reaffirms the leading role of backbone enterprises in technology development;\(^ {75}\) and
- Promotes Chinese enterprises to become dominant in the domestic market and internationally competitive in key industries.\(^ {76}\)

The *Made in China 2025* Notice expressly calls for China to achieve 40% “self-sufficiency” by 2020, and 70% “self-sufficiency” by 2025, in core components and critical materials in a wide range of industries, including aerospace equipment and telecommunications equipment.\(^ {77}\) The “Made in China 2025” Key Area Technology Roadmap (Made in China Roadmap) sets explicit market share targets that are to be filled by Chinese producers both domestically and globally in dozens of high-tech industries.\(^ {78}\)

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\(^{69}\) *Made in China 2025* Notice § 1(3).

\(^{70}\) *Made in China 2025* Notice § 3(1).

\(^{71}\) *Made in China 2025* Notice § 4.

\(^{72}\) *Made in China 2025* Notice § 1(3).

\(^{73}\) See generally *Made in China 2025* Notice. This is particularly the case in quality standard regulations as described in §§ 2(1) and 3(4).

\(^{74}\) *Made in China 2025* Notice § 1(2) describes the growing demand for new equipment, consumption, and safety, while § 1(3) calls for China to “rely more on Chinese equipment and Chinese brands.”

\(^{75}\) *Made in China 2025* Notice § 3(1).

\(^{76}\) *Made in China 2025* Notice § 1(3).

\(^{77}\) *Made in China 2025* Notice, Box 3.

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For example, indigenous new energy vehicles are to achieve an 80% domestic market share\footnote{Made in China 2025 Key Area Technology Roadmap § 6.2.2.} with foreign sales accounting for 10% of total sales by 2025.\footnote{Made in China 2025 Key Area Technology Roadmap § 6.2.2.} Similarly, domestically produced energy equipment is to achieve 90% domestic market share, with exports accounting for 30% of production, by 2020,\footnote{Made in China 2025 Key Area Technology Roadmap § 7.1.2.} and renewable energy equipment with indigenous IP is to achieve 80% domestic market share by 2025.\footnote{Made in China 2025 Key Area Technology Roadmap § 7.1.2.} In comparison to previous plans, Made in China 2025 expands its focus to capturing global market share, not just dominance in the China market, and is part of a “broader strategy to use state resources to alter and create comparative advantage in these sectors on a global scale.”\footnote{Made in China 2025 Explanation 6: The Manufacturing Power ‘Three-Step’ Strategy, MINISTRY OF INDUSTRY AND INFORMATION TECHNOLOGY (May 19, 2015), http://www.miit.gov.cn/n1146295/n1146562/n1146655/c3780688/content.html; see also IGCC REPORT at 47-48.}

The Made in China 2025 Notice sets forth clear principles, tasks, and tools to implement this strategy, including government intervention and substantial government, financial and other support to the targeted Chinese industries.\footnote{IGCC REPORT at 121.} Domestic dominance and global competitiveness are to be achieved by upgrading the entire research, development, and production chain, with emphasis on localizing the output of components and finished products.\footnote{IGCC REPORT at 121.} Foreign technology acquisition through various means remains a prime focus under Made in China 2025 because China is still catching up in many of the areas prioritized for development, and as U.S. companies are front-runners in many of these areas.\footnote{IGCC REPORT at 121.}

China’s Ministry of Industry and Information Technology (MIIT) has explained that Made in China 2025 is part of a three-step strategy for China to become a world leader in advanced manufacturing. Under the first step, by 2025, China should “approach the level of manufacturing powers Germany and Japan during the period when they realized industrialization.” In the second step, China should “enter the front ranks of second tier manufacturing powers” by 2035. In the final step, China should “enter the first tier of global manufacturing powers” by 2045, at which point China will have “innovation-driving capabilities,” “clear competitive advantages,” and “world-leading technology systems and industrial systems.”\footnote{IGCC REPORT at 121.}

In recent years, China also issued policies specific to advanced technologies in which U.S. firms are market leaders. Information and communications technologies have been a focal point, with more and more strategies emanating from the National Informatization Development Strategy (2006-2020), such as the National Integrated Circuit Industry Development Outline, the Internet
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Plus Plan, the “Broadband China” strategy and corresponding implementation plan, and the designation of next-generation information technology as a “strategic emerging industry.”

In addition, China recently announced that it will pursue an “innovation-driven” development strategy and that it has made breakthroughs in higher-end innovation a top priority. At the 19th National Congress of the CCP, held in October 2017, President Xi Jinping’s remarks specifically referenced the goal of building China into a “powerful nation [or power] in science and technology, quality, aerospace, the Internet, and transportation” and called for “accelerating the construction of [China as] a manufacturing power” by “accelerating the development of advanced manufacturing industry” and “promoting the deep integration of the Internet, big data, and artificial intelligence with the real economy.”

Like the MLP a decade ago, newer plans such as the Made in China 2025 Notice and the various plans focused on information and communications technologies call for a wide array of Chinese government intervention and financial and other support designed to transform China into a world leader in technology. While these policies and practices are not necessarily new, their actual and potential effects on foreign companies and their technologies have become much more serious. As James Lewis of CSIS explained in his submission to USTR:

What is new is that unfair trade, security and industrial policies, tolerable in a smaller developing economy, are now combined with China’s immense, government-directed investment and regulatory policies to put foreign firms at a disadvantage…China now has the wealth, commercial sophistication and technical expertise to make its pursuit of technological leadership work. The fundamental issue for the U.S. and other western nations, and the IT sector is how to respond to a managed economy with a well-financed strategy to create a domestic industry intended to displace foreign suppliers.

As detailed in Sections II through VI of this report, a key part of China’s technology drive involves the acquisition of foreign technologies through acts, policies, and practices by the Chinese government that are unreasonable or discriminatory and burden or restrict U.S. commerce. These acts, policies, and practices work collectively as part of a multi-faceted strategy to advance China’s industrial policy objectives. They are applied across a broad range of sectors, overlap in their use of policy tools (e.g., the issuance of planning documents and guidance catalogues), and are implemented through a diverse set of state and state-backed actors, including state-owned enterprises.

- Section II describes the Chinese government’s use of foreign ownership restrictions, such as joint venture (JV) requirements and foreign equity limitations, other foreign

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88 IGCC REPORT at 44.
89 IGCC REPORT at 41 (“This innovation-driven development strategy (IDDS) was officially promulgated by the Chinese authorities in May 2016 and provides a ‘top-level design and systemic plan’ for China’s innovation over next 30 years.”).
90 IGCC REPORT at xiii-xiv.
92 James Lewis, CSIS, Submission, Section 301 Hearing 1 (Sept. 27, 2017).
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investment restrictions, and the administrative licensing and approvals process to require or pressure the transfer of technology from U.S. companies to Chinese entities.

- Section III describes how U.S. companies seeking to license technologies to Chinese entities must do so on non-market-based terms that favor Chinese recipients.

- Section IV describes how the Chinese government directs and unfairly facilitates the systematic investment in, and acquisition of, U.S. companies and assets by Chinese entities, to obtain cutting-edge technologies and intellectual property and generate large-scale technology transfer in industries deemed important by state industrial plans.

- Section V describes how the Chinese government has conducted or supported cyber intrusions into U.S. commercial networks targeting confidential business information held by U.S. firms. Through these cyber intrusions, China’s government has gained unauthorized access to a wide range of confidential business information, including trade secrets, technical data, negotiating positions, and sensitive and proprietary internal communications.

- Section VI describes other acts, policies, and practices of by the Chinese government to acquire foreign technologies, including measures purportedly related to national security or cybersecurity, inadequate intellectual property protection, the Antimonopoly Law of the People’s Republic of China, the Standardization Law of the People’s Republic of China, and talent acquisition.
II. China’s Unfair Technology Transfer Regime for U.S. Companies in China

A. Introduction

The previous section of this report detailed China’s technology drive and how it seeks to support prioritized industries and foster “national champions” by pursuing technology advancement through the acquisition and “re-innovation” of foreign technology. One method China uses to achieve this goal is through restrictions on foreign investment, which it uses to selectively grant market access to foreign investors in exchange for commitments to transfer technology. This section will detail how China uses inbound foreign ownership restrictions, such as joint venture (JV) requirements and foreign equity limitations, and the administrative licensing and approvals process to require or pressure the transfer of technology.

1. Key Elements of China’s Technology Transfer Regime

The evidence collected in this investigation from hearing witnesses, written submissions, public reports, journal articles, and other reliable sources indicates there are two key aspects of China’s technology transfer regime for inbound foreign investment.

First, the Chinese government uses foreign ownership restrictions, such as formal and informal JV requirements, and other foreign investment restrictions to require or pressure technology transfer from U.S. companies to Chinese entities. These requirements prohibit foreign investors from operating in certain industries unless they partner with a Chinese company, and in some cases, unless the Chinese partner is the controlling shareholder. Second, the Chinese government uses its administrative licensing and approvals processes to force technology transfer in exchange for the numerous administrative approvals needed to establish and operate a business in China.

These two aspects of China’s technology transfer regime are furthered by the non-transparent and discretionary nature of China’s foreign investment approvals system. Prior to 2001, China often explicitly mandated technology transfer, requiring the transfer of technology as a quid pro quo for market access. In 2001, China joined the WTO and committed not to condition the approval of investment or importation on technology transfer. Since then, according to numerous sources, China’s technology transfer policies and practices have become more implicit, often carried out through oral instructions and “behind closed doors.”

93 See Section I.C.
96 See, e.g., THOMAS J. HOLMES ET AL., FED. RES. BANK OF MINNEAPOLIS, RES. DEP’T STAFF REP. 486, QUIR PRO QUO: TECHNOLOGY CAPITAL TRANSFERS FOR MARKET ACCESS IN CHINA 3 (2015); TAI MING CHEUNG ET AL., U.S.-
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As the Information Technology and Innovation Foundation (ITIF) stated in its written submission in this investigation:

Chinese officials are careful not to put such requirements in writing, often resorting to oral communications and informal ‘administrative guidance’ to pressure foreign firms to transfer technology.97

According to another expert, Chinese measures and practices “no longer spell out the most controversial requirements in black and white. Verbal instructions and requests to ‘volunteer’ one’s technology are today’s rules of the road.”98 Similarly, a 2014 study of China’s foreign investment policies conducted for the European Union found that China has relied more heavily on opaque administrative processes to promote its technology transfer goals as international trade rules have limited its ability to formally codify foreign investment restraints.99

Another particular challenge is the complex relationship between China’s private sector and the government, which provides both direct and indirect mechanisms by which the government may pressure foreign companies. In some cases, the Chinese government may directly pressure the foreign company to transfer technology, but in other cases the demand may come from a Chinese partner.100 As discussed in more detail below, when confronted with this latter scenario, foreign companies often reasonably understand that the demand originated from the government,101 as “business decisions [in China] are very much influenced by the public policy objectives pursued by the State and the CCP.”102 Moreover, because the Chinese partner serves as the applicant in the approval process on behalf of the JV, the Chinese partner is able, in many cases, to control the communication channels between the foreign investor and the Chinese government authorities.103 Section IV of this report further details how the Chinese government and Chinese Communist Party (CCP) utilize a wide array of actors, regulations, and informal guidance to achieve China’s industrial policy objectives.104

97 ITIF, Submission, Section 301 Hearing 5-6 (Oct. 25, 2017).
103 U.S. CHAMBER OF COMMERCE, CHINA’S APPROVAL PROCESS FOR INBOUND FOREIGN INVESTMENT: IMPACT ON MARKET ACCESS, NATIONAL TREATMENT AND TRANSPARENCY 38-9 (Nov. 2012).
104 See e.g., Mark Wu, The ‘China, Inc.’ Challenge to Global Trade Governance, 57 HARV. INT’L L. J. 284 (May 2016) (“China’s economic structure involves a complex web of overlapping networks and relationships—some formal and others informal—between the state, Party, SOEs, private enterprises, financial institutions, investment
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The fact that China systematically implements its technology transfer regime in informal and indirect ways makes it “just as effective [as written requirements], but almost impossible to prosecute.”\(^{105}\) This difficulty is further exacerbated by the reality that foreign companies have no effective recourse in China and have been hesitant to report these informal pressures for fear of Chinese government retaliation and the potential loss of business opportunities.\(^{106}\) Nevertheless, as shown below, confidential industry surveys, where companies may report their experiences anonymously, make clear that they are receiving such pressure. The lack of transparency in the regulatory environment, the complex relationship between the State and the private sector, and concerns about retaliation have enabled China’s technology transfer regime to persist for more than a decade.\(^{107}\)

In the course of this investigation, certain Chinese trade associations and law firms representing Chinese interests defended China’s technology transfer regime, arguing that technology transfer decisions are products of “voluntary agreement” without “government intervention.”\(^{108}\) They also asserted that JV and technology transfer arrangements are distinct from broader national industrial policies, and that domestic and foreign companies can choose when and whether to establish business partnerships.\(^{109}\) Further, they stated that no Chinese laws or regulations explicitly force foreign investors to transfer technology, and that the central government has instructed local governments not to require technology transfer.\(^{110}\)

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\(^{106}\) See U.S. CHAMBER OF COMMERCE, CHINA’S APPROVAL PROCESS FOR INBOUND FOREIGN INVESTMENT: IMPACT ON MARKET ACCESS, NATIONAL TREATMENT AND TRANSPARENCY 2, 40 (Nov. 2012). ITIF’s submission in this investigation also illustrates how the threat of Chinese government retaliation leads U.S. companies to avoid seeking redress. For example, the ITIF submission provides that, “[a] top executive at a large U.S. plant biotechnology firm told ITIF recently of its experience in China. China was dumping the chemicals for a particular herbicide the U.S. company sold on global markets. The company confronted the Chinese agricultural minister with fact and said that it was planning to bring a complaint before the WTO. The Chinese minister simply responded that if the case were brought, the company would lose access to the Chinese market. Needless to say, the U.S. firm did not bring the case, even as it continued to lose global market share and jobs in the U.S.” ITIF, Submission, Section 301 Hearing 6 (Oct. 25, 2017).

\(^{107}\) See, e.g., U.S. CHAMBER OF COMMERCE, CHINA’S APPROVAL PROCESS FOR INBOUND FOREIGN INVESTMENT: IMPACT ON MARKET ACCESS, NATIONAL TREATMENT AND TRANSPARENCY 38-9 (Nov. 2012); EUROPEAN CHAMBER OF COMMERCE, CHINA MANUFACTURING 2025 15-16 (2017) (“For example, a longstanding feature of China’s industrial policy is that foreign companies are often pushed to transfer technology as the price of market entry...Forced technology transfer is nothing new to FIEs. However, it is now an increasing requirement for more advanced technologies to be shared.”).

\(^{108}\) See generally, CHINA CHAMBER OF COMMERCE FOR IMPORT & EXPORT OF MACHINERY & ELECTRONIC PRODUCTS [hereinafter “CCCME”], Submission, Section 301 Hearing 6 (Oct. 20, 2017); CHINA CHAMBER OF INT’L COMMERCE [hereinafter “CICOIC”], Submission, Section 301 Hearing 12 (Sept. 28, 2017).

\(^{109}\) CCCME Submission, Section 301 Hearing 8-9 (Sept. 27, 2017).

\(^{110}\) CICOIC, Submission, Section 301 Hearing 124 (Sept. 28, 2017).
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USTR has carefully considered these arguments and finds them unsupported by the evidence and unconvincing. As set forth in detail below, the weight of the evidence shows that China uses foreign ownership restrictions, including joint venture requirements and equity limitations, and other investment restrictions to require or pressure technology transfer from U.S. companies to Chinese entities. The evidence further establishes that China uses discretionary and non-transparent administrative reviews and licensing processes to pressure technology transfer or force the unnecessary disclosure of sensitive technical information.

2. A Persistent Problem for U.S. Business

Due to the fact that much of China’s technology transfer regime occurs “behind closed doors,” confidential surveys provide an important source of information on how the regime works in practice. These surveys make clear that China’s technology transfer regime is a persistent problem for U.S companies in China, particularly in high-tech sectors targeted by the Chinese government.

According to the US-China Business Council’s (USCBC) most recent member survey, 19 percent of responding companies stated that in the last year they had been directly asked to transfer technology to China. Of these, 33 percent said that the request came from a central government entity and 25 percent that it came from the local government.

Annual surveys conducted by the American Chamber of Commerce in China (AmCham China) reflect a similar problem. For example, in a 2013 survey of 325 U.S. companies in various sectors, more than one-third of respondents (35 percent) reported that they were concerned about “de facto technology transfer requirements as a condition for market access.” In a 2017 survey, 36 percent of respondents cited “reducing the need for us to engage in technology transfer” as one factor that would cause them to increase their investment levels in China.

Other evidence indicates that this problem may be even more widespread than these surveys suggest. For example, one participant testified in the hearing for this investigation that while he was aware of these survey results, his own research indicated through “many, many private interviews with companies…we did not find a single instance in which companies had not felt pressure and in many cases caved into the pressure to share technology.”

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112 USCBC, 2017 MEMBER SURVEY 9 (2017) (67 percent said the request was made directly by a Chinese company during the negotiations. The survey states, “[t]he request most frequently comes from a Chinese partner, rather than a government entity. While some of these requests may be a normal part of commercial negotiations, in many cases the hand of the Chinese government is behind these requests.”).
113 THOMAS J. HOLMES ET AL. FED. RES. BANK OF MINNEAPOLIS, RES. DEP’T STAFF REP. 486, QUID PRO QUO: TECHNOLOGY CAPITAL TRANSFERS FOR MARKET ACCESS IN CHINA 8 (2015) (citing AM. CHAMBER OF COMMERCE IN CHINA, CHINA BUSINESS CLIMATE SURVEY REPORT (2013)).
114 AMCHAM CHINA, 2018 CHINA BUSINESS CLIMATE SURVEY REPORT 44 (2017). Of these, 22 percent stated that this reduction would be somewhat significant to their investment decision, 9 percent as very significant and 5 percent as extremely significant.
Moreover, in sectors that are the focus of the Chinese government’s industrial policy initiatives, the pressure on U.S. companies to form JVs and transfer technology is particularly intense. For example, according to AmCham China’s 2013 survey, 42 percent of respondents in advanced technology sectors (including aerospace, automotive, chemical, and information technology) were concerned about “de facto technology transfer requirements as a condition for market access.” Only 3 percent of surveyed companies reported that these technology transfer requirements were decreasing, while 37 percent reported they were increasing and 26 percent that they were staying the same.

A 2017 survey of the U.S. integrated circuit design and manufacturing industry conducted by the Department of Commerce’s Bureau of Industry and Security yielded similar results: 25 U.S. integrated circuit companies responded that they will have to form JVs with Chinese entities and transfer intellectual property to obtain or maintain access to the China market. In 2017, these 25 integrated circuit companies accounted for more than $25 billion in total sales and over a quarter (26 percent) of all integrated circuits made and sold in the United States.

U.S. companies are not alone in their concerns about China’s technology transfer regime. According to a 2011 public consultation process conducted by the EU, the top barriers to investment in China included technology transfer requirements; JV requirements; foreign ownership limitations; prohibitions or limitations on the scope of business investments; licensing requirements/procedures; and regulatory approval procedures.

B. Foreign Ownership Restrictions as Used in China’s Technology Transfer Regime

Foreign ownership restrictions such as JV requirements and foreign equity limitations are a cornerstone of China’s technology transfer regime. China’s Catalogue of Industries for Guiding Foreign Investment (Foreign Investment Catalogue), and other rules and regulations, require U.S. companies seeking to invest in certain industry sectors to enter into cooperative

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117 Id. (“N/A or don’t know” responses omitted).
120 EUROPEAN COMM’N, IMPACT ASSESSMENT REPORT ON THE EU-CHINA INVESTMENT RELATIONS, SWD (2013) 185final 12 90, 95 (May 23, 2013).
arrangements with Chinese partners. According to submissions and testimony in this investigation, China’s imposition of these requirements precludes U.S. companies from entering the market on their own terms and lays the foundation for the Chinese government to require or pressure technology transfer. For example, the U.S. Chamber of Commerce states in its written submission that:

As companies negotiate the terms of the joint venture, the foreign side may be asked—or required—to transfer its technology in order to finalize the partnership. Especially in instances where the Chinese partner is a state-owned or state-directed company, foreign companies have limited leverage in the negotiation if they wish to access the market. Although this type of technology transfer may not be explicitly mandated in a Chinese law or regulation, it is often an unwritten rule for market access.

The USCBC similarly states that JV and other investment restrictions necessarily create an “unbalanced negotiation” with respect to technology transfer:

Chinese companies are in an inherently stronger position since their participation is required to form a joint venture or to provide the remaining equity in restricted sectors. As a consequence, a request for technology transfer made by a Chinese party in a business negotiation can reasonably be interpreted by foreign parties as a requirement for the deal to be concluded.

The National Association of Manufacturers (NAM) stressed the negative effects of China’s technology transfer regime on U.S. companies’ global competitiveness:

This tilting of the playing field leaves manufacturers with untenable choices: they must either transfer their technology to the new China-based joint venture, or they must cede the world’s fastest-growing market to foreign competitors, thus harming both their short-term growth and their long-term competitiveness.

1. The Foreign Investment Catalogue and Technology Transfer

China maintains a detailed system for administering inbound foreign investment. The Foreign Investment Catalogue is a starting point for analyzing the restrictions on foreign investment in a particular industry, and is an important element of China’s technology transfer regime. First

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124 USCBC, Submission, Section 301 Hearing 6-7 (Sept. 28, 2017).
125 NAT’L ASS’N OF MANUFACTURERS [hereinafter “NAM”], Submission, Section 301 Hearing 3 (Sept. 28, 2017). See also Lee Branstetter, Submission, Section 301 Hearing 2, 3 (Sept. 28, 2017) (U.S. companies are forced to choose between protecting their valuable technologies or losing access to a critical market. If they choose to forego the Chinese market to protect their valuable intellectual property, their foreign competitors exploit the market opportunity, thereby inhibiting U.S. companies’ global competitiveness in the long-run).
126 In addition to the Foreign Investment Catalogue, there are thousands of other regulations, rules, and regulatory documents related to foreign investment that are issued by central government authorities, as well as a countless local government regulations and restrictions that must be consulted to fully understand the restrictions foreign investors face in any particular sector. See Covington & Burling LLP, Measures and Practices Restraining Foreign
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issued in 1995, and most recently revised in 2017, the Foreign Investment Catalogue has historically divided industries into three basic categories: (1) “encouraged,” (2) “restricted,” and (3) “prohibited.”127 Industries not listed in one of these categories generally are considered to be “permitted.”

Different categories of investment generally lead to different degrees of approval scrutiny or application requirements. For example, foreign investments in “restricted” industries are subject to stricter government review and a case-by-case administrative approval process.128 “Encouraged” industries benefit from special preferences and from a file-for-the-record system of approvals, but can still be subject to investment restrictions.129 Moreover, even for “encouraged” sectors, stakeholders have expressed concerns, based on past experiences, that once China’s economy has achieved self-sufficiency in a particular industry and closed the technology gap, it will impose additional requirements or restrictions in these industries.130

Since its inception, the Foreign Investment Catalogue has required that investments in certain sectors take the form of a JV, that the proportion of foreign equity investment in the JV be capped at a particular level, that the Chinese party hold a controlling interest, and imposed other restrictions.131 These arrangements may take different forms including: (i) a requirement that the U.S. company enter into an equity joint venture (EJV) or contractual joint venture (CJV) with a Chinese party; (ii) a requirement that Chinese parties must be controlling shareholders or hold

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129 Projects in the “encouraged” category may be eligible for certain preferential policies, such as customs duty preferences on the importation of certain capital goods. See e.g., General Administration of Customs Announcement On Implementing Issues Regarding Foreign Investment Industry Guiding Catalogue (amended 2017) §1 (GAC, 2017 Announcement No. 30, issued July 17, 2017). Encouraged industries subject to foreign equity restrictions are listed twice, once under the encouraged category and then again under the restricted category. Foreign Investment Catalogue.
131 U.S. CHAMBER, MADE IN CHINA 2025: GLOBAL AMBITIONS BUILT ON LOCAL PROTECTIONS 27 (2017); EUROPEAN CHAMBER OF COMMERCE, CHINA MANUFACTURING 2025 15 (2017). See also TAI MING CHEUNG ET AL., U.S.-CHINA ECON. & SEC. REV. COMM’N, PLANNING FOR INNOVATION: UNDERSTANDING CHINA’S PLANS FOR TECHNOLOGICAL, ENERGY, INDUSTRIAL AND DEFENSE DEVELOPMENT 166 (2016) (“In cases where China has no bargaining power but wants the technology, it will allow 100 percent foreign ownership since that is the only choice. An example of an ‘encouraged’ investment with no JV or equity requirements is ‘IC design, manufacturing of 28 nm and below large-scale digital IC, manufacturing of 0.11-micron and below analog and mixed signal IC, manufacturing of MEMS and compound semiconductor IC, and BGA, PGA, CSP, MCM, and other advanced packaging and testing.’ This category does not specify any joint venture or Chinese controlled entity requirement.”).
the majority of shares in the venture; and (iii) other types of restrictions on foreign ownership or control.\textsuperscript{132}

Although reforms to China’s foreign investment regime have enabled other forms of investments, including wholly-owned foreign enterprises (WFOEs) in certain sectors, ownership restrictions continue to operate in many key sectors important to foreign investors, including in the services, agriculture, extractive industries, and manufacturing sectors.

Currently, 35 sectors remain in the “restricted” category of the \textit{Foreign Investment Catalogue.}\textsuperscript{133} The category includes, \textit{inter alia}, the following sectors, which are subject to equity limits and/or local partner requirements (see Table II.1).

\begin{table}[h]
\centering
\begin{tabular}{|l|l|}
\hline
\textbf{Sector} & \textbf{Summary of Requirements} \\
\hline
Selection and cultivation of new varieties of crops and production of seeds & Chinese party must be the controlling shareholder. \\
\hline
Exploration and development of oil and natural gas & Limited to CJV or EJV \\
\hline
Manufacturing whole automobiles & Chinese party’s investment cannot be lower than 50 percent, and the same foreign investor may establish no more than two JVs in China for the same kind of automobiles, subject to certain exceptions. \\
\hline
Manufacturing commercial aircraft & Chinese party must be the controlling shareholder. \\
\hline
Construction and operation of nuclear power plants & Chinese party must be the controlling shareholder. \\
\hline
Value-added Telecommunications Services & Foreign investment cannot exceed 50 percent, excluding e-commerce, and is limited to WTO commitments. Note that China classifies a broad range of internet and technology-related services under this sector. \\
\hline
Basic telecommunications services & Chinese party must be the controlling shareholder and foreign investment is limited to WTO commitments. \\
\hline
Banks & Foreign financial institution investment cannot exceed 20 percent or 25 percent depending on how the investment is structured. \\
\hline
Medical institutions & Limited to CJV or EJV. \\
\hline
Surveying and mapping companies & Chinese party must be the controlling shareholder. \\
\hline
\end{tabular}
\caption{Examples of Equity Restrictions and Local Partner Requirements in China’s 2017 \textit{Foreign Investment Catalogue}}
\end{table}

\textit{Source: Foreign Investment Catalogue (2017 Amendment).}

By promoting foreign investment in certain industries while limiting or altogether prohibiting investment in others, the Chinese government uses its foreign investment regime to channel

\textsuperscript{132} \textit{Foreign Investment Catalogue.}
\textsuperscript{133} Sectors in the “restricted” category are described in Appendix D to this Report.
foreign investment into industries of its choosing to support policy objectives.\textsuperscript{134} For example, the U.S. Chamber of Commerce in a March 2017 report on the Made in China 2025 initiative, notes that foreign investment restrictions impact companies in the plan’s targeted industries:

These restrictions either block opportunities for foreign companies to operate in the market, or, in some cases, create a de facto technology transfer requirement to the Chinese partner as a precondition for market access.\textsuperscript{135}

These technology transfer pressures occur not only in the high-tech sectors targeted by Made in China 2025 but also in more traditional sectors in which China has sought to obtain advanced technologies through the imposition of JV requirements. The shale gas industry provides one example of how the Foreign Investment Catalogue is used to channel investment to support industrial policy objectives. In this industry, China seeks to acquire foreign technologies in order to unlock the potential of its shale reserves located in geologically complex areas, and has explicitly stated in its industrial policies that “cooperation” with foreign companies should be used as one way to introduce this technology to China. For example, China’s Shale Gas Development Plan (2011-2015) encourages international cooperation to “absorb and emulate mature advanced technologies from abroad and create core technologies for exploration and development that possess ‘Chinese characteristics.’”\textsuperscript{136} In addition, China’s Shale Gas Industrial Policy reiterates that China will encourage domestic enterprises to engage with foreign enterprises “that possess advanced shale gas technology” in technical cooperation in order to “introduce”\textsuperscript{137} shale gas technology and operational experience.\textsuperscript{138} Accordingly, oil and natural gas exploration and development continue to be subject to a JV requirement in the Foreign Investment Catalogue.\textsuperscript{139} As discussed in more detail in Section V.B of this report, China has also used cyber intrusions to obtain technology and sensitive commercial information from U.S. companies operating in the oil and gas sectors, underscoring how the Chinese government uses a range of tools at its disposal to achieve its industrial policy objectives and to effect the transfer of technology from U.S. companies.

Foreign companies typically prefer to invest in China through a WFOE, rather than a JV, if the option is available. This preference often stems from concerns about the loss of control over their valuable technologies.\textsuperscript{140} In a survey of 1,000 companies conducted on behalf of the EU, only 12 percent of respondents reported they would have chosen their current JV structure in the

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\textsuperscript{134} USTR, 2016 USTR REPORT TO CONGRESS ON CHINA’S WTO COMPLIANCE 103-4 (2017); see also U.S. CHAMBER, MADE IN CHINA 2025: GLOBAL AMBITIONS BUILT ON LOCAL PROTECTION 26 (2017); EUROPEAN CHAMBER OF COMMERCE, CHINA MANUFACTURING 2025 15 (2017).
\textsuperscript{135} U.S. CHAMBER, MADE IN CHINA 2025: GLOBAL AMBITIONS BUILT ON LOCAL PROTECTION 26 (2017).
\textsuperscript{137} See Section I.C for an explanation of China’s IDAR strategy and the concept of “introducing” technology from abroad.
\textsuperscript{138} Shale Gas Industry Policy, art. 9 (NEA, 2013 Order No. 5, issued Oct. 22, 2013). The policy at art. 10 also encourages enterprises to participate in shale gas exploration and development through joint ventures.
\textsuperscript{139} Foreign Investment Catalogue.
\textsuperscript{140} INTERCHINA CONSULTING, ESTABLISHMENT OF A JOINT VENTURE IN CHINA 5 (June, 2011) (“Many foreign investors have discovered through hard found experience that one of the greatest exposures to IPR infringement is by having a Chinese partner.”); EUROPEAN COMM’N, IMPACT ASSESSMENT REPORT ON THE EU-CHINA INVESTMENT RELATIONS, SWD (2013) 185final 12 95-6 (May 23, 2013).
\end{flushleft}
II.  China’s Unfair Technology Transfer Regime for U.S. Companies in China

absence of JV requirements. Most (52 percent) would have preferred a fully-owned business and 32 percent wanted a greater ownership stake in the JV than permitted.141

The risk of technology loss is exacerbated when the Chinese partner in the JV operation maintains other factories and workers that compete with the JV operation.142 The employees of the JV often are recruited from, or have ties to, the Chinese partner’s existing operations.143 Under these conditions, there is a considerable likelihood that the JV’s technology and know-how will leak, either through “unintentional osmosis or through intentional diversion.”144 In contrast, a WFOE has more control over its operations and can sometimes minimize operational decisions that create technology risks.145 Nevertheless, WFOEs also face various technology-related pressures from the Chinese government, as part of China’s numerous administrative review and licensing processes, as described in more detail below.146

In this investigation, the Intellectual Property Law Section of the American Bar Association noted that many U.S. companies—including American Superconductor Corporation (AMSC), Corning, DuPont, Eli Lilly, and General Motors—have sued for the misappropriation of trade secrets by JV partners, employees and others in Chinese courts.147 The U.S. International Trade Commission also has been a frequent forum for U.S. companies asserting trade secret misappropriation claims based on conduct by JV partners and others in China, including SI Group, Fellowes, and Manitowoc Company.148

In response to these concerns, defenders of China’s technology transfer regime argue that China has opened its economy to foreign investment in several respects, such as the introduction of the “Negative List” system, in which foreign investment in all sectors is permitted unless it is expressly included on a negative list.149 Despite these changes, substantial restrictions on foreign

142 OWEN D. NEE, JR., SHAREHOLDER AGREEMENTS AND JOINT VENTURES IN CHINA 583 (Thomson Reuters ed, 2016); see also INTERCHINA CONSULTING ESTABLISHMENT OF A JOINT VENTURE IN CHINA 5 (June, 2011); ITIF Submission, Section 301 Hearing 10 (Oct. 25, 2017) (stating that, “[a]nother way China acquires technology and intellectual property is to steal it.”).
143 OWEN D. NEE, JR., SHAREHOLDER AGREEMENTS AND JOINT VENTURES IN CHINA 583 (Thomson Reuters ed, 2016).
144 OWEN D. NEE, JR., SHAREHOLDER AGREEMENTS AND JOINT VENTURES IN CHINA 583 (Thomson Reuters ed, 2016).
145 OWEN D. NEE, JR., SHAREHOLDER AGREEMENTS AND JOINT VENTURES IN CHINA 583 (Thomson Reuters ed, 2016).
146 See infra Section II(C).
148 ABA IP LAW SECTION, Submission, Section 301 Hearing 3 (Sept. 27, 2017).
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investment remain. First, China continues to use an approach that is fundamentally similar to previous versions of the *Foreign Investment Catalogue*, in which many “restricted” and “prohibited” investments are included under the “Negative List”. During the period of this investigation, key sectors remain subject to JV and other investment restrictions. Moreover, even if China dropped its JV and other foreign ownership requirements, foreign investors would still continue to face pressures to transfer technology or disclose technical information through China’s licensing and administrative approvals regime (detailed in Section II.C, below).

2. Illustrative Examples of China’s Use of Investment Restrictions to Pressure Technology Transfer

While companies from the United States and other advanced economies have long faced JV requirements and other limits on control over their technologies in China, the most intensive technology transfer pressures often arise in sectors that align with the Chinese government’s industrial policy objectives. For example, studies commissioned by the European Commission have found that in key sectors, including machinery and environmental technologies, European companies have to enter into partnerships with Chinese state-owned enterprises (SOEs) and acquiesce to technology transfer demands to access the market or bid on government projects. Highlighted below for purposes of illustration are examples of technology transfer requirements or pressures imposed by the Chinese government in the automotive and aviation sectors.

   a) Auto Manufacturing and New Energy Vehicles

When China initially opened the auto manufacturing sector to foreign investment, its goal was to use the transfer of technology from U.S. and other foreign auto makers to modernize SOEs in the sector. To accomplish this goal, China has long required U.S. and other foreign car makers to enter into JVs where non-Chinese ownership is capped at 50 percent. China’s strategy of leveraging the technology of foreign automakers through JV requirements to grow its indigenous innovation capability has been called the “Changan Model” by Chinese

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150 U.S. CHAMBER OF COMMERCE, Submission, Section 301 Hearing 14 (Oct. 3, 2017) (China’s latest changes to its investment regime have provided, “…little in the way of comprehensive and meaningful openings to foreign investors.”).
151 See Appendix D.
government entities.\textsuperscript{155} This model refers to the 50/50 JV entered into by a U.S. auto manufacturer and Chongqing Changan Automobile (Changan), a state-owned company ultimately controlled by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) through China South Industries Group.\textsuperscript{156} A research division under the State Council lauded the “Changan Model” as an example of China’s Introduce, Digest, Absorb, Re-innovate (IDAR) approach\textsuperscript{157} to technology development through the “introduction of technology and the digestion and re-innovation of technology.”\textsuperscript{158} According to an article on the SASAC website, the model’s advantages include Changan’s control of the JV’s core production technology, the development of domestic innovation capabilities through control of that core technology, and the gradual upgrading of the domestic brand.\textsuperscript{159}

As China gained advanced auto manufacturing technology through JVs and sought to promote its own domestic brands, foreign automakers have found their industry placed in increasingly restrictive sections of the Foreign Investment Catalogue. Thus, the Foreign Investment Catalogue “encouraged” the “manufacturing of complete automobiles” until 2010, “permitted” it from 2011-2014, and “restricted” it in 2015, as China’s domestic capability grew.\textsuperscript{160}

Technology transfer pressures have intensified as China has sought to develop expertise in the manufacture of new energy vehicles (NEVs), which includes plug-in hybrids, electric battery and fuel cell vehicles. The NEV sector was specifically targeted by the Chinese government in 2010 following the release by the State Council of the Decision on Accelerating the Development of Strategic Emerging Industries, which designated NEVs as one of the seven “strategic emerging industries” selected for accelerated development. In 2012, the State Council released the Energy-Saving and New-Energy Automotive Industry Development Plan (2012-2020) (NEV Plan),\textsuperscript{161} which set forth an industrial development blueprint for NEVs calling for the


\textsuperscript{157} See Section II.C for an explanation of China’s IDAR strategy.


establishment of numerous regulations and subsidy programs to support domestic R&D, manufacturing, and utilization of NEVs. The NEV Plan sets a target of achieving cumulative production and sales volume of 5 million NEV units by 2020. A “basic principle” of the NEV Plan is to “expedite the formation of technology, standards, and brands using indigenous intellectual property.” China’s focus on developing its domestic capacity to produce NEVs was recently reconfirmed with the sector’s inclusion in the Made in China 2025 Key Area Technology Roadmap (Made in China 2025 Roadmap), which calls for, inter alia, indigenous NEVs to comprise 70 percent of domestic NEV sales by 2020 and 80 percent by 2025.

Foreign NEV producers seeking to sell their products in China face pressure to produce their automobiles in China with a JV partner rather than exporting them to China, due to a range of Chinese policies, including steep import tariffs and subsidies available for domestically-produced NEVs, as well as a new NEV credit system. These pressures to produce NEVs locally work in tandem with China’s JV requirements to elicit the transfer of technology from foreign automakers to domestic Chinese automakers.

Specifically, market access rules issued in 2009 by the Ministry of Industry and Information Technology (MIIT), which applied to all enterprises that manufactured NEVs in China for use in China and were a condition to be eligible for certain NEV preference programs, required that NEV JVs hold intellectual property rights in one of three key NEV technologies: batteries, drive systems, or control systems. In effect, this requirement forced foreign NEV

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162 NEV Plan § 3(2.1).
163 NEV Plan § 2(2).
164 Made in China 2025 Key Area Technology Roadmap (National Strategic Advisory Committee on Building a Powerful Manufacturing Nation, issued Oct. 2015).
165 Imported passenger vehicles are generally subject to a 25 percent tariff rate. See Customs Import and Export Tariff of the People’s Republic of China (2017).
166 The Chinese government provides subsidies to NEV manufacturers in connection with their sales of NEVs to consumers in China. In the current phase of the program, the central government subsidy amount is based primarily upon vehicle range and is capped at CNY 44,000 ($6,500) per vehicle. In addition, local governments are allowed to offer a subsidy of up to 50 percent of the value of the central government subsidy. Notice on Adjusting Fiscal Subsidy Policies for Promoting the Expanded Use of NEVs (MOF, MOST, MIIT, NDRC, Cai Jian [2016] No. 958, Dec. 30, 2016). Eligibility requirements for these subsidies are described below in more detail.
167 The NEV credit system requires all automakers selling vehicles in China to generate, by 2018, a certain portion of their production and imports from NEVs in order to generate “NEV credits” or be subject to penalties. See Provisional Measures for Administration of the NEV Fuel Use and Credit System, art 36 (MIIT, MOF, MOFCOM, General Administration of Customs, and General Administration of Quality Supervision, Inspection and Quarantine, 2017 Order No. 44, issued Sept. 27, 2017, effective Apr. 1, 2018); see also ITIF, Submission, Section 301 Hearing 6 (Oct. 25, 2017).
170 Provisions on the Administration of Access for New Energy Vehicle Manufacturers and Products (MIIT, [2009] Order No. 44, effective July 1, 2009), Appendix 2, Requirement 5 required the NEV manufacturer “possess intellectual property (at least rights to make design changes or usage rights) for the mastered core technology.”
manufacturers to transfer their valuable technologies to the NEV JV, which they do not control, in order to gain market access.\textsuperscript{171}

The pressure on NEV manufacturers to transfer core NEV technology to their JVs in China has intensified over the last year. New market access rules issued by MIIT in 2017, which also apply to all enterprises that manufacture NEVs in China\textsuperscript{172} and are a condition to be eligible for certain NEV preference programs,\textsuperscript{173} impose an even more onerous standard. These rules require that NEV manufacturers “master” the development and manufacturing technology for a complete NEV, rather than just one of the three key technologies listed in the 2009 market access rules, and possess key R&D capacities.\textsuperscript{174} As foreign automaker investment in China must be through a JV in which the foreign company holds no more than 50 percent equity, the foreign automaker effectively must transfer a high degree of key technologies and components to the JV in order for the JV to acquire mastery of the manufacturing process, including electronic and electrical control systems, on-board energy systems, powertrains, and dynamic coupling equipment.\textsuperscript{175}

Several submissions from U.S. trade associations pointed to China’s NEV rules as evidence of China’s unfair technology transfer regime, with one trade association stating in hearing testimony that China’s NEV rules present “a clear case in the electric vehicle sector that you’re simply not going to be able to sell that product in China unless that local partner has mastered the ability to leverage the technology and take it to produce it going forth.”\textsuperscript{176}

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b) Aviation

The state is the dominant force on the demand-side in many industries in China, both through direct purchases made by the central and local governments and through purchases made by SOEs, which account for a large share of purchasing decisions. According to one hearing participant, “often an implicit part of the deal of whether or not a company has its product or good chosen and purchased is [whether] there’s going to be a transfer of technology concomitant with that sale.” Similarly, AmCham China’s 2013 White Paper on Civil Aviation states “many US companies possess intellectual property (IP) that serves as their source of competitiveness and profitability, yet they are sometimes required (implicitly or explicitly) to transfer such IP to their JV partners”. In the aviation industry, China uses its purchasing power to require JVs and technology transfer in exchange for two types of business opportunities—the sale of commercial aircraft to China’s state-owned airlines and the sale of aircraft components to Chinese-made aircraft.

The fact that China’s three largest airlines—AirChina, China Eastern, and China Southern—are all state-owned and account for the vast majority of aircraft purchases provides the Chinese government with a significant degree of leverage over foreign aircraft makers. Purchases of commercial aircraft by China’s state-owned airlines require approval by the Chinese government. According to industry experts and participants, China uses its leverage to maintain a balance between purchases of foreign aircraft and to pressure them to form JVs with Chinese companies and localize production. China is effectively able to exert this pressure over aircraft manufacturers because of the size of China’s commercial aircraft

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177 The European Chamber of Commerce in China in 2011 estimated that China’s government procurement market including SOEs ranges from 12 percent to 20 percent of China’s GDP. EU CHAMBER OF COMMERCE IN CHINA, PUBLIC PROCUREMENT IN CHINA: EUROPEAN BUSINESS EXPERIENCES COMPETING FOR PUBLIC CONTRACTS IN CHINA 16 (Apr. 2011).


179 AMCHAM CHINA 2013 WHITE PAPER 188 (2012).


182 This problem has been widely discussed in industry and government fora, including in two reports commissioned by the U.S.-China Economic and Security Review Commission which explain how the Chinese government leverages purchases of aircraft in exchange for agreements that it hopes will lead to technology transfers into China’s aviation industry. See, e.g., KEITH CRANE, ET AL., RAND, THE EFFECTIVENESS OF CHINA’S INDUSTRIAL POLICIES IN COMMERCIAL AVIATION MANUFACTURING (2014); ROGER CLIFF, CHAD J. R. OHLANDT, DAVID YANG, RAND, READY FOR TAKEOFF: CHINA’S ADVANCING AEROSPACE INDUSTRY 38 (Mar. 2011).

market, coupled with required government approvals of aircraft purchases by state-owned airlines, and fierce competition for a limited number of government-approved sales.

China similarly uses its purchasing power to foster the development of a domestic supply chain for Chinese-made aircraft, particularly the C919, which will be China’s first “homegrown” large commercial aircraft. Industry observers have described the purchase order process for the C919 as “state directed,” “coerced,” and “choreographed” by the central government. Within this process, JVs are used as a key mechanism for obtaining the technology needed to support the development of a domestic supply chain for Chinese-made aircraft:

Chinese government officials have clearly communicated to foreign firms in the commercial aviation manufacturing industry that their business in China would be much more likely to enjoy success if they are seen as a “friend of China.” Companies can demonstrate this by setting up local production facilities, bringing in technologies, or participating in the C919 project...

Specifically, the Commercial Aircraft Corporation of China (COMAC), a centrally-controlled SOE, has made clear that foreign suppliers to the C919 program must enter into JVs with Chinese suppliers to participate in tenders for key components and systems. This pressure is particularly prevalent in tenders for high-tech functions where Chinese capabilities are lagging,
such as advanced materials and flight control systems. A 2015 press statement issued by COMAC explains that it selected sixteen leading international suppliers and it pushed for these suppliers to partner with domestic enterprises to develop key technologies for the C919. As a result, these sixteen JVs have “improved the overall level of China’s aerospace R&D and manufacturing through technology transfer, diffusion, and spillover.”

AmCham China’s 2012 White Paper on Civil Aviation makes clear how China’s technology transfer regime puts pressure on U.S. aviation companies:

Indigenous innovation industrial policy in the aerospace sector is forcing US companies to form joint ventures (JV) or localize manufacturing in order to participate in domestic aircraft programs such as the C919. Rather than being market-driven, these JVs are often with the Aviation Industry Corporation of China (AVIC) or COMAC designated partners… Additionally, many US companies possess intellectual property that serves as the source of their competitiveness and profitability, yet they are being forced to transfer their intellectual property in order to participate in this sector. It is challenging enough for companies to manage a successful JV when they choose their own JV partner. When JV partners are designated by an outside party, the difficulty of running a successful JV increases further.

In this investigation, the International Association of Machinists and Aerospace Workers (IAM) criticized U.S. aviation companies for responding to this pressure by transferring certain technologies and production to China. Other submissions stated, however, that aviation companies face few realistic alternatives; even if U.S. companies did not accede, those from other countries would do so to and gain a critical competitive advantage. Another submission put the matter more starkly:

[A] ‘voluntary’ technology transfer takes place, but one that is only voluntary in the sense that the business transactions engaged in by the fictional gangster of the Godfather series, Vito Corleone, were voluntary. China is effectively making an offer multinationals cannot refuse. Once Chinese producers are able to produce commercial aircraft, the state-owned airlines can be induced to buy them, even if they lag multinational products in terms of reliability or performance. Shut out of the world’s largest market for their product, multinational players are forced to shrink, export opportunities are lost, and the leading firms have fewer resources to invest in the next generation of products.”

C. Administrative Review and Licensing Processes as Used in China’s Technology Transfer Regime

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192 AMCHAM CHINA 2012 WHITE PAPER 190 (2012).
193 IAM, Submission, Section 301 Hearing 1 (Sept. 29, 2017).
194 Lewis, Submission, Section 301 Hearing 3 (Sept. 27, 2017).
195 Lee Branstetter, Submission, Section 301 Hearing 2 (Sept. 28, 2017).
China also uses its administrative review and licensing processes to force the disclosure of sensitive technical information and to achieve its technology transfer objectives. China maintains numerous administrative review and licensing processes that companies must comply with before establishing or expanding operations, or offering products or services in the China market. These review and licensing processes, which occur in agencies at the central, provincial, and municipal levels, often are used as an opportunity to require technology transfer. Vaguely worded provisions and uncertainty about the applicable rules provide Chinese authorities with wide discretion to use administrative processes to pressure technology transfer, restrict investments to protect domestic competitors, or otherwise act in furtherance of industrial policy objectives.

1. Technology Transfer Pressure in Administrative Approvals and Licensing

Foreign investment in China requires obtaining numerous government approvals depending on the terms of the investment and the industry and location in which the investment occurs. For instance, a foreign investment may be required to obtain (1) investment approval from the Ministry of Commerce (MOFCOM) or its local counterpart, (2) project approval from the National Development and Reform Commission (NDRC), its local counterpart, or the State Council, (3) national security and (4) anti-monopoly approval by MOFCOM, and (5) local approvals for site-related requirements.

At each stage of the approval process, vaguely worded provisions provide government officials with significant discretion to impose technology transfer requirements. For example, China’s regulations governing JVs expressly state that equity joint ventures should raise China’s level of science and technology. Moreover, China’s JV regulations stipulate that MOFCOM in conducting its approval review of an EJV or CJV must consider inter alia whether the

197 USCBC, Submission, Section 301 Hearing 4 (Sept. 28, 2017); U.S. Chamber, Submission, Section 301 Hearing 17 (Oct. 3, 2017) (misuse of administrative license procedures provides the opportunity for a company’s trade secrets to be put at risk of unnecessary disclosure); U.S. Dep’t of State, Investment Climate Statement 6 (2017); Covington & Burling LLP, Measures and Practices Restraining Foreign Investment in China, prepared for the European Commission Directorate-General for Trade 65 (Aug. 2014).
198 USCBC, Submission, Section 301 Hearing 4 (Sept. 28, 2017); U.S. Chamber, Submission, Section 301 Hearing 17 (Oct. 3, 2017) (misuse of administrative license procedures provides the opportunity for a company’s trade secrets to be put at risk of unnecessary disclosure); U.S. Dep’t of State, Investment Climate Statement 6 (2017); Covington & Burling LLP, Measures and Practices Restraining Foreign Investment in China, prepared for the European Commission Directorate-General for Trade 65 (Aug. 2014); U.S. Chamber, Made in China 2025: Global Ambitions Built on Local Protections 27-29, 33 (2017).
199 See generally U.S. Chamber of Commerce, China’s Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency (Nov. 2012); see also James M. Zimmerman, China Law Deskbook (4th ed. 2014). In 2016, some MOFCOM approvals were replaced with a record filing requirement, but MOFCOM approval is still required for those industries listed on the Negative List, and all FIEs are still subject to national security or anti-monopoly reviews where applicable.
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investment is consistent with China’s national economic development needs or industrial policy goals, respectively. 201

In addition, China imposes administrative licensing202 requirements on more than 100 different business activities, such as food and drug production, mining, or telecommunications services, for all enterprises in China.203 Even if a foreign investment in a particular industry is technically permitted, a foreign invested enterprise (FIE) must still obtain an industry-specific license in order to conduct these activities.204 The specific requirements and approval timelines vary widely depending on the industry at issue. For heavily regulated industries, the industry regulator review process can take more than a year.205

The US Chamber of Commerce has highlighted how the Chinese government uses its discretion in the review process to apply vague and unwritten rules in a selective and non-transparent manner:

The relatively opaque nature of the inbound FDI approval processes enables China’s investment approval authorities to favor domestic competitors over foreign investors, should they so desire, without leaving a paper trail of discriminatory written regulations that could clearly offend WTO obligations. Foreign investors have reported this favoritism occurring in two ways: (i) through the application of vaguely worded or unpublished rules or requirements in ways that discriminate against foreign investors; and (ii) through the imposition of deal-specific conditions that go beyond any written legal requirements.206

In one investigation submission, a former in-house counsel reported similar practices from his time doing business in China:

[T]here is a very clear discretionary administrative approval processes and other restrictions adopted by the Government of China that pressure the transfer of intellectual property to Chinese companies and/or to Chinese State Owned Enterprises in order to ‘do business’ in China and receive required licensing approvals. Often the language in Chinese licensing and business registration forms may not be clear as to its required and mandatory expectation for technology transfer by U.S. companies to Chinese firms or state agencies, but licensing officials within regional Chinese centers clarify in person, what is expected, without providing written documents that could be subsequently shared.

202 The Chinese term xiuke zheng is often translated as “license” or “permit”.
203 U.S. CHAMBER OF COMMERCE, CHINA’S APPROVAL PROCESS FOR INBOUND FOREIGN INVESTMENT: IMPACT ON MARKET ACCESS, NATIONAL TREATMENT AND TRANSPARENCY 17 (Nov. 2012).
204 U.S. CHAMBER OF COMMERCE, CHINA’S APPROVAL PROCESS FOR INBOUND FOREIGN INVESTMENT: IMPACT ON MARKET ACCESS, NATIONAL TREATMENT AND TRANSPARENCY 18 (Nov. 2012).
205 U.S. CHAMBER OF COMMERCE, CHINA’S APPROVAL PROCESS FOR INBOUND FOREIGN INVESTMENT: IMPACT ON MARKET ACCESS, NATIONAL TREATMENT AND TRANSPARENCY 18 (Nov. 2012).
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with global trade organizations. So a carefully crafted and structured process has been developed to avoid obvious demands for U.S. technology.\textsuperscript{207}

The administrative licensing and approvals process can also work in tandem with the JV requirements described above to require or pressure technology transfer. A study conducted by the U.S. Chamber of Commerce concluded:

The [JV requirement] creates numerous circumstances where investment approval authorities are able to work in an nontransparent way with the local partner to ensure that valuable intellectual property, market channels, and other assets of the foreign investor are made available to the joint venture — often on extremely favorable commercial terms for the local partner. This problem is exacerbated by the fact that in Sino-foreign joint ventures, the local partner serves as the investment approval process applicant on behalf of the prospective joint venture. As a result, Chinese joint venture partners are able, in many cases, to control the communication channels between the foreign investor and the government approval authorities, making the process even more opaque for the foreign investor and enabling the local partner to shape the approval requirement imposed by the authorities to its advantage.\textsuperscript{208}

Problems with administrative licensing processes are consistently identified as top concerns in annual surveys of U.S. companies in China.\textsuperscript{209} According to the most recent USCBC member survey, for example, companies specifically ranked “obtaining licenses and approvals” and “investment barriers” as the second and third greatest challenges, respectively.\textsuperscript{210} Moreover, 65 percent of respondent companies experienced problems obtaining necessary licenses and approvals in China. According to the survey, these licensing problems occurred overwhelmingly at the central government level (80 percent) and almost three-fourths of respondents report that China’s licensing reforms have had no impact to date.\textsuperscript{211} Similarly, in each of AmCham China’s 2017 and 2018 annual surveys, U.S. companies ranked China’s inconsistent regulatory interpretations as a top challenge.\textsuperscript{212} Companies also repeatedly identified “difficulty in obtaining required licenses” as a top challenge.\textsuperscript{213}

As one legal treatise on foreign investment in China explains:

Even under the existing laws, where approvals are required for foreign investment, it is not unusual to experience a situation where the Catalogue on Guiding Foreign Investment may provide that a certain activity may be conducted by a WFOE, [while] the Chinese

\textsuperscript{207} Stephen Zirschky, Submission, Section 301 Hearing (Sept. 28, 2017).
\textsuperscript{210} USCBC, 2017 Member Survey 2 (2017).
\textsuperscript{211} USCBC, 2017 Member Survey 12 (2017).
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authorities openly state that a WFOE will never be approved—only a joint venture, and only if all material technology is transferred to the joint venture.214

ITIF’s submission in this investigation provides further example of how China’s administrative authorities pressure foreign investors’ decisions on technology and R&D localization:

The CEO of a large multinational telecommunications equipment company recently shared with ITIF that he opened up a large R&D facility in Beijing that employs over 500 scientists and engineers. When asked if he did this to access Chinese engineering talent, he responded bluntly: “Unless I promised the Chinese Government that I would open up an advanced technology lab there, I was told that I would not be able to sell to the Chinese telecommunications providers,” (most of which are de facto controlled by the Chinese government).215

As described above, discretion in China’s administrative licensing process can be used to require technology transfer or impose deal-specific conditions in exchange for the licenses necessary for a foreign investor to operate in China. Similarly, ambiguity in the administrative licensing and approvals process may also result in technology transfer where existing laws and regulations are unclear as to the relevant requirements for foreign investors—this problem is particularly acute in new and emerging industries.

As one submission noted:

“[U]ncertainty surrounding administrative licensing regulations can also serve as a de facto limit for companies hoping to move into certain sectors. Businesses are often particularly cautious about advancing into new and under-regulated business sectors such as telemedicine, fearing that they might find themselves in violation of new regulations after investing.”216

These violations may lead to technology transfer in circumstances where foreign-invested enterprises must quickly comply with new regulations (or new interpretations of existing regulations) that threaten to shut down their existing business in China. According to numerous submissions in this investigation, an important example of how ambiguity in China’s administrative licensing process is used to pressure technology transfer arises in the field of cloud computing.217

Cloud Computing

214 OWEN D. NEE, JR., SHAREHOLDER AGREEMENTS AND JOINT VENTURES IN CHINA 57 (Thomson Reuters ed, 2016). The authors further conclude that even if China does adopt a Negative List approach, “it is doubtful that a [negative list] will effectively abolish such internal regulations or “neibu wenjian.”

215 ITIF, Submission, Section 301 Hearing 6 (Oct. 25, 2017).

216 USCBC, Follow-Up Submission, Section 301 Hearing 4-5 (Oct. 30, 2017).

217 CONSUMER TECHNOLOGY ASS’N [hereinafter “CTA”], Submission, Section 301 Hearing 10 (Sept. 28, 2017); COMPTIA, Submission, Section 301 Hearing 4 (Sept. 28, 2017); INFORMATION TECHNOLOGY INDUSTRY COUNCIL [hereinafter “ITI”], Submission, Section 301 Hearing 3-4 (Sept. 28, 2017); COALITION OF SERVICES INDUSTRIES, Submission Section 301 Hearing 2 (Sept. 28, 2017); see generally TELECOMMUNICATIONS INDUSTRY ASS’N, Submission, Section 301 Hearing (Sept. 28, 2017).
China has prioritized the development of its cloud computing sector and seeks to raise its indigenous cloud computing capability and achieve “systematic breakthroughs” in “indigenously innovated core technology” by 2020.\(^{218}\) Submissions in this investigation raised concerns with China’s restrictions on foreign investment, and related licensing practices and policies in this field.\(^{219}\) These submissions indicate that the Chinese government has used regulatory ambiguity to benefit Chinese cloud computing businesses and pressure technology transfer. China first tacitly permitted foreign investors to partner with licensed Chinese cloud service providers in order to gain market access, and then, once key technology and know-how had been injected into these partnerships, China resolved the regulatory ambiguities that had necessitated these arrangements in favor of the Chinese partner, resulting in the transfer of technology to the Chinese partner.

China precludes U.S. cloud service providers (CSPs) from directly participating in the three most common forms of cloud computing: computing infrastructure as a service (IaaS); computer platform as a service (PaaS); and computer software as a service (SaaS).\(^{220}\) CSPs must obtain certain value-added telecommunication licenses, such as an internet data center (IDC) license, from China’s MIIT or its local counterpart to operate their businesses.\(^{221}\) According to numerous submissions in this investigation, in practice, China does not grant such licenses to U.S. investors and thus does not permit U.S. CSPs to provide cloud computing services directly to customers in China.\(^{222}\)

However, the global nature of cloud computing means that forgoing the China market is simply not a commercially viable option for U.S. CSPs, whose customers demand globally available services.\(^{223}\) This is particularly the case for technology companies that have invested in and built up a market share in China in areas that are rapidly transitioning to cloud-based delivery. Thus, a business built on managing a customer’s computing resources, or supplying and maintaining software applications has little option but to offer those services on a cloud basis, given the economic, technical and security superiority of the cloud model, the transition to which customers now demand.

\(^{218}\) Notice on Issuing 13th Five-year Plan for National Informatization, Sec. 2(3) (State Council, Guo Fa [2016] No. 73, issued Dec. 15, 2016). In addition, the plan states that by 2020, China should have “basically established a secure and controllable IT industry ecosystem”, and asserts that “digitization comprehensively underpins the development of Party and national government initiatives.”

\(^{219}\) CTA, Submission, Section 301 Hearing 10 (Sept. 28, 2017); Comptia, Submission, Section 301 Hearing 4 (Sept. 28, 2017); ITI, Submission, Section 301 Hearing 3-4 (Sept. 28, 2017); U.S. Chamber of Commerce, Submission, Section 301 Hearing 18-19 (Oct. 3, 2017); see generally TELECOMMUNICATIONS INDUSTRY ASS’N [hereinafter “TIA”], Submission, Section 301 Hearing (Sept. 28, 2017).

\(^{220}\) U.S. companies are global leaders in these sectors. USITC, GLOBAL DIGITAL TRADE 1: MARKET OPPORTUNITIES AND KEY FOREIGN TRADE RESTRICTIONS 19-20 (Aug. 2017).

\(^{221}\) See Telecommunications Regulations of the People’s Republic of China, art. 7 and the Telecommunications Services Catalogue, attached as the Annex (State Council Order No. 291, issued Sept. 25, 2000 and amended on July 29, 2014 and Feb. 6, 2016), which lists IDC under the VATS operator license.

\(^{222}\) IDC licenses have only been granted to Chinese companies and joint ventures with Hong Kong or Macau investors and have not been granted to joint ventures with investors from the U.S. and other jurisdictions. See Samuel Yang, Regulation of Cloud Computing in China, PRACTICAL LAW (Apr. 26, 2017).

\(^{223}\) BSA The Software Alliance [hereinafter “BSA”], Submission, Section 301 Hearing 3 (Sept. 28, 2017).
In view of this commercial reality, the only way U.S. suppliers are able to participate in the market is through contractual arrangements with Chinese entities eligible to obtain the required licenses. Under these arrangements, U.S. suppliers will train the employees of the Chinese license holder how to operate complex technology, and are effectively forced to provide their proprietary cloud computing technology, brands, and know-how to their Chinese partners, in exchange for a fee or a share of revenue. This reality disadvantages U.S. companies in China as these contractual arrangements provide even less rights and protections with respect to their investment and technology than would be available through an equity investment.

Until 2016, China permitted such contractual arrangements by granting the requisite license to the Chinese partner. However, recent draft regulations prohibit these arrangements, which have long been relied upon by foreign CSPs for market access. In March 2016, China released the Notice on Regulating Business Operations in Cloud Service Market (Draft for Public Comment) and the Circular on Cleaning Up and Regulating the Internet Access Service Market, which exacerbated the challenges facing U.S. CSPs operating in the Chinese market. According to the written submissions in this investigation, these measures effectively prohibit, inter alia, (1) the Chinese license holder from providing any facilities or other resources to the foreign CSP; (2) the foreign CSP from entering into contracts with customers directly; and (3) the provision of cloud services under the trademark of the foreign CSP.

U.S. and other foreign CSPs operating in China through contractual arrangements inconsistent with this draft notice are now faced with the prospect of needing to restructure their existing arrangements and relinquish ownership and operations of their cloud business to a Chinese company in order to comply with the new rules. Indeed, although the draft notice has yet to be finalized, some U.S. suppliers have already done just that.

2. Forced Disclosure of Sensitive Technical Information

A second technology transfer mechanism used by Chinese administrative agencies is the forced disclosure of sensitive technical information. In a wide variety of industry sectors, the Chinese

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224 See e.g., Jason Verge, *Microsoft Launches Azure in China Via 21Vianet Group*, DataCenter Knowledge, (May 22, 2013) (“In November 2012, Microsoft, 21Vianet and the Shanghai Municipal Government announced a strategic partnership agreement in which Microsoft licensed the technology know-how and rights to operate and provide Office 365 and Windows Azure services in China to 21Vianet. ‘21Vianet will act as an operation entity for Azure, hosting the service in its data centers and handling the customer relationship,’ said Vianet's CFO, Shang Hsiao.”).

225 NAT'L FOREIGN TRADE COUNCIL [hereinafter “NFTC”], *Submission, Section 301 Hearing* 3 (Sept. 28, 2017).


229 Cate Cadell, *Amazon Sells off China Cloud Assets as Tough New Rules Bite*, Reuters, Nov. 13, 2017 (“In November 2017, for example, Amazon.com Inc. sold off its public cloud business in China to its local partner for $301.2 million. According to Amazon, this was done ‘to comply with Chinese law.’”).
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government requires the disclosure of unreasonable amounts of sensitive technical information in exchange for necessary administrative approvals. As noted by European researchers:

A particular concern amongst various industries including but not limited to ICT, pharmaceuticals, chemicals, agro-food (in particular GMOs), machinery and financial services, centers on the depth of information which needs to be provided to the authorities for obtaining the authorization to build a factory, to market a product, etc. In some cases, this information was provided to the local industry who used this data to develop similar activities.230

U.S. stakeholders are particularly concerned because the forced disclosures put technology and intellectual property at risk.231 Forced disclosures of information are especially problematic in cases in which the disclosure must be made not just to government officials but also to outsiders. This occurs when China requires reviews by “expert panels” that may include representatives from Chinese government, industry, academia, or others who may have a competitive interest in the information.232

Information disclosure and expert panel review requirements can arise at any stage of a company’s operations in China and in a wide variety of industries. For example, in the pre-establishment phase, a company may be subject to expert review panels to assess the safety, environmental impact, and energy conservation of the proposed investment.233 Panels typically require companies to respond to “detailed information [requests] about project costs and revenue, capacity and equipment information, raw material and energy requirements, and other sensitive details about the operations.”234

The information required to be disclosed may include trade secrets. For example:

One company that submitted its safety assessment to an approval agency was required to provide specific temperature and pressure range information for its process equipment... that would make it easier for a competitor to learn about a production process the company considered to be a trade secret.235

As noted by the American Chamber of Commerce in Shanghai:

231 USCBC, Submission, Section 301 Hearing 4-5 (Sept. 28, 2017); U.S. CHAMBER, Submission, Section 301 Hearing 17 (Oct. 3, 2017).
233 USCBC, Submission, Section 301 Hearing 5 (Sept. 28, 2017). See e.g., China Energy Conservation Product Certification Management Measures (National Economic and Trade Commission, issued Feb. 11, 1999), art. 3 states that evidence a product meets “standards or technological needs” is one of the criteria for receiving the Energy Conservation Certificate.
235 USCBC, IMPROVING CHINA’S LICENSING SYSTEM: RECOMMENDATIONS FOR KEY SECTORS 3 (Mar. 2014).
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Companies have also expressed concerns about some of China’s product approval requirements. In particular, for companies to gain approval from regulatory agencies they must disclose proprietary formula or designs. Despite assurances by regulators, companies are still not confident that the information will be protected. Some companies report that they have been able to push back but others have not been as successful and must face the difficult choice of seeking product approval, which could put proprietary information at risk, or not pursuing market opportunities in China in order to protect their IP.236

Similarly, environmental impact and energy conservation assessments require expert panel reviews,237 and sometimes involve a “pre-review” by a separate panel prior to application.238 Environmental impact panels “frequently include competitors or scholars affiliated with competitors.”239 In general, the panels introduce significant liability for companies seeking to safeguard their trade secrets, particularly since there are few safeguards in place to ensure that information is not misused.240

Expert review panels do not just apply before a company is established in China. For example, in the post-establishment phase, expert review panels may be required for security reviews in a range of industries under China’s *Cybersecurity Law of the People’s Republic of China* (Cybersecurity Law).241 Although many implementing regulations of the cyber-review regime are in draft form only, stakeholders report concerns that current ambiguities in the law will be used to pressure unnecessary disclosure of companies’ most critical technologies.242 For example, companies may be forced to disclose critical technologies, including source code, complete design databases, behavior models, logic models, and even floor plans and physical layouts of central processing units.243

D. China’s Acts, Policies, and Practices Are Unreasonable

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236 AM. CHAMBER OF COMMERCE SHANGHAI, Submission, Section 301 Hearing 2 (Sept. 28, 2017);
239 USCBC, Submission, Section 301 Hearing 1 (Oct. 20, 2017).
240 USCBC, UPDATE: LICENSING CHALLENGES AND BEST PRACTICES IN CHINA 8-9 (Jan. 2014). See e.g., *Administrative License Law of the People’s Republic of China* (PRC Administrative License Law) (adopted by the Fourth Session of the Standing Committee of the Tenth NPC, Order No. 7, on Aug. 27, 2003, effective July 1, 2004), art. 31 (regarding scope of required information), art. 54-55 (regarding the types of technical material which need to be submitted for certain licenses), and art. 76 (regarding compensation in the event of violation).
241 *Cybersecurity Law of the People’s Republic of China* (adopted by the Twenty-fourth Session of the Twelfth NPC, on Nov. 7, 2016, effective June 1, 2017). Submissions received in this investigation are summarized in Appendix C to this report.
242 See CTA, Submission, Section 301 Hearing 6 (Sept. 28, 2017); U.S. CHAMBER, Submission at 31; TIA, Submission, Section 301 Hearing 2 (Sept. 28, 2017).
243 SEMICONDUCTOR INDUSTRY ASS’N [hereinafter “SIA”], Submission, Section 301 Hearing 10, fn 42 (Sept. 28, 2017).
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Conduct that is “unreasonable” is actionable under Section 301, provided that it also burdens or restricts U.S. commerce. The statute defines an “unreasonable” act, practice, or policy as one that “while not necessarily in violation of, or inconsistent with, the international legal rights of the United States is otherwise unfair and inequitable.” The statute further provides that in determining unreasonableness, the USTR shall take into account, to the extent appropriate, whether foreign companies in the United States have access to reciprocal opportunities to those denied U.S. companies. Based on the foregoing factors, China’s technology transfer regime is unreasonable.

According to the Organization for Economic Co-operation and Development (OECD), very few countries employ foreign equity limitations or screen foreign investments on the basis of potential technology-related benefits. China’s foreign investment restrictions and administrative review and licensing systems not only exert great technology transfer pressures on U.S. companies, but also are substantially more restrictive than those of the United States and most other countries. Indeed, the OECD has consistently ranked China’s foreign investment regulatory regime as one of the most restrictive in the world based on an evaluation of (i) equity restrictions on foreign ownership, (ii) screening and prior approval requirements, (iii) rules for key personnel, and (iv) restrictions on the operation of foreign enterprises. For example, in 2016, China was ranked the fourth most restrictive economy out of 63 OECD and non-OECD member economies measured—only the Philippines, Saudi Arabia, and Myanmar were more restrictive. This low ranking is particularly striking given that China is the world’s second largest economy and it has extensive global trading relationships as compared to the other economies at the bottom of the index. China’s restrictiveness score was also 3.7 times higher than that of the United States.

Moreover, the OECD’s regulatory restrictiveness index does not even account for the full breadth of restrictive practices used by China to pressure technology transfer. The OECD index only captures those laws and policies pertaining to equity caps and pre-establishment administrative screening processes that have been formally adopted by the Chinese central government. As discussed above, China’s technology transfer requirements often do not take

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246 PRzemyslaw Kowalski, Daniel Rabaioli, Sebastian Vallejo, OECD, INTERNATIONAL TECHNOLOGY TRANSFER MEASURES IN AN INTERCONNECTED WORLD: LESSONS AND POLICY IMPLICATIONS, TAD/TC/WP(2017)1/FINAL, 2017 43-45 ¶ 130-1 (2017) (“In particular, making FDI in technology-related sectors conditional upon joint ventures…or requiring direct transfer of technology to the local partner…are not found in most of the countries [surveyed]. This may be a result of awareness that such laws deter investors and may be counterproductive. However, such measures are still present in two developing countries, namely China and Nigeria…Screening on the basis of potential technology-related benefits…is present in only five countries. For example, in China, for a project to be approved, it should meet the requirements of mid and long term planning for national economic development, de facto meaning that the government will screen investment on the basis of its technology-transfer potential.”).
249 In its methodology, the OECD specifies that its regulatory restrictiveness measures do not account for measures imposed at the sub-national level, and do not account for variability in restrictiveness stemming from implementation of formally adopted laws or policies. In other words, the regulatory restrictiveness index does not
the form of written laws or policies promulgated by China’s central government and are often carried out orally and “behind closed doors.” Evidence collected in this investigation also has demonstrated that forced disclosure of technical information occurs throughout the life span of U.S. companies’ operations in China through a variety of administrative reviews and licensing processes. These practices are not captured by the OECD’s index.

China’s regime is ultimately unfair and inequitable because it greatly restricts the freedom of U.S. companies to deploy and fully protect their valuable and hard-won technologies to compete in China. Instead of fostering a level playing field, China’s regime gives systematic and structural support for technology acquisition by Chinese companies from U.S. and other foreign competitors. Faced with China’s regime, U.S. companies must either cede substantial control over their valuable technologies or be closed out of one of the world’s largest and fastest-growing economies. This results in a highly asymmetric playing field where U.S. companies face immensely restrictive policies in China, while Chinese companies are not equally restricted in the United States.

Accordingly, China’s technology transfer regime—including foreign ownership restrictions and administrative approval and licensing process that are used to require or pressure the transfer of technology from U.S. companies to Chinese entities—is unfair, inequitable, and results in nonreciprocal opportunities relative to Chinese companies operating in the United States. These acts, practices, or policies are unreasonable as defined in Section 301.

E. China’s Acts, Policies, and Practices Burden or Restrict U.S. Commerce

The unreasonable act, policy, or practice of a foreign country must also burden or restrict U.S. commerce to be actionable under Section 301. In the present case, required or pressured technology transfer significantly undermines the value of American technology (including IP), thereby distorting markets and compromising U.S. companies’ global competitiveness. Therefore, China’s acts, policies, and practices that effectuate technology transfer burden and restrict U.S. commerce.


See supra Section II.A-C.

See supra Section II.C. In a recent AmCham China survey, 52% of respondents believe that in China the risk of “IP leakage and IT and data security threats” was greater than those in other countries. AMCHAM CHINA, 2018 CHINA BUSINESS CLIMATE SURVEY REPORT 31 (2018).

BSA, Submission, Section 301 Hearing 3-4 (Sept. 28, 2017); CSI, Submission, Section 301 Hearing 5 (Sept. 28, 2017); NAM, Submission, Section 301 Hearing 12-13 (Sept. 28, 2017).

BSA, Submission, Section 301 Hearing 3 (Sept. 28, 2017); U.S. CHAMBER, Submission, Section 301 Hearing 15 (Oct. 3, 2017).


U.S. PATENT & TRADEMARK OFFICE [hereinafter “USPTO”], & ECON. & STATISTICS ADMIN. INTELLECTUAL PROPERTY AND THE U.S. ECONOMY: 2016 UPDATE 1 (2016); see also NAT’L SCIENCE BOARD, SCIENCE & ENGINEERING INDICATORS, 6-20 (2016) (among all major economies, the United States has the highest concentration of knowledge-intensive and technology-intensive industries as a share of total economic activity).
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supported approximately 45.5 million jobs in the United States, and workers in those industries earned significantly higher wages on average than those working in non-IP-intensive industries. Further, IP-intensive companies represented more than 39 percent of U.S. GDP, and accounted for 52 percent of U.S. exports. Therefore, as noted by multiple submissions in this investigation, the well-being of U.S. companies and their workers, along with the broader U.S. economy, is dependent in substantial part on the continued strength of IP-intensive industries.

China’s technology transfer policies effectively deprive U.S. companies of the full value of their IP and technology and inhibit them from fairly competing in the large China market. When U.S. companies are required or pressured to transfer their technology, they may experience not only a direct loss of key competitive assets, but also may lose their technological competitive edge in global markets. Moreover, as noted by submissions in this investigation, Chinese beneficiaries of technology transfer under the highly favorable circumstances created by China acquire powerful advantages without the expense or risk of developing the technology themselves, and thus enjoy an additional competitive advantage over foreign innovators. If U.S. companies alternatively elect not to comply with Chinese requirements, the companies are excluded from an important and growing market, foregoing sales and export opportunities, and economies of scale.

No matter how a U.S. company responds, the Chinese government’s technology transfer regime generates considerable negative impacts on competition by depriving U.S. companies of the ability to achieve reasonable returns on their investments in the Chinese market and exploit legitimately obtained intellectual property rights, and prevents them from making investments at all. Given the strategic importance of the large and growing Chinese market, obstacles to level competition are acutely harmful to U.S. companies.

Moreover, U.S. companies that lose the option of exclusive enjoyment of their valuable technology and are therefore unable to compete fairly in China may become less globally competitive in the long run. When U.S. companies are deprived of fair returns on their investment in IP, they are unable to achieve the growth necessary to reinvest in innovation. In this sense, China’s technology transfer regime directly burdens the innovation ecosystem that is an engine of economic growth in the United States and similarly-situated economies.

258 WILEYREIN, Submission, Section 301 Hearing 11 (Sept. 28, 2017); IP COMMISSION, Submission, Section 301 Hearing 6 (Sept. 28 2017); see generally USPTO, INTELLECTUAL PROPERTY AND THE U.S. ECONOMY: 2016 UPDATE (2016).
259 WILEYREIN, Submission, Section 301 Hearing 11 (Sept. 28, 2017); SOLARWORLD, Submission, Section 301 Hearing 2 (Oct. 20, 2017); NAM, Submission, Section 301 Hearing 9-10 (Sept. 28, 2017); CSIS, Submission, Section 301 Hearing 1 (Sept. 28, 2017).
260 AMCHAM SHANGHAI, Submission, Section 301 Hearing 2 (Sept. 28, 2017); NAM, Submission, Section 301 Hearing 13 (Sept. 28, 2017).
261 WILEYREIN, Submission, Section 301 Hearing 11 (Sept. 28, 2017).
262 WILEYREIN, Submission, Section 301 Hearing 11 (Sept. 28, 2017); see also IAM, Submission, Section 301 Hearing 1 (Sept. 29, 2017).
263 WILEYREIN, Submission, Section 301 Hearing 11 (Sept. 28, 2017).
In fact, the displacement of global industrial leaders—including U.S. companies—so that China may achieve global market dominance is an explicit policy goal of the Chinese government.²⁶⁴ According to China’s *Made in China 2025* initiative, for example, the Chinese government seeks to acquire foreign technology, absorb that technology to boost indigenous innovation, and displace foreign competitors in both domestic and international markets.²⁶⁵ China’s technology transfer regime is a key mechanism to achieve this goal.²⁶⁶

Annual surveys of companies conducted by AmCham China and USCBC indicate that addressing China’s technology transfer regime would significantly increase U.S. investment in China. According to the 2018 AmCham China survey of U.S. companies, surveyed companies stated that they would significantly increase investment if China’s government were able to: provide greater regulatory transparency and predictability; limit the use of industrial policies that create barriers; allow U.S. companies to enter business segments that are currently restricted; provide recourse for unfair investment treatment; allow U.S. companies to increase control over their operations by reducing the need for joint ventures and local business partners; allow strategic acquisitions; and reduce the need to engage in technology transfer.²⁶⁷

Ultimately, China’s acts, policies, and practices that require or pressure technology transfer undermine U.S. companies’ valuable IP, weaken their global competitiveness, and stunt investment in innovation.²⁶⁸ Therefore, China’s acts, policies, and practices with respect to technology transfer burden and restrict U.S. commerce.²⁶⁹

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²⁶⁴ U.S. CHAMBER, MADE IN CHINA 2025: GLOBAL AMBITIONS BUILT ON LOCAL PROTECTIONS 13 (2017); BJÖRN CONRAD, ET AL., MERCATOR INST. FOR CHINA STUDIES [*hereinafter “MERICS”*], MADE IN CHINA 2025 14, 16 (2016).
²⁶⁵ MERICS, MADE IN CHINA 2025 16 (2016) (technological development to achieve the ultimate objective of import substitution is pervasive throughout the plan, which specifically calls for the development and usage of indigenous products in a variety of industries).
²⁶⁶ See MERICS, MADE IN CHINA 2025 41 (2016).
²⁶⁸ WILEYREIN, Submission, Section 301 Hearing 11 (Sept. 28, 2017); U.S. CHAMBER, MADE IN CHINA 2025: GLOBAL AMBITIONS BUILT ON LOCAL PROTECTIONS 7 (2017).
²⁶⁹ This finding is consistent with numerous other sources that confirm that Chinese technology transfer practices burden U.S. commerce. See generally USTR, NTE, SPECIAL 301 AND WTO COMPLIANCE REPORTS; U.S.-CHINA EC. & SEC.REV. COMM’N (2016); USITC, INV. NO. 332-519, CHINA: EFFECTS OF INTELLECTUAL PROPERTY INFRINGEMENT AND INDIGENOUS INNOVATION POLICIES ON THE U.S. ECONOMY (2011); USITC, INV. NO. 332-514, CHINA: INTELLECTUAL PROPERTY INFRINGEMENT, INDIGENOUS INNOVATION POLICIES, AND FRAMEWORKS FOR MEASURING THE EFFECTS ON THE U.S. ECONOMY (2010); U.S.-CHINA ECON. & SEC. REV. COMM’N, CHINA’S FIVE-YEAR PLAN, INDIGENOUS INNOVATION AND TECHNOLOGY TRANSFERS, AND OUTSOURCING (2011).
III. China’s Discriminatory Licensing Restrictions

A. Introduction

The second category of conduct set forth in the Federal Register Notice issued on August 24, 2017, addresses China’s acts, policies, and practices depriving U.S. companies of the ability to set market-based, mutually-desirable terms in licensing and other technology-related negotiations with Chinese companies. In addition to the difficulties with administrative licensing discussed in Section II, China also intervenes in U.S. firms’ investments and related activities in China through restrictions on their technology licensing. These restrictions result in discriminatory technology transfer-related acts, policies, and practices that burden U.S. commerce.

China’s regime of technology regulations deprives U.S. technology owners of the ability to bargain and set terms for technology transfer that are free from interference by China. U.S. firms seeking to license technologies to Chinese enterprises must do so on non-market-based terms that favor Chinese recipients. Moreover, the bureaucratic hurdles contained in licensing regulations provide China with an additional opportunity to pressure firms to transfer more technology, or transfer it on more favorable terms, in exchange for administrative approvals.

China’s imposition of mandatory adverse licensing terms is reflected in official measures that impose a different set of rules for imported technology transfers originating from outside China, such as from U.S. entities attempting to do business in China, compared to separate rules for technology transfers occurring between two domestic companies. The mandatory requirements for importation of foreign technology are discriminatory and clearly more burdensome than the domestic requirements, as explained in detail below. The result of these mandatory terms imposed only on technology import contracts is that foreign entities (including U.S. entities) doing business in China are at a disadvantage compared to Chinese entities. These restrictions benefit domestic entities at the expense of foreign competitors, including U.S. competitors, because the mandatory terms are only imposed on technology import contracts and do not govern technology contracts between two domestic parties. From the outset, the regime is tipped in favor of Chinese entities before a U.S. company even attempts to enter the market in China through a legal framework adversely influencing all technology negotiations and contracts.

As explained in more detail below, due to mandatory provisions in China’s regime of technology regulations, U.S. entities seeking to license foreign technologies to enterprises in China must do so on non-market-based terms that favor Chinese recipients. One such entity, the Office of Intellectual Property (IP) and Industry Research Alliances (IPIRA) at the University of California, Berkeley, summarized its experiences with these unacceptable terms mandated by the Chinese regime, provided at Appendix E to this report.

B. Foreign Licensing Restrictions and China’s Technology Transfer Regime

China regulates instances in which an entity seeks to transfer technology into China under its Regulations of the People’s Republic of China on the Administration of the Import and Export of
To amend section 232 of the Trade Expansion Act of 1962 to require the Secretary of Defense to initiate investigations and to provide for congressional disapproval of certain actions, and for other purposes.

IN THE SENATE OF THE UNITED STATES

AUGUST 1, 2018

Mr. Portman (for himself, Mr. Jones, Mrs. Ernst, and Mr. Alexander) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend section 232 of the Trade Expansion Act of 1962 to require the Secretary of Defense to initiate investigations and to provide for congressional disapproval of certain actions, and for other purposes.

Be it enacted by the Senate and House of Representa-
tives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the “Trade Security Act of 2018”.

SEC. 2. INVESTIGATIONS TO DETERMINE EFFECTS ON NATIONAL SECURITY OF IMPORTS OF ARTICLES AND CONGRESSIONAL REVIEW OF PRESIDENTIAL ACTIONS.

(a) Investigations and Determinations by Secretary of Defense.—Section 232 of the Trade Expansion Act of 1962 (19 U.S.C. 1862) is amended—

(1) in subsection (b)—

(A) in paragraph (1)—

(i) in subparagraph (A), by striking “Secretary of Commerce” and all that follows through “‘Secretary’)” and inserting “Secretary of Defense”; and

(ii) in subparagraph (B)—

(I) by striking “Secretary shall” and inserting “Secretary of Defense shall”; and

(II) by striking “Secretary of Defense of” and inserting “Secretary of Commerce of”;

(B) in paragraph (2)—

(i) by striking subparagraph (B);

(ii) in the matter preceding clause (i)—

(I) by striking “(A) In” and inserting “In”;

and

and
(II) by striking “Secretary” and inserting “Secretary of Defense”; and (iii) by striking clauses (i) through (iii) and inserting the following:

“(A) consult with the Secretary of Commerce regarding the methodological and policy questions raised in any investigation initiated under paragraph (1);

“(B) prepare an assessment of the defense requirements and national security impact of any article that is the subject of an investigation, which shall focus on—

“(i) the impact of the importation of the article on military readiness and critical infrastructure; and

“(ii) the need for a reliable supply of the article to protect national security;

“(C) seek information and advice from the Secretary of Commerce;

“(D) consult with appropriate officers of the United States;

“(E) consult with members of the Committee on Finance of the Senate and members of the Committee on Ways and Means of the House of Representatives; and
“(F) hold public hearings, co-chaired with the Department of Commerce, or otherwise afford interested parties an opportunity to present information and advice relevant to such investigation.”;

(C) in paragraph (3)—

(i) by redesigning subparagraph (B) as subparagraph (D);

(ii) by striking subparagraph (A) and inserting the following:

“(A) Not later than 200 days after the date on which the Secretary of Defense initiates an investigation under paragraph (1) with respect to an article, the Secretary of Defense shall submit to the President a report on the findings of such investigation with respect to the effect of the importation of such article in such quantities or under such circumstances on the national security of the United States.

“(B) If the report described in subparagraph (A) includes an affirmative finding that the importation of an article in such quantities or under such circumstances threatens to impair the national security, the President may direct the Secretary of Commerce to devise recommendations to address such threat.

“(C) Not later than 100 days after receiving from the President under subparagraph (B) a direction to de-
vise recommendations with respect to an article, the Sec-
retary of Commerce, in consultation with the United
States Trade Representative, the Secretary of Defense,
members of the Committee on Finance of the Senate, and
members of the Committee on Ways and Means of the
House of Representatives, shall submit to the President
a report that includes—

“(i) recommendations for action or inaction
under this section with respect to the article; and

“(ii) the findings of the Secretary of Commerce
with respect to the investigation by the Secretary of
Defense under paragraph (1).”; and

(iii) in subparagraph (D), as redesig-
nated by subparagraph (C)—

(I) by striking “Secretary” and
inserting “Secretary of Defense”; and

(II) by inserting “or the report
submitted by the Secretary of Com-
merce under subparagraph (C)” after
“subparagraph (A)”; and

(D) in paragraph (4), by inserting “of De-
fense, in consultation with the Secretary of
Commerce,” after “The Secretary”;}

(2) in subsection (e)(1), by striking subpara-
graph (A) and inserting the following:
“(A) Not later than 60 days after receiving recommendations submitted under subsection (b)(3)(C)(i) with respect to an article, the President shall—

“(i) decide whether to take action based on such recommendations; and

“(ii) if the President decides to take action under clause (i), determine the nature and duration of the action to be taken to adjust the imports of the article and its derivatives so that such imports will not threaten to impair the national security.”;

(3) by redesignating the second subsection (d) as subsection (e);

(4) in subsection (d)—

(A) by striking “the Secretary and the President” each place it appears and inserting “the Secretary of Defense, the Secretary of Commerce, and the President”; and

(B) by inserting “, the production of which is needed for national defense requirements and critical infrastructure in the United States” after “welfare of individual domestic industries”; and

(5) in subsection (e)(1), as redesignated by paragraph (3), by striking “Secretary” and inserting “Secretary of Defense”.
(b) Congressional Disapproval of Presidential Action.—Section 232(f) of the Trade Expansion Act of 1962 (19 U.S.C. 1862(f)) is amended—

(1) in paragraph (1), by striking “of petroleum or petroleum products”; and

(2) in paragraph (2)(B)—

(A) by striking “petroleum imports” and inserting “imports”; and

(B) by striking “of petroleum or petroleum products” and inserting “imports”.

(c) Applicability.—

(1) In General.—Except as provided in paragraph (2), subsection (f) of section 232 of the Trade Expansion Act of 1962 (19 U.S.C. 1862), as amended by subsection (b), shall apply to adjustments of imports under that section on or after July 1, 2018.

(2) Exception.—Subsection (f) of section 232 of the Trade Expansion Act of 1962 (19 U.S.C. 1862), as amended by subsection (b), shall not apply to the presidential actions taken under that section on March 8, 2018, relating to the adjustment of imports of steel and aluminum, or any subsequent actions (including proclamations, Executive orders, or...
other Executive acts) relating to those presidential actions.
To amend the Trade Expansion Act of 1962 to require Congressional approval before the President adjusts imports that are determined to threaten to impair national security.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,
SECTION 1. CONGRESSIONAL APPROVAL BEFORE ADJUSTMENT BY PRESIDENT OF IMPORTS DETERMINED TO THREATEN TO IMPAIR NATIONAL SECURITY.

(a) IN GENERAL.—Section 232 of the Trade Expansion Act of 1962 (19 U.S.C. 1862) is amended—

(1) in subsection (c)—

(A) in paragraph (1)—

(i) by striking subparagraph (B);

(ii) in the matter preceding clause (i), by striking ``(A) Within'' and inserting ``Within'';

(iii) by redesignating clauses (i) and (ii) as subparagraphs (A) and (B), respectively; and

(iv) in subparagraph (B), as redesignated by clause (iii)—

(I) by striking ``determine'' and inserting ``submit to Congress, not later than 15 days after making that determination, a proposal regarding'';

and

(II) by striking ``must'' and inserting ``should''; and

(B) by striking paragraphs (2) and (3) and inserting the following:
“(2) The President shall submit to Congress for review under subsection (f) a report describing the action proposed to be taken under paragraph (1) and specifying the reasons for such proposal. Such report shall be included in the report published under subsection (e).”;

(2) by redesignating the second subsection (d) as subsection (e); and

(3) by striking subsection (f) and inserting the following:

“(f) CONGRESSIONAL APPROVAL OF PRESIDENTIAL ADJUSTMENT OF IMPORTS; JOINT RESOLUTION OF APPROVAL.—

“(1) IN GENERAL.—An action to adjust imports proposed by the President and submitted to Congress under subsection (e)(2) shall have force and effect only upon the enactment of a joint resolution of approval, provided for in paragraph (3), relating to that action.

“(2) PERIOD FOR REVIEW BY CONGRESS.—The period for congressional review of a report required to be submitted under subsection (e)(2) shall be 60 calendar days.

“(3) JOINT RESOLUTIONS OF APPROVAL.—

“(A) JOINT RESOLUTION OF APPROVAL DEFINED.—In this subsection, the term ‘joint
resolution of approval’ means only a joint resolution of either House of Congress—

“(i) the title of which is as follows: ‘A joint resolution approving the proposal of the President to take an action relating to the adjustment of imports entering into the United States in such quantities or under such circumstances as to threaten or impair the national security.’; and

“(ii) the sole matter after the resolving clause of which is the following: ‘Congress approves of the recommendation of the President to Congress relating to the adjustment of imports to protect the national security as proposed by the President in the report submitted to Congress under section 232(c)(2) of the Trade Expansion Act of 1962 (19 U.S.C. 1862(c)(2)) on _________ relating to ________,’ with the first blank space being filled with the appropriate date and the second blank space being filled with a short description of the proposed action.

“(B) INTRODUCTION.—During the period of 60 calendar days provided for under para-
graph (2), a joint resolution of approval may be
introduced and shall be referred to the appro-
priate committee.

“(C) FLOOR CONSIDERATION IN HOUSE OF
REPRESENTATIVES.—If a committee of the
House of Representatives to which a joint reso-
lution of approval has been referred has not re-
ported the joint resolution within 10 calendar
days after the date of referral, that committee
shall be discharged from further consideration
of the joint resolution.

“(D) CONSIDERATION IN THE SENATE.—
“(i) COMMITTEE REFERRAL.—A joint
resolution of approval introduced in the
Senate shall be referred to the Committee
on Finance.

“(ii) REPORTING AND DISCHARGE.—
If the committee to which a joint resolu-
tion of approval was referred has not re-
ported the joint resolution within 10 cal-
endar days after the date of referral of the
joint resolution, that committee shall be
discharged from further consideration of
the joint resolution and the joint resolution
shall be placed on the appropriate calendar.

“(iii) Proceeding to Consideration.—Notwithstanding Rule XXII of the Standing Rules of the Senate, it is in order at any time after the Committee on Finance reports a joint resolution of approval or has been discharged from consideration of such a joint resolution to move to proceed to the consideration of the joint resolution. The motion to proceed is not debatable. The motion is not subject to a motion to postpone. A motion to reconsider the vote by which the motion is agreed to or disagreed to shall not be in order.

“(iv) Rulings of the Chair on Procedure.—Appeals from the decisions of the Chair relating to the application of the rules of the Senate, as the case may be, to the procedure relating to a joint resolution of approval shall be decided by the Senate without debate.

“(E) Rules relating to Senate and House of Representatives.—
“(i) Treatment of Senate joint resolution in House.—In the House of Representatives, the following procedures shall apply to a joint resolution of approval received from the Senate (unless the House has already passed a joint resolution relating to the same proposed action):

“(I) The joint resolution shall be referred to the Committee on Ways and Means.

“(II) If the Committee on Ways and Means has not reported the joint resolution within 2 calendar days after the date of referral, that committee shall be discharged from further consideration of the joint resolution.

“(III) Beginning on the third legislative day after each committee to which a joint resolution has been referred reports the joint resolution to the House or has been discharged from further consideration thereof, it shall be in order to move to proceed to consider the joint resolution in the
House. All points of order against the motion are waived. Such a motion shall not be in order after the House has disposed of a motion to proceed on the joint resolution. The previous question shall be considered as ordered on the motion to its adoption without intervening motion. The motion shall not be debatable. A motion to reconsider the vote by which the motion is disposed of shall not be in order.

“(IV) The joint resolution shall be considered as read. All points of order against the joint resolution and against its consideration are waived. The previous question shall be considered as ordered on the joint resolution to final passage without intervening motion except 2 hours of debate equally divided and controlled by the sponsor of the joint resolution (or a designee) and an opponent. A motion to reconsider the vote on passage of
the joint resolution shall not be in order.

“(ii) TREATMENT OF HOUSE JOINT RESOLUTION IN SENATE.—

“(I) If, before the passage by the Senate of a joint resolution of approval, the Senate receives an identical joint resolution from the House of Representatives, the following procedures shall apply:

“(aa) That joint resolution shall not be referred to a committee.

“(bb) With respect to that joint resolution—

“(AA) the procedure in the Senate shall be the same as if no joint resolution had been received from the House of Representatives; but

“(BB) the vote on passage shall be on the joint resolution from the House of Representatives.
“(II) If, following passage of a joint resolution of approval in the Senate, the Senate receives an identical joint resolution from the House of Representatives, that joint resolution shall be placed on the appropriate Senate calendar.

“(III) If a joint resolution of approval is received from the House, and no companion joint resolution has been introduced in the Senate, the Senate procedures as described in subparagraph (D) shall apply to the House joint resolution.

“(F) Rules of House of Representatives and Senate.—This paragraph is enacted by Congress—

“(i) as an exercise of the rulemaking power of the Senate and the House of Representatives, respectively, and as such is deemed a part of the rules of each House, respectively, and supersedes other rules only to the extent that it is inconsistent with such rules; and
“(ii) with full recognition of the constitutional right of either House to change the rules (so far as relating to the procedure of that House) at any time, in the same manner, and to the same extent as in the case of any other rule of that House.”.

(b) Effective Date.—

(1) In general.—The amendments made by subsection (a) shall apply to any proposed action covered by subsection (c) of section 232 of the Trade Expansion Act of 1962 (19 U.S.C. 1862), as so amended, on or after the date that is two years before the date of the enactment of this Act.

(2) Timing of certain proposals.—If the President makes a determination described in subsection (c)(1)(A) of such section, as so amended, during the period beginning on the date that is two years before the date of the enactment of this Act and ending on the day before such date of enactment, the submission to Congress of the proposal described in subsection (c)(1)(B) of such section, as so amended, shall be required not later than 15 days after such date of enactment.

(3) Modification of duty rate amounts.—
(A) IN GENERAL.—Any rate of duty modified under section 232(e) of the Trade Expansion Act of 1962 (19 U.S.C. 1862(e)) during the period specified in paragraph (2) shall on the date of the enactment of this Act revert to the rate of duty in effect before such modification.

(B) RETROACTIVE APPLICATION FOR CERTAIN LIQUIDATIONS AND RELIQUIDATIONS.—

(i) IN GENERAL.—Subject to clause (ii), any entry of an article that—

(I) was made—

(aa) on or after the date that is two years before the date of the enactment of this Act; and

(bb) before such date of enactment; and

(II) to which a lower rate of duty would be applicable due to the application of subparagraph (A),

shall be liquidated or reliquidated as though such entry occurred on such date of enactment.

(ii) REQUESTS.—A liquidation or reliquidation may be made under clause (i)
with respect to an entry only if a request therefor is filed with U.S. Customs and Border Protection not later than 180 days after the date of the enactment of this Act that contains sufficient information to enable U.S. Customs and Border Protection—

(I) to locate the entry; or

(II) to reconstruct the entry if it cannot be located.

(iii) **Payment of amounts owed.**— Any amounts owed by the United States pursuant to the liquidation or reliquidation of an entry of an article under clause (i) shall be paid, without interest, not later than 90 days after the date of the liquidation or reliquidation (as the case may be).
Accounting for Trade: President Trump and the “Geopolitical Balance Sheet”

William Jannace, LL.M; and Professor Paul Tiffany, PhD
Politics and Economics

It is the intersection of politics and economics that motivates the behavior of most nations when it comes to cross-border trade and investment. However, public commentary often separates these domains when discussing implications of a given policy or proposal for national well-being.¹ This is unfortunate, as it too often limits the proper assessment of political benefits and costs from the policies and actions under discussion. To alleviate this, we propose the notion of a “Geopolitical Balance Sheet” as a better approach to evaluate trade policy outcomes, along with the incorporation of traditional accounting notions of “assets,” “liabilities,” and “owners’ equity.” We believe this is a particularly appropriate time to consider such a proposal, not only because of the new Trump Administration’s frequent pronouncements on trade but also because such terminology might have a more meaningful impact on the business-friendly inclinations of many supporters of this Administration. “When goods don’t cross borders, Soldiers will.” This saying has been ascribed to French economist, Claude Frédéric Bastiat—whether he said it or not—it is we believe particularly important today.

In addition to surrounding himself with several key economic advisors who have left little doubt about their negative views regarding globalism and its supporting institutions, President Trump himself has made multiple negative public pronouncements regarding cross-border free trade, declaring he will “put America first” through policies he terms “fair trade” (Fox News, October 18; M. Fisher; U. Friedman). These include withdrawal from the Trans Pacific Partnership, calls to abandon the long-standing reliance on multi-lateral trade treaties and in their place negotiate bilateral deals, impositions of “Border Adjustment Taxes” on imported goods, new tariffs on imports from China, claims of currency manipulation by China, Germany, and others, and urging citizens to “buy American” and business firms to “hire Americans” (D. Trump, “Inaugural Address”).

Yet while perhaps appealing to many, these actions are not the best long-term means to address the negative side effects that globalization, free trade, and broader neoliberal economic policies have created in this country, and throughout parts of the world. Though we would be among the first to agree that such issues as worker displacement, loss of manufacturing jobs, trade deficits, and growing despair and social alienation for millions of individuals are more than worthy of public interest and attention, the imposition of President Trump’s trade agenda would not only punish those whom he wants to help but could also destroy the political-economic foundations of the world as it exists today.²

The Returns to Trade are More Than Economic

The economic and social costs from trade, however, are real and should not be discounted. But they must be appraised against the benefits that have derived from the same policies and forces that brought them about—many of which are rooted in political dimensions as much if not more than economic considerations. Most pointedly, one could make the case that up through the middle of the 20th century modern history was essentially the history of war, capped by the unprecedented carnage of World Wars I and II. Since the end of the latter conflict, the world has enjoyed an unprecedented era of relative stability, which we would argue has been beneficial to everyone regardless of national affiliation, geographic location, and political persuasion.

Why the historical break from the past? There is no other meaningful answer outside of the global role that the United States—departing from its long traditions of political isolationism—willingly embraced in the late 1940s (B. Bartlett, 1998). Following the prescient instincts of Dean Acheson, President Truman’s Secretary of State—who got Stalin and the Soviet Union right long before many others—the U.S. emerged as the world’s willing hegemon committed to both democracy and a market-based economic system.³ The protectionism that had characterized America’s trade policies almost since the founding of the Republic were finally put to rest as this country took the lead in establishing programs and institutions designed to facilitate cross-border trade; these included the Bretton Woods Agreement, the World Bank, the International Monetary Fund (IMF), the General Agreement on Tariffs and Trade (GATT), the Bank for International Settlements (BIS), and collateral organizations including the UN and NATO (W. Isaacson and E. Thomas). While some argued against this new national posture, the advocates who became known as our “Greatest Generation” ultimately carried
the day beginning with the Marshall Plan that was enacted in 1948. Through the extensive rebuilding plan, more than $100 billion (in current dollars) was committed by the U.S. to the reconstruction of Europe as a democratic capitalist bastion that could further contain Communism and Soviet expansionism. (Beisner).

It is no wonder that recent political insurgencies such as the Tea Party, Occupy Wall Street, and fringe groups associated with the Alt Right have emerged on both sides of the political spectrum.

The result was a massive rise in global prosperity in the second half of the 20th century—the “American Century” in which this nation finally displaced Great Britain as not only the dominant economic power but also as the political leader of the Free World. America’s middle class expanded exponentially, its standard of living rose dramatically, and we became a beacon to the world in terms of the aspirations and hopes of people everywhere for a better life.

But this was hardly a cost-free proposition. Federal budgetary deficits that financed growth rose dramatically from WWII (peaking at over 119% of GDP in 1946) through the Great Recession following the financial meltdown of 2008. While budgetary deficits have stabilized since 2012 (estimates for 2017 are less than 3% of GDP), the cumulative amount totals nearly $20 trillion, over one-third of which is held by off-shore investors. We should also note that the period since 1980 when U.S. budgetary excesses emerged was also the modern era of globalization—when worldwide cross-border trade in goods rose from slightly over $2 trillion in 1980 to nearly $19 trillion by 2014 at its peak (though recently dropping to about $16.5 trillion due to the slowdown in China). Moreover, the U.S. began to consistently incur merchandise trade balance deficits in the 1980s, as nations such as Japan became globally competitive. The deficits then rose dramatically early in this century as the Chinese economy boomed and imports from that nation exploded. This phenomenon peaked in 2006, resulting in a $760 billion deficit in the U.S., and today it still remains at approximately $500 billion—with China still by far the major source of the imbalance (usgovernmentspending.com, and tradingeconomics.com).

Not uncoincidentally, manufacturing employment in the U.S. peaked in 1979 at nearly 20% of the national workforce before trending downward to about 11% today (U.S. Bureau of Labor Statistics and U.S. Federal Reserve Bank of St. Louis). In conjunction with a rising concentration of both income and wealth in a small percentage of the population (many of whom are financial services industry executives directly involved in the facilitation of globalization), along with stagnation in real wages for the middle class as traditional manufacturing jobs disappeared—both trends apparent since the beginning of the Reagan Administration in the early 1980s—it is no wonder that recent political insurgencies such as the Tea Party, Occupy Wall Street, and fringe groups associated with the Alt Right have emerged on both sides of the political spectrum. These groups point to globalization and the perceived budgetary extravagance of public welfare policies as the primary culprits in America’s “demise”—forces which the Trump presidential campaign adroitly addressed and exploited in the upset victory of the 2016 election.

A Geopolitical “Balance Sheet”

But does all of this imply that we are “losing” and that cross-border trade has been “bad” for America and its citizens? That is, have our past economic policies and actions created a vast pool of “liabilities” that demand radical address by President Trump to right the ship of state and establish a steadier course forward towards renewed national “greatness”? If we examine the data
from a purely economic perspective, one can certainly find reason for concern. Interest payments to foreign holders of the budgetary deficit could be better used domestically, repairing dislocations from trade deficits might increase domestic job creation, and a national psychosis about America’s “declining” position in the global economy— no matter how ill-informed— could be alleviated.

As we noted at the outset, a broader perspective would have us also evaluate the “assets” that accrued from our national will to power since the end of WWII and not just dwell on the economic liabilities, such as they are. While these assets are no doubt far more difficult to quantify, that in no way should minimize their value; in fact we argue the opposite is true. Let’s examine why.

First, the willingness of the U.S. to absorb both budgetary and trade deficits helped fund the establishment of the modern global economic and political foundations that still exist today. This investment turned one-time mortal adversaries Japan and Germany, as well as some other states, into key allies and staunch supporters of American policies and values. More recently, this has also facilitated the peaceful integration of China— tightly governed by the Chinese Communist Party that historically had opposed both market-based economic trade and essentially all private property rights— into the capitalist world economy, and reversed a trend that many believed would inevitably lead to armed conflict with the West. These are no mean feats in terms of past history. For example, the inability of the victorious European powers after WWI to stabilize global economic relations and resuscitate Germany led directly to Hitler’s rise and the subsequent destruction of that region. Moreover, and perhaps most pointedly, the implicit goal of these post-WWII American-led reformist policies was also achieved: the defeat of the Soviet Union in the Cold War.

Through the advocacy and support of free trade policies we have encouraged our prior adversaries to pursue outcomes that have been win-win for everyone: global stability free from the political tensions and devastating wars that followed in the footsteps of past failures to create fair and equitable global relations. To be precise, U.S.-led policies that allowed for implementation of a non-prejudicial system of importation of goods from other countries have also built a foundation for the importation of global stability— our positive “owner’s equity” pay-off that must be acknowledged and calculated alongside any trade deficit that accrued. As well, the large budgetary deficits accumulated by America since 1948 have financed the massive military might of the country— generally used, albeit with some unfortunate exceptions— to insure global peace and compliance with global rules and norms by those who might otherwise choose to violate them. For any to argue against this, we would simply remind them of the consequences of post-World War I behaviors: Europe— the overwhelming world leader on essentially any metric chosen at the start of the 20th century— sacrificed nearly everything through adoption of invidious beggar-thy-neighbor protectionist economic policies.

Conclusion: The Time To Act Is Now

We therefore argue that global prosperity is in the American national interest. Our “greatness” cannot be measured by the economic and political deficits we would force trading partners to assume through nationalistic protectionist policies on our part. Rather, it is measured by the collective stability, security, and prosperity that we achieve together, and any accounting of these outcomes must factor them into the final bottom-line tally.

But a problem we clearly acknowledge is that these benefits are measured in the aggregate. When measured in total, over time free trade clearly generates greater benefits than costs as economic efficiencies prevail, waste is reduced, and resource allocation decisions are rationalized— which is the whole point of market-based economic theory. But what this calculation usually fails to adequately address is the social (and increasingly political) costs for some that always accompany economic adjustment. Schumpeter’s “Creative Destruction” is just that— a two-sided sword. But while it is ultimately a force that favors the “creative” side of the equation, by no means should this imply that the negative consequences of change are to be disregarded or neglected as mere collateral damage to be borne by the deplorable or unfortunate.

In our view, a better and more equitable way to address the resulting imbalances and the justifiable grievances of those left behind from economic
progress flowing from globalization and free trade would be to implement a comprehensive new social program, designed to invest displaced factory workers and others with skills to obtain productive employment in emerging economic sectors (e.g., the industrial internet) where such skills are in short supply. In broad form, we envision a modern-day Marshall Plan for America that establishes a foundation for future national greatness. The architecture of such a program would insure strict requirements for participant inclusion, defined metrics for evaluation of participant progress and retention, and tight fiscal oversight—much as how one would manage a successful construction project, for example (something with which the President has familiarity). Tax incentives could be provided to firms that employ program graduates, and penalties imposed on firms that bypass domestic opportunities in favor of off-shore employment; indeed, the entire program could be outsourced to U.S.-based private enterprise with appropriate rewards for achievement (an approach that has succeeded in the past toward public policy goals, for example the construction of affordable housing for low-income citizens).

Moreover, we also would posit that a program such as we advocate be superior to recent discussion about a “guaranteed annual income” as a means to deal with economic transitions. Through provision of marketable skills, our proposal would maintain the dignity of the individual and would thus contribute towards long-term economic rehabilitation of both people and the nation as a whole.

Accordingly, we think that an approach incorporating re-skilling through training can prepare America and Americans for a better future, at a cost significantly less than engaging in trade wars that ultimately distort efficient resource allocation decisions, bring reputational damage, and in general prove destructive for all involved, politically as well as economically. We would urge that a full accounting be used in the bookkeeping involved in this proposal, acknowledging the positive benefits that global peace and stability have generated (assets) alongside the costs of U.S. budgetary and trade balance deficits (liabilities). By improving the domestic situation while remaining the global guarantor of a free and open trading system—the classical “benign hegemon”–we can secure a more stable world based upon shared prosperity reflected in “owners’ equity,” the major proportion of which would still accrue to the USA due to the size, structure, and dynamism of our economy.

Recent events would indicate that we are already beginning to witness a reclassification of national “debits and credits” in the geopolitical balance sheet as we have characterized it in this paper. News reports indicate that President Trump might be altering his views on a number of topics relative to trade; these include, among others, a reversal of earlier claims that China is a currency manipulator, that the Export-Import Bank should be abolished, the Chair of the Fed should go, and that NATO was an obsolete institution (C. Wang, 2017; N. Kitroeff, 2017). To be sure, this might reflect little more than a “learning curve” effect that any President undergoes once the campaign trail ends and the realities of office emerge; as well, the ambiguities of the President’s commitment to his prior statements raise doubts. Nevertheless, it is a tentative start towards a more realistic assessment of the benefits that globalization can provide to the nation as well as the entire world economic system. If this can now be extended and deepened through future Presidential action, we welcome it as a positive step towards increasing the “owner’s equity” of globalization and paving the way for a future stream of dividends that will enrich all stakeholders in the game. This, we conclude, can truly make America great again.

NOTES

¹ Academic approaches to the social sciences tend to separate subjects into discrete categories, as interdisciplinary studies are often perceived as too generalized to be of serious consequence; for example, see issues of the Journal of International Economics or the Political Science Quarterly among others. However, we might also note that President Trump has recently conflated these topical areas: he called on China to get tougher on North Korea’s nuclear armaments program and indicated that China’s trade relations with the US could be improved if that happened; see J. Wagner, “Trump Breaks Silence on North Korea, Defends Reversal on China, The Washington Post (April 16, 2017).

² One need only recall the various anti-free trade legislative actions of many of the trading nations of the world that occurred in the 1920s, capped by passage of the US Smoot-Hawley tariff of 1930 and the 1932 legislation of the Commonwealth countries, to realize how nationalistic economic policies played into political
movements that resulted in the rise of totalitarian dictatorial regimes in Europe and elsewhere and the subsequent descent into WWII. See, for example, A. Tooze, The Deluge: The Great War, America and the Remaking of the Global Order, 1916-1931 (2014) and B. Eichengreen, The European Economy Since 1945 (2007)

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R. Beisner, Dean Acheson- A Life in the Cold War, NY: Oxford U P, 2006, especially chapters 8, 9, and 14. This initiative was an integral part of the policy of “containment” authored by George Kennan, deputy head of the U.S. mission in Moscow. In 1946, Kennan sent a telegram to then Secretary of State James Byrnes outlining a new strategy for diplomatic relations with the Soviet Union, memorialized in a Foreign Affairs article in 1947 (written under the pseudonym “X”) entitled “The Sources of Soviet Conduct.” Ultimately this protracted policy of containment supported by U.S. encouragement of free trade and open markets led to the dissolution of the Soviet Union without direct confrontation between the two super powers during the “Cold War.”


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http://www.tradingeconomics.com/united-states/balance-of-trade (for data on US trade balance history)


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R. Zoellick, “The Currency of Power; Want to understand America’s place in the world? Write economics back into the plan,” Foreign Policy (October 8, 2012)
Mid-Year Enforcement Update page 2

MARC J. FAGEL of Gibson, Dunn & Crutcher LLP highlights significant developments in SEC enforcement during the first half of 2017, including the continued trend of public company financial reporting and insider trading cases.

Sustainability Disclosures in the EU page 12

TRICIA DUNLAP of Dunlap Law PLC, REBECCA GRAPSAS of Sidley Austin LLP, KATRIEN VORLAT of Monard Law, and RAINER LOGES of Gleiss Lutz discuss the EU Directive requiring certain large public companies to provide disclosures concerning environmental, social and employee-related matters, respect for human rights, anticorruption and bribery issues, and board and management diversity.

New SEC Chairman’s Principles page 23

SEC CHAIRMAN JAY CLAYTON lays out the principles he believes should guide the Commission going forward and some places where he sees opportunities to apply these principles to the SEC’s agenda.

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**SECURITIES ENFORCEMENT**

2017 Mid-Year Securities Enforcement Update

While the first half of 2017 was unusually quiet for the SEC’s Division of Enforcement, the trend towards a growing number of public company financial reporting cases continued unabated, as did insider trading cases. But much of the action was in the realm of non-controversial retail fraud—Ponzi schemes and penny stock pump and dump schemes.

By Marc J. Fagel

The first half of 2017 was unusually quiet for the SEC’s Division of Enforcement. This undoubtedly stemmed from the change in administration following the November election. With Chair Mary Jo White and various other members of the agency’s senior leadership (including the Director of the Division of Enforcement) stepping down, and only two sitting Commissioners for much of the period, authorization of new cases slowed somewhat.

Pending the Senate’s confirmation of the new Chair in May, the SEC generally avoided novel or controversial matters. In contrast to recent years, there were no groundbreaking cases involving private investment funds (and, indeed, few investment adviser cases, period) or headline-generating sweeping enforcement initiatives. On the other hand, the trend towards a growing number of public company financial reporting cases continued unabated, though such cases remained on the smaller side. Insider trading cases likewise continued apace. But much of the action was in the realm of non-controversial retail fraud – Ponzi schemes, penny stock pump and dump schemes, and so forth.

However, by May the Commission was again firing on all cylinders—or at least most cylinders, as two of the five Commission seats remain vacant (for what is now going on two years). What remains to be seen is how much the new Chair and new Enforcement leadership team will reshape enforcement practices and priorities.

**Significant Developments**

**New Leadership; New Directions?**

On May 2, 2017, the Senate confirmed Jay Clayton as the new Chair of the SEC. Clayton joined the agency from private practice, where he had spent most of his career as a big-law corporate attorney specializing in mergers & acquisitions and capital markets work.\(^1\) While he has written critically about Foreign Corrupt Practices Act (FCPA) enforcement,\(^2\) his views on other enforcement-related issues remain largely unknown. However, it may be telling that the SEC press release announcing his swearing-in led with his statement, “The work of the SEC is fundamental to growing the economy, creating jobs, and providing investors and entrepreneurs with a share of the American Dream.”\(^3\) Contrast this with the far more enforcement-oriented swearing-in statement from his predecessor, Chair White: “Our markets are the envy of the world precisely because of the SEC’s work effectively regulating the markets, requiring comprehensive disclosure, and vigorously enforcing the securities laws.”\(^4\)

Chairman Clayton’s public statements to date have focused more on issues of capital formation than enforcement. In his first public speech as Chairman, his discussion of enforcement identified as a priority the protection of “Main Street” investors from perpetrators of affinity, microcap and pump and dump frauds.\(^5\) The Chairman also noted the importance of maintaining market integrity and

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efficiency through oversight of professional market participants. With respect to cybersecurity, the Chairman sounded a note of restraint, expressing the need for the SEC to be cautious about punishing companies who are the victims of cyber attacks. (Editor’s note: see accompanying article for an extended excerpt from this speech.)

In June, Clayton appointed his law firm partner Steven Peiken as Co-Director of the Enforcement Division, where he will join Stephanie Avakian, who had served as Deputy Director under prior Division Director Andrew Ceresney. Avakian’s retention as Co-Director suggests some continuity, though Peiken’s impact on enforcement is not easily susceptible to prediction. While, like Clayton, he joins the agency from the defense bar, he also had spent eight years as an Assistant U.S. Attorney in the Southern District of New York (an experience he shares with Ceresney).

Of course, most of the work of the Enforcement Division is relatively non-controversial; whether to sue crooked stock promoters, insider traders, or corporate officials who falsify financial statements is not a matter of political ideology. The real question is the extent to which the new administration will pursue some of the more aggressive enforcement practices of the prior administration, including:
- Demanding admissions of wrongdoing from selected defendants as a condition of settlement;
- Far-reaching “sweeps” against multiple parties for technical, non-fraud securities law violations;
- Significant monetary penalties from public companies in corporate misconduct cases;
- Expansive fee and expense disclosure requirements for private fund managers;
- Broad use of in-house administrative proceedings in lieu of federal court trials; and
- Enhanced whistleblower protection, including continuing crackdown on routine corporate confidentiality agreements.

In their initial weeks in office, neither Avakian nor Peiken has given any speeches providing insight into their priorities. In their lone joint interview upon their appointment, Avakian and Peiken heralded cybersecurity as a major enforcement priority for the Division. They noted an uptick in the number of SEC investigations involving cybercrime in recent years, leading the agency to start collecting relevant statistics to detect broader market-wide issues. Among other things, the Division is looking at individuals stealing information for the purpose of insider trading or hacking into accounts to steal assets, place unauthorized trades, or manipulate markets. But the interview made no reference to broader Enforcement priorities or potential changes to SEC practices.

Now, only the Co-Directors of Enforcement can authorize formal orders on behalf of the Commission.

Indeed, the most significant practical change in Enforcement tactics was made prior to the new Chair’s appointment, under Acting Chair Michael Piwowar. According to news reports, Piwowar revoked the authority that had been delegated to senior Enforcement Division officials nationwide to issue formal orders of investigation, which had allowed for more expedited issuance of subpoenas requiring witnesses to testify under oath and produce documents to the SEC staff. This procedural change reverses then-Chair Mary Schapiro’s 2009 decision to give more investigative authority to senior enforcement attorneys in response to the financial crisis. Now, only the Co-Directors of Enforcement can authorize formal orders on behalf of the Commission. This may be a first step towards eliminating delegated authority entirely and returning to the pre-2009 procedures, under which the SEC Commissioners themselves would need to approve all formal investigations. While the Commissioners rarely if ever rejected formal order requests in the past, this change would slow investigations and provide the Commissioners with greater oversight of the Enforcement Division’s investigative docket.
Ultimately, the pace and scope of the Enforcement Division’s work may be driven less by policy changes than by budgetary ones. Chairman Clayton (and the Administration) have proposed a 2018 budget of $1.6 billion—essentially unchanged from 2016 and 2017. The proposed budget would reduce the size of the Enforcement Division staff by a few dozen, which could impact the number of new investigations pursued by the Division. By contrast, prior to leaving the SEC, former Chair White had proposed a preliminary fiscal increase for 2018 of $445 million over the agency’s request for 2017. Under the current budget proposal, the Division of Enforcement is facing a $10 million decrease from 2017. That said, the SEC’s budget essentially has doubled over the past decade, and the agency is certainly better situated than other federal agencies facing massive proposed cuts under the new Administration.

Whistleblowers

The SEC continued to roll out multi-million dollar whistleblower awards throughout the first six months of the year, including:

- On January 6, the SEC announced an award of more than $5.5 million to a company employee who provided “critical” information that allowed the SEC to uncover the employer’s ongoing scheme.

- On January 23, the SEC rewarded three whistleblowers for their assistance in the agency’s successful prosecution of an investment scheme by giving $4 million to the whistleblower responsible for the SEC opening its investigation, and splitting $3 million between two additional whistleblowers who contributed new information during the investigation.

- On April 25, the SEC disclosed an award of nearly $4 million to a whistleblower who gave the agency “detailed and specific information about serious misconduct,” then assisted during the investigation itself by offering their industry expertise.

- And on May 2, the SEC authorized more than $500,000 to a company insider whose information revealed hard-to-detect securities laws violations.

The SEC also continued its crackdown on corporate confidentiality agreements perceived as impeding potential whistleblowers from coming forward. The SEC brought a pair of settled actions involving severance agreements which removed the financial incentives for blowing the whistle. In a settled cease-and-desist order, the SEC criticized a financial services firm for “directly target[ing] the SEC’s whistleblower program” by including provisions in its separation agreements that forced departing employees to waive “any right to recovery of incentives for reporting of misconduct” before the employees could receive separation payments from the company. The firm agreed to pay a $340,000 penalty, in addition to taking other remedial actions.

Two days later, the SEC announced another settled action against a company that had allegedly taken actions that could potentially discourage whistleblowers. First, the company’s severance agreements included provisions that waived a departing employee’s entitlement to monetary rewards for reporting issues to government entities. Second, according to the SEC, the company took steps to identify an employee whistleblower it assumed existed after the SEC requested the company produce documents related to certain accounting issues. Without admitting any wrongdoing, the company agreed to pay a $500,000 penalty to settle the case (including the part of the case arising out of the underlying accounting issues).

Recent weeks also saw a significant legal development involving whistleblower retaliation. In June, the Supreme Court granted cert in a case expected to resolve a circuit split among the Second, Fifth and Ninth Circuits as to whether Dodd-Frank’s anti-retaliation provision for “whistleblowers” extends to internal whistleblowers—that is, those who have not reported the alleged misconduct to the SEC. Digital Realty Trust Inc. v. Paul Somers arose from claims by a former executive that the company terminated him after he had complained to senior management about an executive who had eliminated certain internal
company controls. The district court denied the company's motion to dismiss the complaint, and a divided Ninth Circuit upheld the decision on the grounds the anti-retaliation provision in Dodd-Frank protected “unambiguously and expressly” internal whistleblowers, as well as those reporting to the SEC. The decision is at odds with a Fifth Circuit panel that said only those who report to the SEC are protected under the provision.

**Administrative Proceedings**

Throughout the past administration, the SEC’s increasing use of its administrative forum for litigated enforcement actions—and the subsequent reversal of this trend—was a consistent theme of these publications. The phenomenon led to constitutional challenges to SEC administrative proceedings, and one issue—the manner in which the SEC appoints its administrative law judges—now appears likely to be headed to the Supreme Court.

**The Division of Enforcement appears to have shifted back towards pursuing more litigation in federal court.**

In contrast to *Bandimere*, the D.C. Circuit Court of Appeals had come to the opposite conclusion in August 2016, upholding the constitutionality of the SEC’s administrative law judge appointments in *Lucia v. SEC*. On June 26, 2017, the D.C. Circuit divided evenly on the respondent’s *en banc* rehearing petition; as a result, the original panel decision remains in place, leaving a split between the D.C. and Tenth Circuits that may be heading toward the Supreme Court for resolution.

Amidst the judicial challenges to SEC administrative proceedings, as well as questions being asked about the overall fairness of such proceedings, the Division of Enforcement appears to have shifted back towards pursuing more litigation in federal court. According to one report, SEC administrative law judges issued only eight initial decisions in the first quarter of 2017—half as many as in the first quarter of 2016.

**Other Significant Court Rulings**

On June 5, 2017, the Supreme Court issued a significant decision applying a five-year statute of limitations to SEC claims for disgorgement. In *Kokesh v. SEC*, the Court unanimously held that “[d]isgorgement in the securities-enforcement context is a ‘penalty’ within the meaning of” 28 U.S.C. § 2462, and thus SEC enforcement actions seeking disgorgement “must be commenced within five years of the date the claim accrues.” The ruling follows the Court’s earlier unanimous decision applying § 2462’s five-year limitations period to SEC claims for civil money penalties.

The Court’s unanimous decision terminates the SEC’s longstanding practice of seeking disgorgement based on conduct that occurred more than five years before filing. No less significantly, the Court’s broad reasoning in *Kokesh* would appear on its face to apply equally to SEC claims for other relief that may operate as a penalty—such as associational or practice bars and injunctions—which the SEC historically has contended are not subject to the statute of limitations (with mixed results in the lower courts). However, in a decision shortly after *Kokesh*
down, the Eighth Circuit Court of Appeals concluded that an “obey the law injunction” did not constitute a penalty subject to the five-year statute of limitations. In *Collyard v. SEC*, the court acknowledged *Kokesh*’s broad language, but while contending it did not need to resolve the issue, concluded that the injunction was purely remedial and not punitive and thus outside the scope of § 2462.27

**Potential Legislation**

On June 8, 2017, the Republicans in the U.S. House of Representatives passed H.R. 10, the “Financial CHOICE Act,” which would repeal a number of reforms established by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.28 While much of the attention on the legislation has focused on its impact on Dodd-Frank’s banking regulations, the bill also has a number of provisions aimed at SEC enforcement practices. Although the CHOICE Act is not expected to pass the U.S. Senate, the bill reveals which current SEC enforcement policies and tactics may subject to scrutiny under a Republican-controlled Congress and administration.

For example, the Act targets the Enforcement Division’s use of administrative proceedings rather than federal court for litigated actions, as referenced above. Currently, the SEC has the discretion to choose whether to pursue an enforcement action in federal court or in an administrative proceeding (AP); the CHOICE Act effectively eliminates this discretion by permitting AP respondents to petition the SEC to file the case in federal court instead. In addition, for those respondents who choose to litigate in the administrative forum, the legislation would require the Enforcement Division to prove its case through clear and convincing evidence, rather than the lower preponderance of the evidence standard currently applicable in federal court and APs.

The CHOICE Act also includes several other provisions aimed at providing greater oversight of SEC investigations and enforcement actions, including:

- Requiring additional economic analysis before monetary penalties can be imposed on public companies, and curtailing other sanctions, including officer and director bars;
- Giving the recipient of a Wells notice—the indication from the Enforcement staff of its intention to recommend that the Commission authorize an enforcement action—the right to make an in-person presentation to the SEC staff, and permitting the Commissioners themselves to attend such a presentation if they choose;
- Prohibiting the SEC from bringing an enforcement action absent specific guidance that the conduct in question violated the federal securities laws; and
- Appointing an “Enforcement Ombudsman” for persons under investigation by the SEC.

**Public Company Reporting and Accounting Cases**

**Revenue Recognition Cases**

For anyone who thought revenue recognition-related fraud was a thing of the past, 2017 provided a rude awakening, with a significant number of accounting fraud cases involving efforts to prematurely record revenue or otherwise artificially boost revenue through financial tricks.

In January, the SEC instituted settled proceedings against a Texas-based medical device company alleged to have improperly recorded revenue for contingent transactions and for sales subject to significantly extended payment terms.29 According to the SEC, the misconduct was widespread and continued for several years. The SEC simultaneously accused the company of violating the Foreign Corrupt Practices Act. The company agreed to admit wrongdoing (despite receiving credit for its cooperation) and to pay over $14 million in disgorgement and penalties (of which $8.25 million was attributed to the accounting issues). In related settlements, a former accounting executive agreed to pay a $20,000 penalty and to be suspended from appearing before the SEC as an accountant for two years, and two former sales executives agreed to pay
penalties of $40,000 and $25,000. The company's former CFO agreed to reimburse the company for bonuses he received during the period when the company committed accounting violations and to pay a $35,000 penalty. The CEO, who was not charged with wrongdoing, already had reimbursed the company for cash bonuses and stock awards during the period in question and thus the SEC did not seek a clawback.

Also in January, the SEC instituted settled proceedings against a government contractor for its failure to maintain proper internal controls related to revenue recognition. According to the SEC, the company improperly recorded millions of dollars in revenue by creating invoices associated with unresolved claims against the U.S. Army that were never paid, and whose payment was still known to be in dispute. The SEC noted that personnel alerted internal audit of the issue by filing an ethics complaint, but internal audit failed to uncover the improper billing due to a failure to understand the complicated billing procedures. Without admitting wrongdoing, the company agreed to pay a $1.6 million penalty. The SEC subsequently pursued charges against two company executives; a division president agreed to pay a $25,000 penalty, while a vice president is litigating against the agency.

In February, the SEC filed a litigated case against the former CFO and director of accounting of a California-based computer network testing company, while simultaneously settling with the company and CEO. The SEC alleged that the company artificially divided revenue from software sales and related training and professional services in order to accelerate revenue recognition. Without admitting or denying the allegations, the company agreed to pay a $750,000 penalty, and the CEO agreed to a five-year officer-and-director bar and a $100,000 penalty. In its ongoing litigation against the CFO and director of accounting, the SEC alleges that the executives enabled and implemented the policy and then concealed the practice from auditors.

The SEC announced a settlement in March with the former CFO of a Colorado-based environmental solutions company, alleging that he oversaw the inaccurate recording of multiple transactions, including prematurely recognizing revenue on long term contracts as well as failing to record a significant loss contingency in connection with an adverse arbitration ruling and failing to properly account for warranty accruals. The CFO agreed to pay disgorgement and penalties totaling almost $250,000 and to be barred from serving as an officer or director of a public company or appearing before the SEC as an accountant for five years. Without admitting the allegations, the company agreed to pay a $500,000 penalty.

Also in March, the SEC alleged that one of Mexico’s largest homebuilders, a NYSE-listed company, overstated revenue by about $3.3 billion by reporting fake sales of homes for a more than three-year period. According to its press release announcing the action, the SEC used satellite imagery to demonstrate that the company had not even broken ground on many homes for which it had reported revenues, and asserted that the company’s financial results were “almost completely made up.” Without admitting or denying allegations, the company agreed to be prohibited from offering securities in U.S. markets for at least five years.

In May, the SEC instituted settled proceedings against a South Korean semiconductor manufacturer and its former CFO for allegedly inflating revenue through incomplete shipments, and managing earnings through improper round-trip transactions and delayed booking of obsolete inventory. Without admitting wrongdoing, the company agreed to pay a $3 million penalty, and the CFO agreed to pay a $135,000 penalty and to be barred from serving as an officer or director or from appearing as an accountant before the SEC.

Earnings Management and Other Financial Fraud

The SEC also brought a number of cases alleging various earnings irregularities. In January, following an earlier settlement with a Kentucky wire and cable company, the SEC charged the former CEO and CFO of a foreign division with fraudulently
concealing inventory accounting errors from executive management. The complaint alleged that, in addition to concealing tens of millions of dollars of missing inventory, these executives directed subordinates to destroy documents and conceal accounting problems in furtherance of the fraud. A former senior vice president separately agreed to cooperate with the SEC’s investigation and to settle the charges against him.

Also in January, the SEC charged a shipping conglomerate and its former CFO with inflating earnings by failing to recognize hundreds of millions of dollars in tax liabilities. According to the SEC, the company had accumulated $512 million in unrecorded tax liabilities over a 12 year period. Without admitting the allegations, the company agreed to pay a penalty of $5 million, and the former CFO agreed to pay a $75,000 penalty.

In late June, the SEC filed a complaint against an oil and gas company and its top finance executives alleging an extensive, multi-year accounting fraud. Multiple top executives, including the former CFO, allegedly moved hundreds of millions of dollars in expenses to capital expenditure accounts to artificially reduce operating costs. The former operations controller is cooperating with the SEC and has agreed to settle with a permanent injunction, suspension, and officer-and-director bar. The SEC’s litigation against the other executives—the former CFO and former vice president of accounting and reporting—is ongoing. The SEC also noted that two former CEOs, who were not charged, already had reimbursed the company for bonuses and stock awards and thus no clawback proceedings were necessary.

Also in June, the SEC charged two executives from a Chicago-area information technology company with siphoning millions of dollars out of the company through an accounting fraud scheme. The company agreed to settle the case subject to terms to be set by the court, while the former CEO and CFO face both the SEC action as well as related criminal charges filed by the U.S. Attorney’s Office. And in another litigated action filed in June, the SEC charged a Las Vegas-based hemp oil company and its CEO with overstating the company’s assets by reporting the purchase of another company at a highly inflated value.

Internal Controls and Disclosures

In January, the SEC instituted settled proceedings against a U.S. automobile manufacturer for its alleged failure to properly assess the potential impact of a defective ignition switch. According to the SEC, as a result of the company’s deficient internal controls, an internal investigation into the defective switches proceeded for 18 months without notifying accountants at the company of a possible recall, preventing the company from properly evaluating potential losses from such a recall. Without admitting the allegations, the company agreed to pay a $1 million penalty.

Also in January, the SEC instituted settled proceedings against a New-York based marketing company for improper disclosures of a non-GAAP financial measure as well as failures to disclose certain perks enjoyed by its then-CEO. The company presented a metric called “organic revenue growth” that measured revenue absent the effects of two reconciling items. However, without informing investors, the company added a third reconciling item into its calculation, which inflated organic revenue growth results. The company also failed to give GAAP measures equal or greater prominence than related non-GAAP metrics in its earnings releases. Finally, the SEC alleged that the company had disclosed an annual perquisite allowance of $500,000 for its CEO, but failed to disclose additional personal benefits including the company paying for private aircraft usage, club memberships, cosmetic surgery, and other personal expenses. The CEO resigned and returned over $11 million to the company. Without admitting or denying the allegations, the company agreed to pay a $1.5 million penalty to settle the case. The SEC subsequently settled with the CEO for $5.5 million in disgorgement and penalties and a five-year officer and director bar.

In June, the SEC instituted settled non-fraud proceedings against the former CEO and CFO of
a Southern California freight forwarding and logistics company (subsequently acquired by a Danish entity) for failing to include adequate information in the company’s MD&A regarding the company’s liquidity and future prospects. According to the SEC, the company’s internal operating system was causing late invoices and delayed payments, but the company failed to report the cause of its cash flow problems. The two former officers agreed to pay penalties of $40,000 each.

Corporate Control Cases

In addition to more traditional accounting cases, the SEC pursued a number of cases against public companies for issues arising out of changes in corporate control. In January, the SEC announced that a subsidiary of a large Ireland-based drug manufacturer agreed to admit securities law violations and pay a $15 million penalty for disclosure failures in the wake of a hostile takeover bid. The company received a tender offer in June 2014, in response to which it filed a Schedule 14D-9 with the SEC stating that the offer was inadequate and that the company was not undertaking or engaged in negotiations that could result in an “extraordinary transaction.” However, after this disclosure, the company engaged in negotiations with other potential bidders, culminating in a November 2014 merger announcement. The SEC alleged that the company failed to amend its earlier filing even though material changes had occurred.

On Valentine’s Day, the SEC announced a pair of cases also involving disclosures during battles for corporate control. In one case, the SEC alleged that a Texas-based oil refinery company had failed to adequately disclose the material terms of its “success fee” arrangements worth $36 million with two investment banks it retained to fend off a hostile takeover bid. The SEC alleged that the company did not adequately inform shareholders of potential conflicts of interest that stemmed from the fee arrangements—namely that the banks could still earn success fees even if the hostile bidder secured control. The company settled the case without admitting the allegations and avoided a penalty because of its remedial acts and extensive cooperation with the SEC’s investigation.

In the other case, the SEC alleged that groups of activist investors failed to adequately disclose information during a series of campaigns to exert influence over public microcap companies. According to the SEC, the investors (including individuals and fund managers) collectively owned more than five percent—and sometimes more than ten percent—of the companies’ outstanding common stock, yet their disclosures of ownership percentages required by Sections 13(d) and 13(g) of the Exchange Act were either incomplete, untimely, or absent. Without admitting the SEC’s allegations, the investors consented to penalties ranging from $30,000 to $180,000.

Auditor Cases

In contrast to past years, the SEC brought relatively few cases against auditors, and the few cases it did pursue involved smaller firms auditing primarily brokers and advisers, rather than public companies. However, the Enforcement Division’s focus on accounting fraud investigations would make this appear to be more of an anomaly than a trend.

In May, the SEC instituted a settled proceeding against the engagement partner of an accounting firm for his audit of an oil and gas investment fund. The SEC alleged that the partner failed to adequately plan the audit, which resulted in certain deficiencies in auditing the fair value of the fund’s assets, and failed to adequately supervise the audit team. Without admitting the allegations, the partner agreed to a two-year bar from appearing before the SEC.

And in June, the SEC instituted settled proceedings against an auditor based on his failure to obtain engagement quality reviews for his audits of multiple broker-dealer clients, as well as auditor independence deficiencies. The auditor and his firm agreed to be barred from appearing before the SEC for seven years and to pay a $35,000 penalty.
Conclusion

At the current time, the 5-person Commission still has two vacancies. The new Enforcement Division leadership has had little to say publicly. And enforcement actions appearing on the SEC's press page since the end of June, aside from one large FCPA action (alleging conduct no more recent than 2011), were primarily limited to boiler room scams and offering frauds. The direction of SEC enforcement in the Clayton era thus remains somewhat to-be-determined.

Notes

available at www.bna.com/sec-inhouse-decisions-n57982086473/.


27. SEC v. Collyard, No. 16-1405 (8th Cir. June 29, 2017).


The European Union’s 2014 directive requires enhanced disclosure of corporate social responsibility matters and is in different stages of implementation across EU member states. US companies should be aware of this important development and what it means for them.

By Tricia Dunlap, Rebecca Grapsas, Katrien Vorlat, and Rainer Loges

Boards, managers, investors and other stakeholders increasingly are focused on the impact of sustainability performance on operations and corporate value. The resulting demand for corporate sustainability disclosures comes after decades of work by investors, business interests, regulators, and non-governmental organizations in driving these issues into the mainstream.

While the US is often at the vanguard of enhancing disclosure through regulation, the European Union has taken the lead on corporate social responsibility (CSR) disclosures. A significant development has been the EU Parliament’s passing of EU Directive 2014/95/EU (2014 Directive). The 2014 Directive requires certain large companies to provide disclosure with respect to environmental matters, social and employee-related matters, respect for human rights, anticorruption and bribery issues, and board and management diversity. The 2014 Directive requires member states to pass legislation implementing the 2014 Directive by December 2016, with disclosure—on a comply or explain basis—beginning in 2018.

Background to the 2014 Directive

The EU’s official embrace of CSR dates to at least July 2001, when the European Commission presented a Green Paper called “Promoting a European Framework for Corporate Social Responsibility” (2001 Green Paper). In that paper, the Commission defined CSR as “a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment.” The Council of the European Union welcomed the 2001 Green Paper and declared that “[s]ocial responsibility can contribute not only to encouraging a high level of social cohesion, environmental protection and respect for fundamental rights, but also to improving competitiveness in all types of businesses.”

The 2001 Green Paper sought input from public authorities, international organizations, corporations, social partners, non-governmental organizations, other stakeholders and interested individuals on “how to build a partnership for the development of a new framework for the promotion of corporate social responsibility, taking account of the interests of both business and stakeholders.” The Commission received more than 250 responses to the 2001 Green Paper. The consultation resulted in the Commission issuing another Green Paper in 2002 (2002 Green...
that, among other things, proposed a strategy for the EU to promote CSR. The 2002 Green Paper stated that “[d]espite the wide spectrum of approaches to CSR, there is large consensus on its main features:

- CSR is behaviour by businesses over and above legal requirements, voluntarily adopted because businesses deem it to be in their long-term interest;
- CSR is intrinsically linked to the concept of sustainable development: businesses need to integrate the economic, social and environmental impact in their operations;
- CSR is not an optional ‘add-on’ to business core activities—but about the way in which businesses are managed.”

The Commission found that “responsible behaviour leads to sustainable business success” and proposed to focus its strategy on the following areas:

- Increasing knowledge of the business case for CSR’s positive impact on business and society;
- Developing the exchange of CSR experience and best practices;
- Promoting the development of CSR management skills;
- Fostering CSR among small and medium enterprises;
- Launching an EU-wide multi-stakeholder forum on CSR; and
- Integrating CSR into European community policies.

In the 2002 Green Paper, the EU stated its commitment to fully integrating economic, CSR and fundamental human rights (including labor standards and gender equality) into its policies and actions and in 2003 began making good on that commitment with its communication titled “Modernising Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward.” In that document, the Commission stated its objectives to foster efficiency and competitiveness of business, and strengthen shareholders rights and third parties protection, noting that “[w]ell managed companies, with strong governance records and sensitive social and environmental performance, outperform their competitors.” Thereafter, the Commission continued to issue communications promoting CSR and the need for transparency in relation to CSR matters, and in 2011 formalized its strategy into a three-year plan that ultimately culminated in the EU Parliament’s adoption of the 2014 Directive. The 2014 Directive amends EU Directive 2013/34/EU on annual financial statements and consolidated financial statements (2013 Directive), which requires, among other things, disclosure of payments to governments by companies that are active in the extractive business or in the business of logging primary forests.

Key Features of the 2014 Directive

The 2014 Directive consolidates all major non-financial reporting requirements applicable to certain large companies. By reporting annually on a certain set of CSR factors, the EU seeks to improve consistency and comparability of the information disclosed by companies and corporate groups, with a view to enhancing long-term sustainable corporate performance and increasing investor and consumer trust.

Applicability

Most of the CSR reporting requirements set forth in the 2014 Directive apply to companies meeting each of the following requirements:

- The company is a public-interest entity, which is defined to include, among others:
  - Companies that are governed by the law of an EU member state and whose transferable securities are admitted to trading on a regulated market of any member state;
  - Banks and financial institutions;
  - Insurance and reinsurance companies; and/or
  - Companies designated by member states as public-interest entities, for example, companies of significant public relevance because of the nature of their business, their size or the number of employees; and

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On the balance sheet date, the company or its consolidated group qualifies as large in that it has:

- At least 500 employees on average during the financial year; and
- A balance sheet total of at least EUR 20 million or net turnover of at least EUR 40 million.19

EU listed companies also are required to provide diversity-related disclosure (described below) if they exceed the limits of at least two of the following three criteria:

- A balance sheet total of EUR 20 million;
- Net turnover of EUR 40 million; and
- Average number of employees during the financial year of 250.20

Member states have flexibility to apply the 2014 Directive’s reporting requirements to a broader group of companies, such as smaller companies and/or foreign companies with a significant presence in the member state. For example, as discussed below, the Belgian government expanded the scope of the 2014 Directive to government (majority) owned companies, as they should lead by example.

**Disclosure Requirements**

The 2014 Directive requires large public-interest entities to include in the management report section of the annual report21 information to the extent necessary for an understanding of the company’s “development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.”22

Large public-interest entities are required to provide the following disclosure with respect to each of these matters, or provide a clear and reasoned explanation for not providing such disclosure (comply or explain):

- A brief summary of the company’s business model;
- The policies pursued by the company, including due diligence processes, and the results achieved from those policies;
- The principal risks related to these matters linked to the company’s operations including, where relevant and proportionate, its business relationships, products or services which are likely to cause adverse impacts in those areas, and how the company manages those risks; and
- The non-financial key performance indicators that are relevant for the specific business activities of the company.23

The 2014 Directive also requires EU listed companies to include in the corporate governance statement section of the management report a description of the company’s diversity policy in relation to the company’s board, management and administrative bodies, or explain why the company has no such policy. The description should address issues such as age, gender, and educational/professional background and the objectives of the policy, how it was implemented and the results achieved during the reporting period.24

Member states can incorporate a safe harbor provision into national law, by permitting companies to omit information where the board and management has determined that disclosure would be “seriously prejudicial” to the company’s commercial position, provided that such omission does not prevent a fair and balanced understanding of the company’s development, performance, position and impact of its activity.25

Member states may require the CSR disclosure to be included in a report that is separate from the annual report, provided the company publishes the separate report together with the management report or posts it on the company’s website within six months after the balance sheet date and refers to it in the management report.26

Corporate groups are required to prepare reports on a consolidated basis, i.e., at the same level at which annual consolidated financial reports are prepared in compliance with the 2013 Directive.27

**Independent Verification**

The 2014 Directive requires a statutory auditor or audit firm to verify that the management report or separate report includes CSR disclosure. The member states also may require an independent assurance
services provider to verify the information itself that is included in such disclosure.28

Implementation

The deadline for member states to implement the 2014 Directive was December 6, 2016.29 Despite the deadline having passed, many member states have yet to implement the 2014 Directive into national law—though legislation is pending in some jurisdictions. Member state delays in implementing EU directives are not unusual.

Originally, companies impacted by the Directive were due to begin disclosures in 2017—for the 2016 reporting year. However, the Commission pushed this start date back to 2018 so that companies could take into account non-binding guidelines on the disclosure of information required by the 2014 Directive that were adopted by the Commission on June 26, 2017 (Guidelines).30

The Guidelines are designed to help companies fulfill the requirement to disclose relevant and useful information on environmental and social matters in a consistent and more comparable way. Frequently asked questions accompanying the Guidelines clarify that companies retain “significant flexibility” to disclose relevant information in the way that they consider most useful. Furthermore, they may use international, European or national guidelines according to their own characteristics or business environment, such as the United Nations Guiding Principles on Business and Human Rights, ISO 26000, or the German Sustainability Code. In developing the Guidelines, the Commission took into account the results of its own consultation as well as the work of the Financial Stability Board’s Task Force on Climate-Related Financial Disclosures.31

Implementing the 2014 Directive

Once implemented, the 2014 Directive will harmonize national laws with respect to key CSR-related disclosures. The flexibility built into the 2014 Directive will result in some differences among member state requirements.

United Kingdom

The UK implemented the 2014 Directive by adopting new regulations that amend the Companies Act 200632 and amending the Disclosure and Transparency Rules (DTR).

The UK has implemented a dual narrative reporting regime as follows:

- Companies covered by the 2014 Directive will need to include in the strategic report section of the annual report a statement containing the information required by the 2014 Directive.33 This information does not need to be verified by an independent assurance services provider although companies can do this on a voluntary basis.
- Companies not covered by the 2014 Directive (such as smaller companies) will continue to comply with pre-existing UK non-financial reporting requirements.
- Note that where appropriate, a company can choose to comply with the 2014 Directive’s regime, rather than the comparable domestic provisions, on a voluntary basis in order to prevent those companies at the margins of the 2014 Directive’s scope from having to move between disclosure regimes due to changes in their size from year to year.

The majority of CSR disclosure requirements under the 2014 Directive are similar to, or already reflected in, the UK’s pre-existing strategic report requirements as set forth in Part 15 of the Companies Act 2006 (as amended).34 Companies must produce a strategic report35 and a directors’ report that are included in the annual report.36 The content of each report depends on the size of the company and whether it is quoted or has a premium listing of equity shares on the main market of the London Stock Exchange. UK companies also may be required to disclose CSR-related information outside of the annual report. For example, certain companies are or will be required to disclose steps taken to ensure that the supply chain is free from slavery (required by the Modern Slavery Act 2015), and information about the gender pay gap (disclosure required beginning April 2018).37
Strategic report. The purpose of the strategic report is to inform the company's shareholders and help them assess how the directors have performed their statutory duty to promote the success of the company. It must contain a fair review of the company's business, and a description of the principal risks and uncertainties facing the company. To the extent necessary for an understanding of the development, performance or position of the company's business, the report is required to include analysis using financial and (where appropriate) non-financial key performance indicators (KPIs), including information relating to environmental matters and employee matters.

Quoted companies also must disclose in the strategic report the main trends and factors likely to affect the future development, performance and position of the company's business; and information about environmental matters (including the impact of the company's business on the environment); the company's employees; and social, community and human rights issues. Quoted companies must also include a description of the company's strategy, a description of the company's business model and information on gender diversity broken down by directors, other senior managers, and company employees.

Directors' Report. The contents of the directors' report depends on the size of the company and may include CSR disclosures. For example, quoted companies are required to disclose greenhouse gas emissions and companies with more than 250 employees are required to disclose the company’s policy on employment of disabled persons.

The Financial Conduct Authority amended the DTR to require UK companies with securities admitted to trading on a regulated market in the EU to include information on board and management diversity in the corporate governance statement. Companies that meet the size criteria to qualify as small or medium-sized under UK company law are exempt from the new DTR requirement. For financial years beginning on or after January 1, 2017, this statement must include a description of the diversity policy applied to the company's administrative, management and supervisory bodies with regard to aspects such as age, gender or educational and professional backgrounds, the objectives of the diversity policy, how the diversity policy has been implemented, and the results in the reporting period. If the company has not adopted a diversity policy, the corporate governance statement must explain why this is the case.

The UK government has implemented the 2014 Directive notwithstanding the so-called Brexit vote. Until exit negotiations have concluded, the UK remains a full member of the EU and all the rights and obligations of EU membership remain in force. The UK is generally supportive of transparency in corporate reporting and already has a well-established regime for non-financial reporting. As noted above, the matters covered by the 2014 Directive were in many respects already part of the UK regime. Going forward, once the UK exits from the EU, divergences may appear if the EU makes further changes and the UK does not wish to align its disclosure regime with those changes.

Germany

Prior to the implementation of the 2014 Directive, German law did not require CSR disclosure.


The legislation amended the German Commercial Code (Handelsgesetzbuch) so as to be fully in line with the 2014 Directive. The scope of application is set out in the new Section 289b of the Commercial
Code and requires major capital market-orientated companies (i.e., mainly listed companies) having more than 500 employees and meeting either the balance sheet test or net turnover test set forth in the 2014 Directive (described above) to include CSR disclosure in the status report that is included in the annual report (Lageberichte).

The reporting requirements under the legislation comprise five aspects:

- Environmental concerns (e.g., greenhouse gas emissions, water consumption, air pollution, use of renewable and non-renewable energies, protection of biodiversity);
- Employee concerns (e.g., measures guaranteeing gender equality, working conditions, implementation of fundamental ILO Conventions, observance of the rights of employees and trade unions, occupational health and safety);
- Social concerns (e.g., information on social activities at local community or regional level or on measures taken to ensure the protection and development of local communities);
- Human rights (e.g., information on the avoidance of human rights violations); and
- Combatting bribery and corruption (e.g., existing instruments for doing so).

The new law also specifies the content of the non-financial reporting. Companies are required to provide details on which policies (including due diligence processes) they have introduced to promote the aspects listed above and what results have been achieved. In the absence of a policy for a particular aspect, the company will be obliged to give a clear explanation of the reasons for such absence in its non-financial declaration. Companies also are required to disclose the material risks ensuing from the company’s operations and business relations that are very likely to have an adverse impact on the above aspects, and to explain how these risks are dealt with. The disclosure is also required to include the key non-financial company performance indicators. An exception to the duty to disclose may apply if such reporting would cause considerable harm to the company concerned in cases where, for example, there is a risk of disclosing competitively sensitive information or business secrets.

Companies also are required to disclose their diversity policies in line with requirements that track the language of the 2014 Directive.

Companies are required to disclose CSR information in German and English, for all fiscal years beginning after December 31, 2016. They may disclose CSR information in:

- The annual report as an extension of the status report;
- A separate sustainability report included in the annual report but outside the status report; or
- A separate sustainability report published within six months of the end of the fiscal year, provided the company’s status report indicates where the separate sustainability report can be found on the corporate website.

The new law does not require CSR information to be reviewed by an auditor other than to check that the disclosure has been made. Companies can arrange for voluntary audits of content; if so, the findings are required to be made publicly available. Note that an external audit might, however, be introduced by the back door. In this regard, the new law provides for amendments to the German Stock Corporation Act (Aktiengesetz): Section 171(1) Stock Corporation Act (new version) requires the supervisory board to audit the separate non-financial declaration. To avoid liability risks the supervisory board may seek to protect itself through a voluntary external audit. Section 111(2) Stock Corporation Act (new version) therefore now explicitly entitles the supervisory board to engage an external auditor to audit the non-financial declaration. It remains to be seen how companies will deal with this in practice.

The new law also provides for considerable fines on companies with reporting obligations that fail to make the relevant information public. Fines may amount up to EUR 10 million or up to five percent of the yearly turnover of the affected company.
Belgium

On July 20, 2017, the latest text of the draft legislation implementing the 2014 Directive (Draft CSR Act) was presented by the Belgian Government to the Parliament, which approved the text. The Draft CSR Act requires promulgation by the King to become final.

Article 3 of the Draft CSR Act requires large public-interest entities to provide CSR disclosures. Public-interest entities include, among others, banks, financial institutions, insurance and reinsurance companies as well as listed companies. Large companies are enterprises that on the balance sheet date of the latest approved accounts have:

- At least 500 employees on average during the financial year; and
- A balance sheet total of at least EUR 17 million or net turnover of at least EUR 34 million (excluding value-added tax)—these thresholds are lower than those set forth in the 2014 Directive.

Article 4 of the Draft CSR Act also imposes CSR disclosure responsibilities on certain government-controlled companies, on the basis that such companies should lead by way of example.

The Draft CSR Act tracks the language of the 2014 Directive in terms of the content of the required disclosures. Companies are required to disclose policies, main risks and outcomes relating to environmental matters, social and HR related issues, respect of human rights as well as bribery issues. In respect to these issues the company shall describe the policies pursued and results achieved, the business model adhered to, the monitoring of the risks linked to CSR matters as well as non-financial key performance indicators that are relevant for the specific business activities pursued by the company. A company that is subject to CSR reporting can provide the required disclosure or explain why it does not comply. Belgian companies can use the European or international recognized reference models, such as EMAS, ISO 26000, to make such disclosures. A Royal Decree possibly may specify which reference models would take preference.

The Draft CSR Act permits an exemption where disclosure would be seriously prejudicial to the commercial position of the company, provided that such omission does not prevent a fair and balanced understanding of the company's or group's development, performance, position and impact of its activity.

The Draft CSR Act also requires listed companies to disclose their diversity policy applicable to the board and senior management, including the policy's objectives, implementation and results achieved. Diversity pertains not only to gender but also to age, education and professional experience. In addition, this disclosure is required to describe what efforts the company has undertaken to have at least one-third of the board be comprised of women. If a listed company has no diversity policy, it must explain why.

The Draft CSR Act permits companies to include CSR disclosure in a separate report, instead of the annual report, provided the separate report is made public jointly with the annual report. Companies must submit this disclosure for information purposes to the works council. The statutory auditor is required to verify that the company has provided CSR disclosure.

The Draft CSR Act introduces a criminal sanction in case of non-disclosure of CSR information. Directors of non-compliant companies may face criminal fines and/or imprisonment.

The enactment of the Draft CSR Act is expected before the end of 2017. If this occurs, Belgian companies will have to prepare CSR disclosures for accounting years beginning on or after January 1, 2017.

What the 2014 Directive Means for US Companies

Shareholders, customers, employees, and business partners of US companies increasingly expect more meaningful CSR disclosure, in addition to the financial information and risk disclosure in SEC filings. While most large US public companies provide additional CSR disclosure in the form of a sustainability report, major investors such as
BlackRock⁴⁸ and State Street⁴⁹ are bringing CSR issues into sharper focus in boardrooms through their letters to portfolio companies and other engagement efforts.

While the 2014 Directive itself does not apply to US companies, US companies should consider the following steps in light of this important development.

**Confirm whether the company is required to make CSR disclosure in EU member states in which the company does business and/or has a stock exchange listing.** US companies should review member state legislation implementing the 2014 Directive on a country-by-country basis, in case member states have opted to apply the 2014 Directive’s reporting requirements in a manner that captures them (such as foreign companies with a significant presence in the member state and/or a stock exchange listing).

**Review CSR disclosures by peer companies.** Knowing what peer companies in EU member states are disclosing in response to the 2014 Directive, and how that disclosure evolves over time, can assist US companies in crafting disclosure that meets their own needs. These reviews can start now; many EU companies have not waited for national legislation implementing the 2014 Directive and are already voluntarily disclosing CSR information.

**Stay abreast of best practices relating to CSR reporting and practices.** US companies should keep track of the frameworks used by relevant EU companies to prepare CSR disclosures to determine whether those methodologies would be appropriate for the US company. US companies also can use information relating to CSR activities to benchmark their activities against what relevant EU companies are doing.

**Engage with shareholders on approaches to CSR disclosure and consider whether to expand the company’s CSR reporting in light of investor feedback.** US companies can engage with shareholders on what CSR information they find most useful and where disclosure can be improved, drawing lessons from the EU experience as appropriate. This could help forestall shareholder proposals calling for disclosure on specific CSR issues, which are becoming more prevalent and generally achieving greater levels of shareholder support.⁵⁰

**Consider what other US companies are doing more broadly on CSR issues.** Events such as the Conference of Parties (COP) meetings sponsored by the United Nations Framework Convention on Climate Change are no longer just for negotiations between governments. It now has become the norm for business leaders, including CEOs, to attend and provide significant input at COP meetings and similar events. In addition, many US companies are proactively committing to action on issues such as climate change, and this momentum can have flow-on effects for enhanced CSR reporting. For example, although the Trump administration announced in June 2017 that the US is withdrawing from the COP21 agreement to reduce greenhouse gas emissions, more than 1,600 businesses and investors have nevertheless declared that they will continue to support climate action to meet the COP21 agreement.⁵²

US companies can use what they learn from EU disclosures to enhance their own CSR disclosure in a way that meets the needs of an investor base that is increasingly calling for this information, as well as focus board and senior management attention on how CSR issues relate to corporate values, strategy and long-term sustainability.

**Notes**

1. In this article, European Union and EU refer to the European Commission (also referred to herein as the Commission), the European Parliament (also referred to herein as the Parliament), and the Council of the European Union (also referred to herein as the Council), collectively, unless otherwise specified. These multi-lateral government bodies work together as the decision-making bodies of the European Union. More information on the Commission is available at https://europa.eu/european-union/about-eu/institutions-bodies/european-commission_en. More information on the Council

2. In the EU, the term CSR has a consensus-based meaning (as discussed in this article) and is in common use, whereas in the US the term sustainability is commonly used in place or parallel to CSR. We use the terms interchangeably.


18. The 2014 Directive’s preamble refers to resolutions passed by the European Parliament in 2013 that acknowledge the “importance of businesses divulging information on sustainability such as social and environmental factors, with a view to identifying sustainability risks and increasing investor and consumer trust. Indeed, disclosure of nonfinancial information is vital for managing change towards a sustainable global economy by combining long-term profitability with social justice and environmental protection. In this context, disclosure of non-financial information helps the measuring, monitoring and managing of undertakings’ performance and their impact on society.” 2014 Directive at 330/1.

21. The management report section of the annual report contains similar information to that included in the MD&A section of the Annual Report on Form 10-K that US reporting companies are required to file with the Securities and Exchange Commission (SEC).
23. 2014 Directive, Article 1(1) (adding Article 19a(1) to the 2013 Directive) and Article 1(3) (adding Article 29a(1) to the 2013 Directive).
25. 2014 Directive, Article 1(1) (adding Article 19a(1) to the 2013 Directive) and Article 1(3) (adding Article 29a(1) to the 2013 Directive).
31. The Financial Stability Board Task Force on Climate-Related Financial Disclosures (Task Force), chaired by Michael R. Bloomberg, develops “voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders,” taking into consideration “the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries.” About the Task Force, available at https://www.fsb-tcfd.org/about/. The Task Force notes that climate-related risks are material risks for many organizations, and this framework should be useful to organizations in complying more effectively with existing disclosure obligations and aligning their disclosures with investors’ needs. In December 2016, the Task Force issued its proposed standards for climate-related financial disclosures in their mainstream financial filings and invited public comment through mid-February 2017. The Task Force published its final recommendations report and supporting materials on June 29, 2017. See Task Force Publications, available at https://www.fsb-tcfd.org/publications/.
35. Companies Act 2006, Chapter 4A.
38. DTR 1B.1.7R. A company generally qualifies as small under sections 382 to 383 of the Companies Act 2006 if it satisfies two or more of the following requirements in a financial year: turnover of not more than GBP 10.2 million, balance sheet total of not more than GBP 5.1 million and not more than 50 employees. A company
generally qualifies as medium-sized under sections 465 to 466 of the Companies Act 2006 if it satisfies two or more of the following requirements in a financial year: turnover of not more than GBP 36 million, balance sheet total of not more than GBP 18 million and not more than 250 employees.


41. Wetsontwerp dd 20 juli 2017 betreffende de bekendmaking van niet-financiële informatie en informatie inzake diversiteit door bepaalde grote vennootschappen en groepen, Parl. St. Kamer 2016-17, nr. 54 2654/006.

42. These thresholds are calculated on an individual basis, except in case of a parent company. A subsidiary is exempted from making CSR disclosures if such information is made public at the level of the parent company. Similarly, if a subsidiary provides its own CSR disclosure, the parent company’s CSR declaration may refer to its subsidiary’s report.

43. Draft CSR Act, Articles 3 and 5.

44. Draft CSR Act, Article 3.

45. Draft CSR Act, Articles 3 and 5.

46. CSR reporting for US companies is most often triggered by the following SEC disclosure requirements:
   - Regulation S-K Item 101—Business description disclosure
   - Regulation S-K Item 103—Legal proceedings disclosure
   - Regulation S-K Item 303—MD&A disclosure of material known events and uncertainties
   - Regulation S-K Item 503(c)—Risk factor disclosure
   - SEC Release Nos. 33-9106; 34-61469; FR-82 (Feb. 8, 2010)—Guidance regarding climate change disclosure
   - Securities and Exchange Act Rule 13p-1—Conflict minerals disclosure


52. "We Are Still In," available at http://wearestillin.com/. See also “America’s Pledge on Climate,” available at https://www.americaspledgeonclimate.com/. In addition, more than 2,000 corporations globally have committed to reduce greenhouse gas emissions, increase investments in low- or no-carbon technologies, divest from fossil fuels, reduce water use, achieve zero waste-to-landfill impact, and ensure net-zero deforestation in their supply chains. Through its “Non-State Actor Zone for Climate Action” (NAZCA) the United Nations tracks commitments by cities, regions, companies, investors, civil society organizations (e.g. universities, foundations, advocacy groups), and cooperative initiatives among these groups, available at http://climateaction.unfccc.int/.
The new SEC Chairman lays out the principles he believes should guide the Commission going forward and some places where he sees opportunities to apply these principles to the SEC’s agenda.

By SEC Chairman Jay Clayton

I am delighted to speak to you here at the Economic Club of New York. The Club has established itself as an esteemed, non-partisan forum for economic discourse. It is an ideal place to discuss policy of the U.S. Securities and Exchange Commission (SEC, Commission, or the agency) and its effects on the U.S. economy and the American people. I intend to do just that in this, my first public speech as Chairman of the SEC.

Nearly six months ago, my predecessor Mary Jo White gave her last public address as SEC Chair in this same forum. In her remarks, she stated “I am confident in reporting that the agency is today a stronger protector of investors than ever before and much better equipped to meet the challenges of the fast-paced, complex, and interconnected securities markets of 2017.”1 I am pleased—and thankful—to say that I agree with Chair White. When I arrived at the Commission, I made it a priority to meet with staff across the agency. With each meeting, I became more impressed by the breadth of issues my 4,600 colleagues cover, and even more, by their dedication.

The Dodd-Frank Act of 20102 required the SEC to complete an unprecedented array of congressionally mandated rulemakings—all on top of the agency’s usual work. Under Chair White’s leadership, the Commission made great strides, adopting a number of the rules with which it was charged. Admittedly, there are still Dodd-Frank mandates to be completed. But I have inherited an agency with considerably more discretion over its agenda.

Today, I will share my perspective on the Commission and the principles that should guide where we go from here. I will then talk about some of the specific areas where I believe the agency should take action in the near-term to further its mission.

Guiding Principles

I believe in a model of leadership that is rooted in principles. I want to outline eight principles that will guide my SEC Chairmanship.3

Principle #1: The SEC’s Mission Is Our Touchstone

The SEC has a three-part mission: (1) to protect investors, (2) to maintain fair, orderly, and efficient markets, and (3) to facilitate capital formation. Each tenet of that mission is critical. If we stray from our mission, or emphasize one of the canons without being mindful of the others, investors, companies (large and small), the U.S. capital markets, and ultimately the economy will suffer.

Principle #2: Our Analysis Starts and Ends with the Long-Term Interests of the Main Street Investor

How does the SEC assess whether we are being true to our three-part mission? The answer: the long-term interests of the Main Street investor. Or, as I say when I walk the halls of the agency, how does what we propose to do affect the long-term interests of Mr. and Ms. 401(k)? Are these investors benefitting from our efforts? Do they have appropriate investment opportunities? Are they well informed? Speaking more granularly: What can the Commission

Jay Clayton was sworn in as SEC Chairman on May 4, 2017. These remarks were delivered in New York, NY, on July 12, 2017. He indicated that the words were his own and do not necessarily reflect the views of the Commission of the SEC staff.
do to cultivate markets where Mr. and Ms. 401(k) are able to invest in a better future?

I am confident this is the right lens for our analysis; and the one the American people would want the Commission to use. I am also confident that the women and men of the SEC share this perspective.

**Principle #3: The SEC’s Historic Approach to Regulation Is Sound**

Disclosure and materiality have been at the heart of the SEC’s regulatory approach for over eighty years. As my colleague, Commissioner Michael Piwowar, recently said,

> Unlike merit-based regimes, our system of disclosure comports well with American traditions ... By arming investors with information, they can evaluate and make investment decisions that support more accurate valuations of securities and a more efficient allocation of capital.4

The Commission, following the guidance of the Supreme Court, should continue to strive to ensure that investors have access to a well-crafted package of information that facilitates informed decision-making.5

In addition to disclosure-based rules, the SEC has placed heightened responsibilities on people and organizations that are central to, or actively participate in, our securities markets. The rules that apply to securities exchanges, clearing agencies, broker-dealers, and investment advisers (to name a few) protect markets and investors where information and market forces alone may not be enough.

The third leg of the stool—the anti-fraud regime established by Congress and the Commission—acts as a back-stop to the aforementioned disclosure rules and oversight systems. The government can bring to bear its extensive enforcement capabilities on those who try to circumvent established investor protections or otherwise engage in deceptive or manipulative acts in the markets.

In sum, I believe in the regulatory architecture that has governed the securities markets since 1933. It is abundantly clear that wholesale changes to the Commission’s fundamental regulatory approach would not make sense.

**Principle #4: Regulatory Actions Drive Change, and Change Can Have Lasting Effects**

Incremental regulatory changes may not seem individually significant, but, in the aggregate, they can dramatically affect the markets. For example, our public company disclosure and trading system is an incredibly powerful, efficient, and reliable means of making investment opportunities available to the general public. In fact, this disclosure-based regime has worked so well that we—not just the SEC, but lawmakers and other regulators—have slowly but significantly expanded the scope of required disclosures beyond the core concept of materiality. Those actions have been justified by regulators and lawmakers alike, often based on discrete, direct and indirect benefits to specific shareholders or other constituencies. And it has often been concluded that these benefits outweigh the marginal costs that are spread over a broad shareholder base.

But the roughly 50 percent decline in the total number of U.S.-listed public companies over the last two decades6 forces us to question whether our analysis should be cumulative as well as incremental. I believe it should be. As a data point, over this period, studies show the median word-count for SEC filings has more than doubled, yet readability of those documents is at an all-time low.7

While there are many factors that drive the decision of whether to be a public company, increased disclosure and other burdens may render alternatives for raising capital, such as the private markets, increasingly attractive to companies that only a decade ago would have been all but certain candidates for the public markets. And, fewer small and medium-sized public companies may mean less liquid trading markets for those that remain public. Regardless of the cause, the reduction in the number of U.S.-listed public companies is a serious issue for
our markets and the country more generally. To the extent companies are eschewing our public markets, the vast majority of Main Street investors will be unable to participate in their growth. The potential lasting effects of such an outcome to the economy and society are, in two words, not good.

**Principle #5: As Markets Evolve, So Must the SEC**

Continuing with the theme of change, technology and innovation are constantly disrupting—in mostly positive ways—the manner in which markets work and investors transact. The SEC must recognize this and strive to ensure that our rules and operations reflect the realities of our capital markets. As my colleague Commissioner Kara Stein has noted, “We need to take into account new tensions, risks, uncertainties, and conflicts.”

While this dynamic atmosphere presents challenges, it also provides opportunities for improvements and efficiencies. It is our job as regulators to find these. Technology is not just the province of those we regulate. The SEC has the capability to develop and utilize it, too. We apply sophisticated analytic strategies to detect companies and individuals engaging in suspicious behavior. We are adapting machine learning and artificial intelligence to new functions, such as analyzing regulatory filings.

As the SEC evolves alongside the markets, however, we must remember that implementing regulatory change has costs. Companies spend significant resources building systems of compliance, hiring personnel to operate those systems, seeking legal advice concerning the design and effectiveness of those systems, and adapting the systems as regulations change. Shareholders and customers bear these costs, which is something that should not be taken lightly, lest we lose our credibility as regulators.

**Principle #6: Effective Rulemaking Does Not End with Rule Adoption**

With respect to rulemaking, the SEC has developed robust processes for obtaining public input and is committed to performing rigorous economic analyses of our rules, at both the proposing and adopting stages. These efforts are critical to identifying the benefits and costs of regulatory actions, including situations where a rule’s effects may not be consistent with expectations. But we should not stop there.

The Commission should review its rules retrospectively. We should listen to investors and others about where rules are, or are not, functioning as intended. We cannot be shy about being introspective and self-critical.

**Principle #7: The Costs of a Rule Now Often Include the Cost of Demonstrating Compliance**

Rules are meant to be followed, and the public depends on regulators to make sure that happens. It is incumbent on the Commission to write rules so that those subject to them can ascertain how to comply and—now more than ever—how to demonstrate that compliance. Vaguely worded rules can too easily lead to subpar compliance solutions or an overinvestment in control systems. We must recognize practical costs that are sure to arise. For example, when the SEC requires a Chief Executive Officer to make a certification that a specific requirement has been met, while he or she retains ultimate responsibility, realistically, it should be expected that the responsibility will be supported through the chain of command in a demonstrable manner. This can be an expensive practice that goes well beyond a prudent management and control architecture; when third parties, such as auditors, outside counsel, and consultants, are involved, the costs—financial costs and, in many ways more important, the cost in terms of time—can skyrocket. This may be the appropriate regulatory approach, and to be clear, in some areas I think it is. However, the Commission needs to make sure at the time of adoption that we have a realistic vision for how rules will be implemented as well as how we and others intend to examine for compliance.

**Principle #8: Coordination Is Key**

Last, the SEC shares the financial services space with many other regulatory players charged with
overseeing related or overlapping industries and market participants.9 The Commission works alongside more than 15 U.S. federal regulatory bodies, more than 50 state and territory securities regulators, the Department of Justice, state attorneys general, self-regulatory organizations (SROs), and non-SRO standard setting entities. We also participate in several major international bodies and cooperate with regulators in more than 115 foreign jurisdictions. Coordination with, between, and among all these organizations is essential to a well-functioning regulatory environment.

One such area where coordination is essential is our regulatory scheme governing over-the-counter derivatives. Congress established, through Title VII of the Dodd-Frank Act, a dual regulatory structure for these instruments: the SEC was assigned authority over “security-based swaps,” and the Commodity Futures Trading Commission (CFTC) was assigned authority over “swaps.” For this structure to be effective, there must be close coordination between the SEC and CFTC. I am fully committed to that. I am also committed to working with the CFTC to explore ways in which the agencies can achieve greater harmonization of Title VII rules and reduce unnecessary complexity as well as costs to both regulators and market participants. Having said that, importantly, all such efforts will need to take into account statutory variances as well as differences in products and markets.

Speaking more generally, cybersecurity is also an area where coordination is critical.10 Information sharing and coordination are essential for regulators to address potential cyber threats and respond to a major cyberattack, should one arise. The SEC is therefore working closely with fellow financial regulators to improve our ability to receive critical information and alerts and react to cyber threats.11

Putting Principles into Practice

Let’s turn from principles to practice. There are some particular places where I see opportunities to apply these principles to the SEC’s agenda.

Enforcement and Examinations

The SEC has strong and active enforcement and examination programs. I fully intend to continue deploying significant resources to root out fraud and shady practices in the markets, particularly in areas where Main Street investors are most exposed. Terms like “affinity fraud” and “microcap fraud” sound unremarkable and remote on paper, but they are sinister behaviors that strike at Americans’ vulnerabilities.

Investors should know that the SEC is looking out for them. In this regard, we are taking further steps to find and eliminate from our system pump-and-dump scammers, those who prey on retirees, and increasingly those who use new technologies to lie, cheat, and steal. Turning to the more sophisticated participants in our markets, the Commission will continue to use its enforcement and examination authority to support market integrity. We are committed to making our markets as fair, orderly, and efficient—as liquid—as possible. I know market professionals are critical to, and enhance, the operation of our markets. I also know they know the rules and principles, and I expect them to adhere to and be guided by them. You have a special place in our economy, do not take unfair advantage of it.

As a final comment on enforcement, I want to go back to cybersecurity. Public companies have a clear obligation to disclose material information about cyber risks and cyber events. I expect them to take this requirement seriously. I also recognize that the cyber space has many bad actors, including nation states that have resources far beyond anything a single company can muster. Being a victim of a cyber penetration is not, in itself, an excuse. But, I think we need to be cautious about punishing responsible companies who nevertheless are victims of sophisticated cyber penetrations. Said another way, the SEC needs to have a broad perspective and bring proportionality to this area that affects not only investors, companies, and our markets, but our national security and our future.
Capital Formation

I have been vocal about my desire to enhance the ability of every American to participate in investment opportunities, including through the public markets. I also want American businesses to be able to raise the money they need to grow and create jobs. As I mentioned earlier, evidence shows that a large number of companies, including many of our country’s most innovative businesses, are opting to remain privately held. Just yesterday I met with a broad group of businesses at different stages of capital raising and heard firsthand about the regulatory requirements and other considerations that factor into their decision to stay private or go public. One message was loud and clear: private markets operate well in many sectors and, in these areas, they offer a very attractive alternative to the public markets. I believe we need to increase the attractiveness of our public capital markets without adversely affecting the availability of capital from our private markets.

As an agency, we have learned a great deal while implementing the JOBS Act on-ramp for emerging growth companies (EGCs).12 The JOBS Act allows issuers with less than roughly $1 billion in revenue to submit their draft registration statements confidentially and phase in their reporting obligations gradually. This regime has had a clear appeal to EGCs. Since the enactment of the JOBS Act, approximately 87 percent of the initial public offerings (IPOs) that have gone effective were for EGCs, and the vast majority of these companies have relied to some extent on the confidentiality and gradation components of the JOBS Act.13

Starting this past Monday, the JOBS Act approach is accessible more broadly. The SEC’s Division of Corporation Finance non-public review process is now open to IPO draft registration statements from larger domestic and non-U.S. companies that do not qualify as EGCs.14 I hope that allowing these companies to submit their sensitive information on a non-public basis while the Commission staff reviews their draft offering documents will encourage them to find the prospect of selling their shares in the U.S. public markets more attractive generally, and at an earlier stage in their development.15

My last point on capital formation is a reminder. There are circumstances in which the Commission’s reporting rules may require publicly traded companies to make disclosures that are burdensome to generate, but may not be material to the total mix of information available to investors. Under Rule 3-13 of Regulation S-X, issuers can request modifications to their financial reporting requirements in these situations. I want to encourage companies to consider whether such modifications may be helpful in connection with their capital raising activities and assure you that SEC staff is placing a high priority on responding with timely guidance.

Market Structure

Regarding equity market structure, an enormous amount of thought—at the Commission, in Congress, and in the private sector—has been devoted to this topic. While there are certainly challenging issues that merit further consideration, it is time to shift the focus to action. One recommendation where there is broad consensus to proceed is the launch of a pilot program to test how adjustments to the access fee cap under Rule 610 of the Securities Exchange Act of 1934 would affect equities trading.16 Such a pilot should provide the Commission with more data to assess the effects of access fees and rebates—including “maker-taker” and other pricing systems—on liquidity provision, liquidity taking, and order routing. These, in turn, affect the functioning of markets and investor welfare. I expect the Commission will consider a proposal of this type in the coming months.

The SEC’s Equity Market Structure Advisory Committee (EMSAC) has provided the Commission with valuable perspectives on these and many other issues. The committee’s charter is set to expire next month. My hope is that EMSAC’s tenure is extended into 2018.

Let me make one additional point about market structure. The time is right for the SEC to broaden its review of market structure to include specifically
the efficiency, transparency, and effectiveness of our fixed income markets. As waves of Baby Boomers retire every month and need investment options, fixed income products, which are viewed as a stable place to store hard-earned money, will attract more and more Main Street investors. Yet, many of those investors may not appreciate that fixed income products are part of markets that differ significantly from the better-known equities markets.

The Commission must explore whether these markets are as efficient and resilient as we expect them to be, scrutinize our regulatory approach, and identify opportunities for improvement. To that end, I have asked the staff to develop a plan for creating a Fixed Income Market Structure Advisory Committee. Like the EMSAC, this committee would be made up of a diverse group of outside experts, who will be asked to give advice to the Commission on the regulatory issues impacting fixed income markets. I am also pleased to note that this week, Chairman Hensarling and Chairman Huizenga of the House Financial Services Committee and its subcommittee on Capital Markets, Securities, and Investment have called for a hearing on fixed income market structure, and I look forward to working with Congress on these issues.

**Investment Advice and Disclosures to Investors**

**Fiduciary rule.** Another area that has been the subject of extensive study is the standards of conduct that investment professionals must follow in providing advice to Main Street investors. With the Department of Labor’s Fiduciary Rule now partially in effect, it is important that the Commission make all reasonable efforts to bring clarity and consistency to this area. It is my hope that we can act in concert with our colleagues at the Department of Labor in a way that best serves the long-term interests of Mr. and Ms. 401(k).

There is a lot of work to do, and this issue is complex. That should not deter us, and we are moving forward. In June, I issued a statement seeking public input on standards of conduct for investment advisers and broker-dealers. The Commission had last solicited information on this issue four years ago. Suffice it to say a lot has happened since then. Robust public comment can help us evaluate potential regulatory actions in light of current market activities and risks. And, any action will need to be carefully constructed, so it provides appropriate and meaningful protections but does not result in Main Street investors being deprived of affordable investment advice or products. I encourage the public to send us feedback and any data that may be helpful to us. Instructions for how to submit this information are available on www.sec.gov.

**Improving disclosure to investors.** Regardless of whether investors participate in our markets directly or indirectly, and with or without investment advice, it is clear that they and their advisors must have access to information about potential investments that is easily accessible and meaningful. The Commission has several initiatives underway to improve the disclosure available to investors. For example, last November, the SEC staff issued a report recommending ways to modernize and simplify Regulation S-K disclosure rules. This report also included recommendations on how to improve the readability and the navigability of disclosure. The staff is making good progress on preparing rulemaking proposals based on this report for the Commission.

**Resources to Educate Investors**

No matter how robust our enforcement and examination programs, the reality is that the SEC cannot be everywhere. The agency has exceptional tools that can help investors research professionals giving them investment advice, spot signs of fraud, and take action to protect themselves.

A priority for me is getting the wealth of information that the SEC has into the hands of investors, through whatever means can reach them. Among other things, we are leveraging technology to do this, including conducting data analyses to assess how individual investors interact with the SEC and where and how we can increase engagement. Commission staff also has efforts underway to simplify and
enhance resources to educate investors on how to conduct online background searches on investment professionals and make informed decisions about whether to establish financial relationships. In this regard, I have a short but important message for Main Street investors: the best way to protect yourself is to check out who you are dealing with, and the SEC wants to make that easier.20

Conclusion

In my seventy days since joining the SEC, I have become aware of some of the challenges ahead. The Commission has no choice but to face any challenges—both the ones we know and those we will come to know—head-on. As we take that journey, I am fortunate to be surrounded by a tremendously talented set of public servants in the SEC staff and my fellow Commissioners. I aim to apply a level of dedication and hard work that matches their own.

Notes

3. On February 3, 2017, President Donald J. Trump issued an executive order setting forth seven “core principles” intended to form the basis for his administration’s regulation of the U.S. financial system. See Presidential Executive Order on Core Principles for Regulating the United States Financial System (Feb. 3, 2017), available at: https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states. I believe the principles articulated here are consistent with, and complementary to, the broader principles for financial regulation set forth by the President.
5. See TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (“An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote....Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”). See also Basic Inc. v. Levinson, 485 U.S. 224 (1988).
6. The total number of listed companies in 2016 was approximately 4,300, compared to about 8,100 in 1996. Commission staff produced these estimates using data from the Center for Research in Securities Prices US Stock and US Index Databases (2016), The University of Chicago Booth School of Business.
7. See, e.g., Travis Dyer, Mark Lang, Lorien Stice-Lawrence, “The Evolution of 10-K Textual Disclosure: Evidence from Latent Dirichlet Allocation” (Oct. 2016). See also SEC Office of the Investor Advocate, “Report on Objectives: Fiscal Year 2017” (June 30, 2016), available at: https://www.sec.gov/advocate/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2017.pdf, at 5 (“Given the important role of disclosure, the requirements for various types of disclosure are robust. As a result, an S-1 or 10-K can be hundreds of pages long, and the length and complexity of the disclosures has led many to question whether the disclosure requirements are properly calibrated to effectively communicate all material information to investors while eliminating immaterial, outdated, or duplicative data that may dilute the impact of the more meaningful disclosures.”).


10. See id. at 123.

11. The SEC is a member of the Financial and Banking Information Infrastructure Committee.


15. The Division of Corporation Finance will also accept draft registration statements for non-public review for many companies throughout their first year in the SEC’s reporting system. This is meant to encourage newly reporting companies to explore follow-on capital raises in the public markets, which could present additional investment opportunities for retail investors and add liquidity to a newly public company’s shares. See id. The experience with the JOBS Act confidential review process demonstrates that this approach is fully consistent with investor protection. Companies are still required to publicly file their disclosure documents well before they begin their “road shows.” That said, in the spirit of being retrospective, I am open to continuing to examine whether the SEC has struck an appropriate balance between the capital formation and investor protection tenets of our mission.


20. The agency is trying different approaches. For example, in addition to our ongoing efforts to create and disseminate educational content through www.investor.gov and other platforms designed for retail investors, we recently posted a short video on the SEC website that includes tips for investors to avoid falling victim to fraud. See SEC Office of Investor Education and Advocacy, “Straight Talk: From the SEC” (June 29, 2017), available at: https://investor.gov/additional-resources/specialized-resources/public-service-campaign.
Second Circuit Clarifies Ascertainability and Predominance Standards

By Brad Karp, Richard Rosen, and Audra Soloway

On July 7, 2017, in In re Petrobras Securities Litigation,1 the Second Circuit addressed the standards for certifying Rule 23(b)(3) classes in securities fraud cases concerning over-the-counter securities that trade in a global market.2 In order for a class to be certified under Rule 23(b)(3), questions that are common to the class must predominate over those that only affect individuals (the “predominance” requirement), and the class action form must be “superior to other available methods for fairly and efficiently adjudicating the controversy” (the “superiority” requirement). In addition, some courts have held that there is also an implied requirement of “ascertainability.” While acknowledging the administrative difficulties of determining which transactions are “domestic,” and thus subject to the U.S. securities laws, the Second Circuit joined the Ninth Circuit in rejecting the Third Circuit’s holding (and the Second Circuit’s own prior dicta) that Rule 23’s implied requirement of ascertainability includes a requirement of “administrative feasibility.” The Second Circuit went on to hold that the District Court’s finding of predominance was inadequate because it did not sufficiently address extraterritoriality issues related to securities that trade over-the-counter outside of the United States.3

Background

Petróleo Brasileiro S.A. (Petrobras) is an oil and gas corporation that is majority-owned by the Brazilian government. In 2014, Brazilian investigators uncovered a corruption scheme: Petrobras officials had received bribes in exchange for providing information, approvals, and other assistance to a cartel of private companies that formed to bid on Petrobras’s construction projects. As details of the investigation became public, the price of Petrobras’s securities declined sharply.

Investors in Petrobras securities filed putative class actions under the Securities Act of 1933 and the Securities Exchange Act of 1934 against Petrobras, along with its officers, subsidiaries, auditor, and underwriters, alleging false and misleading statements regarding Petrobras’s value, management, and controls.

While Petrobras’s common and preferred stock are listed on a Brazilian stock exchange and are thus exempt from registration under the U.S. securities laws, Petrobras’s American Depositary Shares (ADSs) trade on the New York Stock Exchange (NYSE), and its debt securities, like most corporate debt, trade in the over the counter (OTC) market.

A key issue in the case is whether the U.S. securities laws apply to OTC trades in Petrobras’s debt. In Morrison v. Australian National Bank,4 the Supreme Court held that the U.S. securities laws apply only “to [i] transactions in securities listed on domestic exchanges and [ii] domestic transactions in other securities.” The Second Circuit has held that the latter prong requires that “irrevocable liability to carry out the transaction” was incurred in the United States.5

In February 2016, the U.S. District Court for the Southern District of New York (Rakoff, J.) certified classes of investors who purchased Petrobras ADSs on the NYSE and who purchased Petrobras’s debt securities in “domestic transactions.”6 The defendants appealed the District Court’s certification order to the Second Circuit under Federal Rule of Civil Procedure 23(f), and the Second Circuit agreed to hear the appeal.
The Second Circuit Clarifies That AscertAINABILITY Does Not Require “Administrative Feasibility”

One question before the Second Circuit was whether the debt class satisfied Rule 23’s implied requirement of ascertainability, which the Second Circuit acknowledged in Brecher v. Republic of Argentina. The defendants argued that it would be difficult to determine which of the many OTC trades in Petrobras’s debt were domestic, and thus that class membership could not be defined by reference to “domestic transactions.”

While acknowledging the underlying difficulties, the Second Circuit held that they posed no ascertainability problem. The court held that the ascertainability requirement is satisfied if the class is “defined using objective criteria that establish a membership with definite boundaries.” Applying this standard to the certified class, the Second Circuit found that the District Court’s criteria, “securities purchases identified by subject matter, timing, and location,” were “clearly objective,” and it was therefore “objectively possible” to determine which securities were acquired in domestic transactions. The certification order therefore satisfied the ascertainability test.

In reaching this conclusion, the court clarified that ascertainability does not require “a showing of administrative feasibility at the class certification stage.” While acknowledging that Brecher had suggested such a requirement, the court concluded that this language “was not strictly part of the holding.” The Second Circuit acknowledged that its holding squarely conflicts with the “heightened ascertainability” test applied by the Third Circuit, which does require administrative feasibility.

The Second Circuit Vacates the Class Certification Order Due to an Insufficient Showing of Predominance

The Second Circuit went on to hold that the District Court’s finding of “predominance”—i.e., that “questions of law or fact common to class members … predominate over any questions affecting only individual class members”—was insufficient. The Second Circuit held that the extraterritoriality issue was a “merits question” and a “material question.” As a result, the Second Circuit held that the predominance inquiry required consideration of whether the extraterritoriality issue is “susceptible to generalized class-wide proof.” The District Court had made no such finding. Indeed, the District Court “did not mention Morrison at all” in its predominance analysis. The Second Circuit thus vacated the “domestic transactions” portion of the class certification order and remanded to the District Court to conduct a full predominance analysis.

The Second Circuit noted that, based on the record before the court, the question of whether a transaction was domestic implicated “transaction-specific facts” related to the acquisition of each security, and therefore “appears to be an individual question requiring putative class members to present evidence that varies from member to member.” The court instructed that the District Court “must account for such individual questions,” without taking a position as to how the District Court should rule.

Implications

The Second Circuit’s decision has significant implications for securities litigation concerning securities that are traded in the OTC market. Because debt securities are more likely than stocks to be traded OTC, rather than on a domestic or foreign exchange, litigation involving debt securities is particularly likely to be affected. If the District Court’s order had been affirmed, plaintiffs would have faced an easy path to class certification, simply by defining classes with reference to “domestic transactions,” thus deferring any extraterritoriality issues until post-verdict proceedings. Such post-verdict proceedings rarely occur because cases involving certified classes typically settle pre-trial. The practical result of deferring resolution of these issues would be to increase defendants’ potential exposure and thus potentially increase plaintiffs’ leverage in settlement
negotiations. This would have substantially burdened international debt markets, and could have resulted in efforts by issuers to restrict how their securities trade. For example, while much corporate debt is currently issued with both a domestic and foreign component so that it can trade globally, issuers could restrict their debt to trade only in the U.S. market, or only outside the U.S. market. If the District Court certifies a similar class on remand, the likely result will be another Rule 23(f) appeal.

The Second Circuit’s ascertainability ruling will have implications not only for securities class actions, but for class actions generally. By accepting class definitions whose application is “objectively possible,” even if not “practical[ ,]” the Second Circuit’s new standard may make it more difficult for defendants to estimate their exposure and for absent potential class members to determine their membership. Such issues will be relegated to post-verdict proceedings, which will only occur if defendants lose at trial or settle. Settling defendants also may have a greater interest in how settlement funds are administered, and may seek a larger role in the process.

In rejecting the Third Circuit’s heightened requirement of ascertainability, the Second Circuit has aligned itself with the Ninth Circuit (which, unlike the Second Circuit, does not acknowledge an implied requirement of “ascertainability”). Given the split among the circuits as to ascertainability, the Supreme Court may grant certiorari in a case that raises the issue to resolve the conflict.

Notes

3. In addition to the issues described below, the Second Circuit held that the District Court did not abuse its discretion by applying a “blended method” of determining market efficiency. Plaintiffs in securities actions must show reliance. Reliance will be presumed if plaintiffs can establish that there was an efficient market in the securities at issue. This is called the “fraud on the market” theory of reliance. The District Court found that there was an efficient market in Petrobras securities based on a “blended method” that used both direct and indirect evidence. The Second Circuit held that the District Court did not abuse its discretion, and left open the possibility that market efficiency can be established using only indirect evidence.
5. Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 69 (2d Cir. 2012).
7. 806 F.3d 22, 24 (2d Cir. 2015).
8. Plaintiffs had argued that all transactions that were settled through the Depository Trust Company (“DTC”) or another domestic securities depository were domestic transactions. The District Court rejected that argument, and the Second Circuit agreed, holding that settlement was an action needed to carry out a transaction, but did not itself constitute a transaction. The Second Circuit also credited the District Court’s observation that if DTC settlement alone sufficed to make a transaction domestic, “the entire thrust of Morrison and its progeny would be rendered nugatory.”
9. See Byrd v. Aaron’s Inc., 784 F.3d 154 (3d Cir. 2015).
Alston & Bird LLP
Washington, DC (202-756-3300)

Supreme Court to Review Concurrent State Court Jurisdiction in Securities Act of 1933 Cases (July 5, 2017)

A discussion of the U.S. Supreme Court’s grant of certiorari in Cyan Inc. v. Beaver County Employees Retirement Fund. The issue to be decided is whether, pursuant to the Securities Litigation Uniform Standards Act of 1998, state courts have concurrent subject matter jurisdiction over class actions solely alleging violations of the Securities Act of 1933.

Andrews & Kurth LLP
Houston, TX (713-220-4200)

CEO Pay Ratio Disclosure: State and Local Governments May Add to Burden (July 2017)

A discussion of the effort by some state and local governments to apply new taxes and other charges to publicly traded companies with disclosed pay ratios that exceed certain thresholds.

Cahill Gordon & Reindel LLP
New York, NY (212-701-3000)

Supreme Court to Consider the Scope of Dodd-Frank Whistleblower Provisions (July 6, 2017)

A discussion of the U.S. Supreme Court’s grant of certiorari in Somers v. Digital Realty Trust Inc. to consider whether the anti-retaliation provisions for whistleblowers in the Dodd-Frank Act extend to individuals who have not reported alleged misconduct to the SEC.

Chapman and Cutler LLP
Chicago, IL (312-845-3000)

MSRB and FINRA Provide Guidance on New Rules Requiring Bond Mark-Ups/Mark-Downs on Trade Confirmations (July 14, 2017)

A discussion of FAQs issued by the Municipal Securities Rulemaking Board (MSRB) concerning amendments to MSRB Rule G-15 and FINRA Rule 2232 that will subject firms to new transaction-related disclosure requirements to retail investors for certain fixed income securities.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

Increased Activity and Emerging Patterns in Securities Litigation Against Life Sciences Companies (July 19, 2017)

A discussion of emerging trends in recent decisions in securities actions involving life sciences companies.

Debevoise & Plimpton LLP
New York, NY (212-909-6000)

Streamlining the EU Prospectus Regime (July 17, 2017)

A discussion a new prospectus regulation adopted by the European Union, the majority of provisions of which will apply beginning July 21, 2019.
DLA Piper  
Phoenix, AZ ([www.dalpiper.com](http://www.dalpiper.com))

SEC Report on Tokens as Securities: Seven Takeaways (July 31, 2017)
A discussion of a report issued by the SEC on tokens (blockchain-enabled means for raising capital) as securities, using DAO (a crowdsourced venture capital platform created by Stoxk.t and based on Ethereum blockchain) as a lens for analyzing the issue.

Gibson, Dunn & Crutcher LLP  
Los Angeles, CA (213-329-7870)

2017 Mid-Year FCPA Update (July 10, 2017)
A discussion of the Foreign Corrupt Practices Act as well as domestic and international anti-corruption enforcement, litigation, legislation and policy developments from the first half of 2017.

2017 Mid-Year Update on Corporate Non-Prosecution Agreements and Deferred Prosecution Agreements (July 11, 2017)
A discussion of the global theme this year of U.S. and foreign enforcement authorities in which cooperation is a deciding factor in accomplishing a non-prosecution or deferred prosecution agreement.

2017 Mid-Year Securities Litigation Update (July 20, 2017)
A discussion of securities litigation developments and trends for the first half of 2017.

Mayer Brown LLP  
Chicago, IL (312-782-0600)

New Heads of Enforcement at the U.S. Securities and Exchange Commission Continue Agency’s Focus on Cybersecurity (July 12, 2017)
A discussion recent statements by new SEC Enforcement Division Co-Directors Stephanie Avakian and Steven Peiken underscoring that the SEC’s cybersecurity initiative will remain a high priority.

Get Ready to Hyperlink SEC Exhibit Filings Beginning September 1 (July 20, 2017)
A discussion of new SEC requirements, effective September 1, 2017, requiring that exhibits listed in the exhibit index of specified filings made with the SEC be hyperlinked.

Morrison & Foerster LLP  
San Francisco, CA (415-268-7000)

Delaware Signs Groundbreaking Blockchain Legislation (July 27, 2017)
A discussion of newly enacted Delaware legislation that provides, among other things, specific statutory authority for Delaware corporations to use “distributed electronic networks or databases,” aka distributed ledgers or blockchain technology, for the creation and maintenance of corporate records, including the corporation’s stock ledger.

Wachtell, Lipton, Rosen & Katz  
New York, NY (212-403-1000)

Second Circuit Limits Judicial Scrutiny of Deferred Prosecution Agreements (July 13, 2017)
A discussion of a Second Circuit Court of Appeals decision, *United States v. HSBC Bank USA, N.A.*, substantially limiting a district court’s power to scrutinize deferred prosecution agreement, thereby following a similar course as the D.C. Circuit.

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On June 29, 2017, the Securities and Exchange Commission (SEC) extended to all issuers some of the benefits that Congress granted to emerging growth companies (EGCs) in 2012 under the Jumpstart Our Business Startups Act (JOBS Act). By way of background, the JOBS Act effectively created a two-tiered system for US IPOs, easing the path for EGCs to become public companies while maintaining restrictions for non-EGCs. A portion of the relief involved relaxing disclosure requirements that required investments of time and resources that were arguably not commensurate with the related benefits to investors in smaller companies. However, other areas of relief—notably those related to the IPO process itself—had no clear rationale based on the size of the issuer. The SEC’s June 29, 2017 announcement goes some way towards addressing this disparity with respect to the offering process. However, as outlined below, additional work for the SEC remains in order to finish the job of levelling the playing field between EGCs and non-EGCs with respect to the IPO process.

SEC Relief for IPOs of Non-EGCs

Confidential Submission

The SEC is allowing two new groups of companies to submit their initial registration statements confidentially in draft form and maintain that confidentiality until 15 days before a roadshow or, if there is no roadshow, 15 days prior to the effective date of the registration statement. The first group is non-EGCs. This effectively permits all issuers to submit IPO registration statements confidentially. The second group is companies filing a registration statement under the Securities Exchange Act of 1934 (Exchange Act). This would include, for example, foreign private issuers traded overseas and seeking to list on the New York Stock Exchange or Nasdaq in a non-capital-raising transaction by means of a direct listing or a Level II ADR program.

The SEC clarified in FAQs that the confidentiality provisions of Section 6(e)(2) of the Securities Act of 1933 (Securities Act) are limited specifically to draft registration statements of EGCs. Accordingly, the SEC has reminded non-EGCs using this method of submission that they should consider the use of SEC Rule 83 when submitting registration statements and related correspondence confidentially. This rule requires the SEC to notify the filer if it receives a Freedom of Information Act (FOIA) request with respect to the registration statement and provides the filer with an opportunity to seek confidential treatment for relevant portions of the filing and related correspondence.

A non-EGC seeking to submit confidentially should include a legend at the top of each page of the electronically submitted draft registration statement indicating that it has requested confidentiality. In addition, in its responses to SEC comments, an issuer should identify any information in the registration statement for which it intends to seek confidential treatment upon public filing to ensure that the SEC does not include such information in its comment letters. The SEC reiterated in FAQs that, consistent with its practice in all filing reviews, the staff will release publicly its comment letters and issuer responses to staff comment letters on EDGAR no earlier than 20 business days following the effective date of a registration statement.

Colin Diamond, Michelle Rutta, and John Vetterli are partners, and Irina Yevmenenko is counsel, at White & Case LLP in New York, NY.
The SEC also clarified in FAQs that a filing fee is still due only when the registration statement is first publicly filed on EDGAR. The voluntary submission of a draft registration statement is not considered a “filing” so no fee is due at that time. Furthermore, a submission of a draft registration statement is not required to be signed by the registrant or by any of its officers or directors, nor is it required to include the consent of auditors and other experts, as it is not filed with the SEC. In addition, an issuer submitting a draft registration statement for non-public review may not make a public announcement about its offering in reliance on the Rule 134 safe harbor but may use the Rule 135 safe harbor instead.

Non-Required Financial Statements

The SEC will accept and review a registration statement that omits financial statements and related information that the issuer reasonably believes will not be required at the time the registration statement is publicly filed. This is similar—but not identical—to the relief provided under the December 2015 Fixing America’s Surface Transportation Act (FAST Act) which allowed EGCs to omit financial information that relates to a historical period that the issuer reasonably believes will not be required to be included at the time of the contemplated offering. The reason for the slight difference is unclear, but is potentially meaningful for non-EGCs that decide to make an early public filing of their registration statement in order to be able to test the waters with investors.

SEC Relief for All Companies in 12 Months Following IPOs

The SEC is allowing all companies to submit a registration statement confidentially during the 12 months following effectiveness of an IPO registration statement or the initial Exchange Act registration statement. Such confidentiality can be maintained until 48 hours before the requested effective time of the registration statement at which time the registration statement must be filed publicly on EDGAR. However, the ability of such companies to submit a registration statement confidentiality applies only to the first filing while any second filing—for example to make amendments to respond to SEC comments—must be public.

The ability to submit a registration statement confidentiality for the 12 months following effectiveness of an initial registration statement is a welcome development for issuers, but the limitation to only the first submission of a registration statement may result in issuers seeking to avoid filing an amendment to a registration statement selected for review and, instead, they may try to respond to SEC comments via correspondence filings only. Moreover, the SEC relief results in disparate treatment for a company whose registration statement is selected for review and one that is not—something that is not within an issuer’s control. For this reason, it is hoped that the SEC will extend its relief to all filings until, for example, 48 hours before the effective date.

It also is hoped that the SEC will extend the ability to file confidentially beyond 12 months. The 12-month period is roughly coterminous with the date on which an issuer would presumptively become eligible to file a Form S-3 or F-3. An issuer that has more than US$700 million in unaffiliated public float at that time likely would be a well-known seasoned issuer (WKSI). Such Form S-3 or F-3 would be effective automatically thereby removing the potential market impact of filing a registration statement and having to wait to learn whether the SEC intends to review it or not. However, for Form S-3 or F-3 issuers that are not WKSI, the ability to file confidentially initially while learning whether the SEC intends to review the filing, as well as during any review process, could reduce meaningfully any adverse market impact. This challenge is even more pronounced for issuers that are eligible to use a Form S-3 or F-3, but are subject to the “baby shelf” rules (i.e., Form S-3 or F-3 eligibility rules applicable to issuers with an unaffiliated public float of less than US$75 million undertaking a primary capital raise), and may therefore have to use a Form S-1 or F-1 to achieve their desired offering size. A broader
extension of the ability to submit confidentially would likely be appreciated by issuers as it would aid capital formation without adversely impacting investors.

**Outcome of SEC Relief**

The chart below sets out the interplay between various offering-related requirements and relief therefrom in light of the recently announced SEC relief.

<table>
<thead>
<tr>
<th></th>
<th>Securities Act Registration</th>
<th>Exchange Act Registration</th>
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<tbody>
<tr>
<td></td>
<td>EGC</td>
<td>Non-EGC</td>
</tr>
<tr>
<td>Confidential filing</td>
<td>✓</td>
<td>✓ (pursuant to JOBS Act)</td>
</tr>
<tr>
<td></td>
<td>(pursuant to JOBS Act)</td>
<td>✓ (pursuant to SEC relief)</td>
</tr>
<tr>
<td>Two (not three) years of financial statements</td>
<td>✓ (pursuant to JOBS Act)</td>
<td>✓</td>
</tr>
<tr>
<td>Omission of financial statements not reasonably expected to be necessary at the time of public filing</td>
<td>✓ (pursuant to FAST Act)</td>
<td>✓ (pursuant to SEC relief)</td>
</tr>
<tr>
<td>Ability to “test the waters” with investors</td>
<td>✓ (pursuant to JOBS Act)</td>
<td>✓</td>
</tr>
<tr>
<td>Ability of syndicate members to publish pre-IPO research</td>
<td>✓ (pursuant to JOBS Act)</td>
<td>✓</td>
</tr>
<tr>
<td>Ability of a research analyst to attend a pitch meeting for an IPO</td>
<td>✓ (pursuant to JOBS Act)</td>
<td>✓</td>
</tr>
</tbody>
</table>

As indicated in the chart, the SEC relief with respect to Exchange Act registration statements only extends to filing confidentially and does not reduce the number of years of financial statements required for filers that technically would qualify as an EGC if they filed a Securities Act registration statement. US filers of Exchange Act registration statements must still include three years of audited financial statements even if they are an EGC and foreign private issuers are permitted to include only two years if they are US GAAP and not IFRS reporting companies. This highlights an incongruity in extending the benefit of confidential filing to filers of Exchange Act registration statements while still requiring three years of audited financial statements.

It is hoped that this difference and the different treatment of US GAAP and IFRS will be addressed by the SEC in subsequent initiatives.

**Time to Level the Playing Field Entirely**

Given the SEC’s efforts to level the playing field, there remains a fundamental question as to why the United States has meaningfully different restrictions applicable to IPOs by EGCs compared to those by other issuers. It is important to note that since the beginning of 2016 through the date of the SEC relief, there were 206 IPOs in the United States of which 180 were by EGCs and only 26 were by non-EGCs. Those non-EGCs did not have the benefit, for example, of being able to test the waters through early interactions with investors and, instead, had to wait until the first public filing of their registration statement. The challenges faced by non-EGCs potentially are exacerbated because of the SEC’s new relief allowing non-EGCs to delay publicly filing their registration statement in the same manner as EGCs. There does not appear to be a strong policy reason why a non-EGC taking advantage of that relief should not be able to test the waters like an EGC.
One might argue that disparate treatment of EGCs and non-EGCs is unimportant since non-EGCs appear to be able to raise capital irrespective of these limitations. However, other leading IPO jurisdictions—London and Hong Kong in particular—have no meaningful restrictions on early engagement with investors. This affords large issuers the ability to enhance deal certainty through early investor interactions. These jurisdictions also permit early publication of research by analysts in order to facilitate investor education. Such a regime enables the investment bank to reach a larger number of potential investors than individual analysts can reach in a US IPO. This is because, in the absence of published research, sell-side analysts from the IPO syndicate have to call potential investors and discuss their views one-on-one. In addition, because research in these jurisdictions can be published before the roadshow, the issuer and underwriters are able to better assess the appropriate price range.

The JOBS Act sought to facilitate the publication of pre-IPO research solely with respect to EGCs in an effort to achieve the goals of enhanced investor education and price certainty. However, in the United States, where 8.4 percent of the companies comprising the S&P 500 became subject to a securities class action claim during 2016\(^1\) and where issuers and underwriters seek to avoid inclusion of projections in IPO prospectuses, it is easy to understand why investment banks are not willing to take the risk of liability that they may face in the US through publication of pre-deal research. Encouraging such research likely will require securities class action liability reforms that go beyond what the SEC can achieve through rulemaking and probably what Congress can achieve politically.\(^1\) That being said, the other areas of the JOBS Act related to the IPO offerings process, particularly testing the waters with investors, could be addressed through SEC rulemaking. Accordingly, the SEC will have to do additional work to the extent its goal is to ease capital formation by non-EGCs as well as EGCs.

**Notes**

1. An “emerging growth company” is defined as an issuer with “total annual gross revenues” of less than US$1.07 billion (after recent upward adjustment for inflation) during its most recently completed fiscal year.
4. See Question 11, FAQs, issued June 30, 2017.
5. See Question 10, FAQs, issued June 30, 2017.
6. See Question 8 and Question 9, FAQs, issued June 30, 2017.
7. See Question 17 and Question 18, FAQs, issued June 30, 2017.
8. Form S-3 and F-3 eligibility commences at the end of the 12th complete calendar month after a company becomes subject to Exchange Act reporting obligations subject to the company being current with its filings and having filed required filings during that period.
9. No distinction is drawn between EGCs and non-EGCs in connection with the filing of an Exchange Act registration statement since JOBS Act benefits are expressly tied to filing a registration statement under the Securities Act.
10. Section 7(a)(2)(A) of the Securities Act mandating only two years of financial statements for EGCs, which was added by the JOBS Act, does not make a parallel change to the Exchange Act.
11. See paragraph 3 of Instructions to Item 8.A.2 of Form 20-F.
13. Underwriters have also sought to avoid distribution of research for 25 days after an IPO in order to avoid any conflict with prospectus delivery requirements during that period.
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