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The Alibaba Problem: Will outbound investment restrictions on AI cover Alibaba?

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Background

For some time, foreign investors have ignored warnings about the Environmental, Social, and Governance (ESG) risks of investing in Chinese technology companies like Alibaba.

This has been despite Alibaba's record being worthy of closer attention by public pension funds and investors guided by ESG. Not least, because of the company's legal obligation to work hand in glove with the state under the People's Republic of China's National Intelligence law.

In recent years the company has been accused of helping the People's Republic of China (PRC) to build technological infrastructure to target the Uyghur Muslims in Xinjiang, lost 71% of its market value (from Nov 2020- July 2023) after facing an unprecedented crackdown and forced reorganisation, and seen its popular and outspoken former Chief Executive Jack Ma banished.

Now foreign investors face a new risk when it comes to Alibaba, which is its growing central prominence when it comes to PRC efforts to develop Artificial Intelligence (AI).

Alibaba and AI

In the last six months, Alibaba has developed its own generative chatbot to rival ChatGPT called Tongyi Qianwen and led the largest single funding round for a Chinese AI startup: Moonshot AI.

Aside from these direct interventions into China's AI sector, Alibaba's cloud provides the backbone for 80% of China's technology companies, including half of the organizations working on AI and large language models. On 28 February 2024, Alibaba slashed its cloud service fees by as much as 55% to fuel AI investor growth in China.

Alibaba in December 2023 announced the creation of a new emerging technology unit at its Damo Academy in the Yuhang district of Hangzhou, capital of Zhejiang province. As part of its plans the technology company intends to recruit and support (with $140,000 award) one hundred post-graduates working in the fields of artificial intelligence and semiconductors.

In filings to the US Securities and Exchange Commission, Alibaba revealed that 12 of its business units have stakes from Chinese state-owned enterprises and government backed sovereign wealth funds. This includes two units in Alibaba's logistics division which have government ownership of 73.5%, a Chinese state-owned enterprise owns 20% of a unit in its health division, and another Chinese state-owned enterprise owns a third of a joint-venture with Alibaba in innovation.

Alibaba has used its data cloud and smart sensors to develop a "city brain" command centre for smart cities which has been used by China to increase up to date surveillance of cities. The ambition is to connect these "city brains" across China and perhaps across the Belt and Road by integrating AI. It has sought to export this model abroad to other countries, including Malaysia.

Unlike the democratic world, where AI development has largely been led by the free market, the private sector, and discussion of regulations have focused on multilateral agreements, the Chinese Communist Party has driven AI regulation in the country since 2017 (producing at least 9 policy documents on the matter from 2017-2023).

Given the CCP's early focus on AI regulation paired with a heavy hand in industrial policy, state funded AI labs, and the centralisation of the economy under party management under Xi Jinping, it is hard to believe that Alibaba's foray into AI is not directed by the upper echelons of the state.

Outbound investment restrictions

The tight control by the PRC over China's AI sector and the likely drive for dual military use of this technology has raised concerns in Washington DC, London, and across Europe, where policymakers are considering outbound investment restrictions.

All AI companies in China are subject to the broad, draconian 2021 Data Security Law, under which they must all cooperate with the authorities. This includes handing over data collected by AI algorithms and reporting on how it is used. The 2015 National Security Law, meanwhile, requires that all entities, whether public or private, mobilise their personnel to uphold and safeguard national security.

China's 2017 Next Generation AI Development Plan describes AI as a core strategic technology. Many of China's leading AI systems are being integrated into the country's domestic surveillance network and social credit system. In 2017, China also created the Central Commission for Integrated Military and Civilian Development to direct the transfer of AI technology from commercial entities and research labs to the military.

In an Executive Order issued by the Biden Administration on 9 August 2023 announcing outbound investment restrictions on the PRC and Hong Kong, President Biden stated that developments in the PRC's AI capabilities 'significantly enhances their ability to conduct activities that threaten the national security of the United States'.

The UK Prime Minister, Rishi Sunak, is currently consulting with the business community over the introduction of similar restrictions on outbound investment to China's AI sector as part of the Atlantic Declaration. It is likely that without bespoke UK restrictions, many in the City of London will follow US outbound investment restrictions by default.

Pressing ahead with outbound investment restrictions on China's AI sector presents investors in the UK with an Alibaba-shaped problem.

Given its central role in the PRC's attempts to rapidly develop and compete with the US on AI, it is hard to see how Alibaba could avoid being covered by outbound investment restrictions. If the UK presses ahead with outbound investment restrictions on China's AI sector, it will present investors with an Alibaba-shaped problem.

UK investors in Alibaba

After all, the largest Emerging Markets Index funds, which foreign investors passively track, continue to have significant holdings in Alibaba. At the time of writing Morgan Stanley's Emerging Markets Index Fund at Alibaba as its fourth largest holding, and FTSE Russell's Emerging Markets Index Fund had Alibaba as its third largest holding.[1]

Collectively these two index funds alone are driving around $360bn worth of passive investment into Alibaba, which in turn is being used to develop China's AI sector.

Similarly, Legal and General, which manages the UK's civil service pension scheme and the parliamentary staffers' pension scheme, and Aviva, another large UK pension fund manager, continue to have significant holdings of Alibaba through their respective emerging markets funds.

They are not alone. Several local authorities appear to have invested their pension funds in the past in Alibaba as well. This includes the Local Pension Partnership (launched by the London Local Authority and the Lancashire Local Authority), the Border to Coast Pension Partnership, and the Brunel Pension Partnership.

Perhaps just as worrying is the continued investment of the Universities Superannuation Scheme in nearly 400m (£393m) worth of equities in Chinese technology companies (As of 30 September 2023 the last publicly available data) that are working on developing Artificial Intelligence, closely linked to the People's Liberation Army, and accuse of complicity in human rights violations.

This figure includes investments in Chinese technology companies Alibaba, Tencent, Baidu, and China Mobile, which have been at the forefront of funding and developing China's own artificial intelligence industry.

Putting aside Alibaba, Tencent, and Baidu have had their ESG rating downgraded by MorningStar for complicity in China's internship censorship and China Mobile is currently blacklisted by the US Government for its close links to the People's Liberation Army.

None of this is new. Therefore, there are significant questions for the Universities Superannuation Scheme to answer when it comes to how these investments meet with its strict adherence to uphold Environmental, Social, and Governance (ESG) criteria.

VIE Structures and British Overseas Territories

Of course, it is a great irony that Alibaba and other Chinese technology partners have only been able to benefit from significant sums of foreign investment because of their Variable Interest Entity (VIE) structures and offshore listings in the Cayman Islands (a British Overseas Territory).

VIE Structures allow Chinese companies to list offshore, raise foreign investment, and bypass strict PRC laws on foreign ownership. Investors in VIEs do not hold any direct equities in the Chinese operating company but instead in a non-Chinese holding company.

It remains unclear, if Alibaba were listed under outbound investment restrictions by the UK and other governments, how these restrictions would apply to its VIE structure and offshore listing in the Cayman Islands.

Last year, the PRC introduced new rules on VIE structures, which given Chinese regulators powers to order Chinese companies with VIE structures to delist if their listing is deemed to harm national security or its controlling shareholder has committed financial crimes against China.

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[1] As of 31 January 2024

If Alibaba were to fall under US, UK, or EU outbound investment restrictions, the PRC could use these new rules to force Chinese technology companies to wind up VIE structures, delist from foreign financial exchanges, and in doing so, put significant levels of investment at risk.

Conclusion

Democratic governments should spend more time mapping out and analysing the role large technology companies are playing in China's growing AI sector.

The inclusion of large technology companies like Alibaba in any outbound investment restriction regimes deserves serious consideration, particularly if more information is brought to light that Alibaba's involvement is (1 being directed by the PRC state and (2 is clearly being used for civil-military fusion purposes.

1. UK public pension funds should ensure they have done sufficient due diligence to see whether companies like Alibaba meet their commitments to uphold Environmental, Social, and Governance (ESG) criteria. Such a review should consider the company's involvement in developing China's AI sector.
2. More broadly, pension funds and foreign investors should be reviewing whether investments in China's AI sector undermine their commitment to ESG and are inadvertently funding AI that is being integrated into the PRC's military sector.
3. As governments develop ESG and wider regulations of investments in sensitive sectors of foreign economies, they should consider the social risks that investments in AI development could create.