TAKING STOCK OF "CHINA, INC.": EXAMINING RISKS TO INVESTORS AND THE U.S. POSED BY FOREIGN ISSUERS IN U.S. MARKETS

VIRTUAL HEARING

BEFORE THE

SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP, AND CAPITAL MARKETS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTEENTH CONGRESS

FIRST SESSION

OCTOBER 26, 2021

Printed for the use of the Committee on Financial Services

Serial No. 117–56

U.S. GOVERNMENT PUBLISHING OFFICE
46–245 PDF WASHINGTON : 2022

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TAKING STOCK OF "CHINA, INC.": EXAMINING RISKS TO INVESTORS AND THE U.S. POSED BY FOREIGN ISSUERS IN U.S. MARKETS

Tuesday, October 26, 2021

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:06 a.m., via Webex, Hon. Brad Sherman [chairman of the subcommittee] presiding.

Members present: Representatives Sherman, Scott, Himes, Foster, Vargas, Gottheimer, Gonzalez of Texas, Axne, Casten; Huizenga, Wagner, Hill, Emmer, Mooney, Davidson, Hollingsworth, Gonzalez of Ohio, Steil, and Taylor.

Ex officio present: Representative Waters.

Also present: Representative Barr.

Chairman SHERMAN. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee are authorized to participate in today's hearing.

Today's hearing is entitled, "Taking Stock of 'China, Inc.': Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets."

I will now recognize myself for 4 minutes for an opening statement. I believe the Chair of the Full Committee, Chairwoman Waters, will be here soon for a 1-minute opening statement as well. If not, I will also claim her 1 minute and reiterate some of the same points.

The intertwining of the American and Chinese economies has given China substantial power here in the United States. It really hasn't given America any power, political power in Beijing.

We have great witnesses here today, but the most articulate witnesses are those who are not here today. Their decision to pull out of this hearing due to pressure, economic pressure, speaks loudly to China's strong economic power over politics and economics here in the United States.

There are those who think that we shouldn't encourage or allow investment in China because it means American capital is flowing

to their economy, but let us remember that this is a two-way street. Some $1.2 trillion of American capital is invested in China in their securities, not to mention $116 billion of direct investment. But some $2 trillion of Chinese capital is invested in American securities.

But we do have to make sure, if it is going to be a two-way street, that it is a fair street. We have heard of Luckin Coffee, Evergrande, and DiDi.

Luckin Coffee tells us that we need good audits and good oversight of those audits, and that the Public Company Accounting Oversight Board (PCAOB) needs to oversee the audits.

DiDi illustrates the issue of whether the boards of directors of companies are loyal to the shareholders, and whether the corporations have property rights that are protected by the courts of China, or whether you, in fact, are investing in a company whose assets could disappear due to capricious government action.

The SEC has created special rules for foreign private issuers, based on the idea that, say, that private issuer from abroad is from the United Kingdom, where you get all of the investor protection from the host country. And then, we will just add a little bit of American investor protection; we don't need all of the usual American investor protection. That model obviously needs to be turned on its head in dealing with China, where you get little or no investor protection from the home country.

We see that China is able to pressure index funds to include Chinese companies, but it is not Chinese companies that are in the index funds. An index fund may choose to put the 1,000 biggest companies in the world in the index, but you can't buy Alibaba; you buy Alibaba of the Cayman Islands.

Now, Alibaba is one of the 1,000 biggest companies in the world, but Alibaba Cayman Islands—the Cayman Islands isn't even one of the thousand biggest islands in the world. You are investing in a shell company, that invests in another shell company, that has a contractual relationship with Alibaba. Does that belong in an index?

But we do see that China is able to pressure Morgan Stanley and others to include these questionable entities in indexes. Now, when you invest in China, you are investing in a police state to some degree, one that imprisons a million Uyghurs in Xinjiang.

We will be discussing a number of bills here before us, two that were noticed early, the Accelerating Holding Foreign Companies Accountable Act, and a second one which deals with the Uyghur Forced Labor Disclosure Act.

I have also quickly, in advance of this hearing, distributed bills designed to force a review by the SEC of the special status they give private foreign issuers to see if that is relevant to companies based in China. And a bill to prohibit a phony name from being used; you shouldn't call yourself, "Alibaba," if you are not, "Alibaba," but you are really, "Cayman Islands Alibaba." And finally, we will get into the variable interest entities (VIEs), which are not real companies, and whether they belong in indexes.

At this point, I will recognize the ranking member for his opening statement, and I wonder whether I should recognize him for 4 minutes or for 5 minutes? Do you have the whole Republican time?

Mr. HUIZENGA. Yes, at this point, I do and—

Chairman SHERMAN. Then, I will recognize you for 5 minutes.

I now recognize the ranking member of the subcommittee, the gentleman from Michigan, Mr. Huizenga, for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

Actually, before I get into my comments, I am curious if you could clarify two things? One, those bills that you were just talking about, were they noticed for this hearing, or did you just introduce them? Because we were not aware of them.

Chairman SHERMAN. Those are, at most, discussion drafts that I circulated just yesterday. And—

Mr. HUIZENGA. Okay.

Chairman SHERMAN. —they are among the many things that will be discussed here today.

Mr. HUIZENGA. Okay. Well, I am looking forward to getting our hands on those and having that conversation. And then, I would appreciate it, too, if you would clarify—you mentioned the four witnesses that we have before us, but you mentioned that there were some others who either refused or didn't come or felt pressure, because I fully believe that. We have seen that with, whether it is entertainment companies, others, the NBA. There has been a lot of pressure, but I am curious if you could clarify that?

Chairman SHERMAN. I am not here to end any careers on Wall Street by explicitly identifying names. There are those with whom we were in discussions, some who had actually agreed to come testify, then notified us that they decided it was in the interest of their careers that they not appear before us. We decided not to have one of those witnesses in the House Foreign Affairs Committee, where we have had people who might be subject to torture. We have had screens and muffled voices there, but we chose not to do that here.

Mr. HUIZENGA. Understandable. I am going to reclaim my time, because I do need to get through my statement, and I, too, am not in the business of endangering that, but certainly that is a significant, serious accusation that is getting thrown out. So, I think it is important that we begin this hearing by level setting and acknowledging what is really happening with China and the Chinese Communist Party (CCP). We often just use the acronym and kind of blow over what it actually stands for.

China is gearing up for a fight to attempt to replace the U.S. as the premier world leader, both economically and geopolitically. China's preparation to compete with us relies on ensuring that the CCP's control is absolute. That is exactly what the CCP has been working towards. It is critical that we, as policymakers, acknowledge this fact. If we don't, we are missing a bigger picture and a bigger threat, and doing so will lead to short-sighted half measures in response to China's threat.

I am a little afraid we may be losing sight with today's hearing. I just want to make sure that we are not. China's threat is far greater than just that of investment-related risk. It is far more multidimensional, and therefore, we have to be far more multidimensional.

Legislation like the Holding Foreign Companies Accountable Act (HFCAA), which passed on a bipartisan basis last Congress, rep-

resents one of the important pieces that should be a well-rounded, multi-pronged approach from Washington. It properly corrected an investor protection imbalance whereby China- and Hong Kong-based companies were operating under different rules than everyone else. That certainly cannot stand.

But we should be focusing on how to complement the HFCAA with policies pulled from a diverse toolkit beyond the securities laws. For example, attempting to deal with the threat of China through mandatory disclosures that are unrelated to financial materiality for foreign policy purposes, I believe is also a bit shortsighted. These disclosures will not likely change China's behavior, especially considering these disclosure requirements would be applicable to all public companies, no matter where they are incorporated.

The SEC tends to be the wrong agency to address national security and human rights issues, and we have seen that before with things like the failed conflict minerals provisions of the Dodd-Frank Act, et cetera.

For example, we should be sanctioning Chinese firms instead that pose national security threats, and imposing export controls to deprive these Chinese firms—(government)—of advanced technologies needed for their quest for global dominance.

Fostering entrepreneurship and encouraging business activity should be another policy priority of ours to deal with China's threat. Chinese regulators have been cracking down on their own entrepreneurs and shutting them off from foreign investment. So, we have an opportunity here, folks.

In response, doubling down on American economic growth through innovation and promoting economic freedom would be a tremendously effective approach for us in contrast to the top-down authoritarian approach of the CCP.

Again, we have an opportunity. Let's seize it. Fostering entrepreneurship and encouraging business activity are squarely within our subcommittee's jurisdiction and explicitly within the SEC's mission.

So, let's discuss those policies. Outcompeting China in the long term will depend on American economic growth. If we are only focused on addressing China through ineffective mandatory disclosures, and not growing our economy, then we are choosing to face the threat of China with both hands tied behind our back.

And with that, I yield back.

Chairman SHERMAN. I thank the distinguished ranking member for his statement.

I will now recognize the Chair of the full Financial Services Committee, Chairwoman Waters, for 1 minute, and also indicate that if Chairwoman Waters wants to be the first questioner, that would be my honor as well.

Chairwoman WATERS. Thank you, Chairman Sherman. I am very pleased that you are holding this hearing today.

Our capital markets are the envy of the world, raising trillions of dollars for large and small businesses, and supporting the retirement and savings of investors. Our markets work because participants have to play by the rules.

For example, companies that want to raise capital, gain the trust and confidence of investors by providing access to reliable and ac-

curate financial information. Our regulators then have unhindered access to both this information and those who audit the information.

However, some jurisdictions, like the People's Republic of China, have created obstacles to this effective oversight and are undermining the bedrock of investor confidence. So, I look forward to reviewing the actions that Congress and the SEC can take to protect our markets.

I thank you, and I yield back my time.

Chairman SHERMAN. Thank you.

Today, we welcome the testimony of our distinguished and, in some cases, courageous witnesses: Karen Sutter, a specialist in Asian trade and finance with the Congressional Research Service; Samantha Ross, the founder of AssuranceMark, The Investors' Consortium for Assurance; Claire Chu, a senior analyst with RWR Advisory Group; and Eric Lorber, the senior director of the Center on Economic and Financial Power at the Foundation for Defense of Democracies.

Witnesses are reminded that their oral testimony will be limited to 5 minutes. You should be able to see the timer on your desk in front of you that will indicate how much time you have left. When you have 1 minute remaining, a yellow light will appear. I will ask you to be mindful of the timer, and when the red light appears, to please wrap up very quickly.

And without objection, your written statements will be made a part of the record.

Ms. Sutter, you are now recognized for 5 minutes.

STATEMENT OF KAREN SUTTER, SPECIALIST IN ASIAN TRADE AND FINANCE, CONGRESSIONAL RESEARCH SERVICE (CRS)

Ms. SUTTER. Good morning. Chairman Sherman, Ranking Member Huizenga, distinguished members of the subcommittee, thank you for inviting the Congressional Research Service to testify today.

I would like to raise six points today for your consideration.

To start, I would like to discuss how China is selectively opening its financial markets to a few U.S. investment firms, allowing them to expand China offerings to U.S. investors. These firms see growth opportunities in China, but their market participation is still curtailed by Chinese government controls and the dominant market position of China's large state banks.

Some U.S. firms and investors may profit from investments in Chinese companies, but these transactions appear to leave U.S. investors in a passive role in three respects.

One, U.S. financial investors cannot leverage the productive industrial or technological capabilities that their capital may help China to develop.

Number two, U.S. financial investments do not appear to open China's economy to U.S. competition, especially in strategic industries that they fund.

Number three, the Chinese government can exercise control, influence, and discretion over U.S. investments and the underlying business operations and assets that are in China.

Next, I would like to discuss the limited and targeted nature of China's financial investment openings to date which appear designed in part to attract capital, U.S. capital to areas where China's economy is weak, such as bad assets and debt. Increased U.S. capital flows to China's debt markets could create growth opportunities, but also could create increased U.S. risk exposure by placing more U.S. capital in areas where there are systemic market risks. The Chinese government's current efforts to address debt and overcapacity in its property market highlights an example of such risks.

Third, the Chinese government appears to be seeking U.S. capital and expertise to fund its strategic and emerging industries, to strengthen China's capital markets, and to position Chinese firms as global leaders and competitors. U.S. investors are funding some companies that are tied to the Chinese government's dual use industrial policies, such as Made in China 2025.

Similarly, China is investing in some U.S. firms that have technologies and capabilities that the government is seeking to advance its goals. While these investments may promote economic growth, offer strong returns for some U.S. investors, and provide financing for certain firms, at the same time, they also may develop competitive Chinese capabilities.

Fourth, the role of the state in China's economy and business ecosystem has increased dramatically since 2014, under China's leader Xi Jinping. This is intensifying the potential challenges and risks in financial and commercial ties with China for U.S. companies, U.S. investors, and the United States more broadly. A significant increase in two-way financial investment could give the Chinese government greater influence over U.S. companies, as well as the U.S. and global marketplace.

Fifth, the corporate structures that Chinese firms are using to expand overseas and invest in U.S. capital markets, such as the variable interest entity (VIE) are complex. These structures appear to make it difficult for U.S. investors to assess potential risks. While U.S. underwriters, accountants, or legal counsel may have insights into these risks, they may not share this knowledge fully with U.S. investors, who ultimately bear the costs of these risks.

These complex corporate structures also separate the underlying Chinese company and its operations and assets from U.S. investors. This potentially limits the ability of U.S. investors to exercise their rights, including the right to seek full legal recourse if necessary.

In closing, I would like to discuss nonpublic transactions. There appears to be a lack of transparency on deals and an absence of publicly available data on the main and growing two-way investment pathways, which include private equity, venture capital, and private placements. This situation is complicated by U.S. and Chinese monies that appear to be increasingly commingled through funds that operate in the United States and China.

Without greater transparency, it is difficult to assess how some financial transactions may support related deals that could involve the transfer of technology or know-how. Transparency gaps also potentially affect the U.S. Government's ability to assess aggregate U.S. financial and economic exposure to China and potential risks.

Thank you for your consideration. I look forward to your questions.

[The prepared statement of Ms. Sutter can be found on page 85 of the appendix.]

Chairman SHERMAN. Ms. Ross, you are now recognized for 5 minutes.

STATEMENT OF SAMANTHA ROSS, FOUNDER, ASSURANCEMARK, THE INVESTORS' CONSORTIUM FOR ASSURANCE

Ms. ROSS. Thank you.

Chairman Sherman, Ranking Member Huizenga, Chairwoman Waters, and members of the subcommittee, I am pleased to appear before you today to discuss the significant risks that investors face from China-based companies that benefit from access to U.S. markets but do not comply with the important investor protections under U.S. law.

My testimony is based on my experience of over 18 years serving in the Division of Enforcement at the SEC, where I gained first-hand knowledge of fraudulent accounting practices by foreign private issuers, and at the Public Company Accounting Oversight Board (PCAOB), where I helped design audit oversight rules and initiatives that laid a framework to protect investors in foreign companies that issue securities in U.S. markets.

The PCAOB's job is to oversee and inspect the auditors of companies that access U.S. public capital markets. Eight hundred and forty non-U.S. accounting firms from more than 80 jurisdictions are registered with the PCAOB in order to be able to prepare or participate in the preparation of audit reports provided to U.S. investors and submitted to the SEC.

Not all of these firms actually do so, though, but when they do, the PCAOB is required to inspect their work to ensure that their audits comply with our standards. Both independently and through numerous cooperative agreements with local authorities, the PCAOB is able to inspect firms in all relevant jurisdictions except Mainland China and Hong Kong.

The People's Republic of China's (PRC's) resistance to the PCAOB's inspections is not just a theoretical compliance issue. Our markets are being tested by a string of frauds by China-based companies that obtained capital from our markets but failed to comply with our investor protection rules.

By enacting the Holding Foreign Companies Accountable Act and continuing vigilant monitoring through hearings such as this one, Congress is playing a critical role in signaling that companies that seek access to capital from U.S. markets must adhere to our rules.

I also commend the SEC and the PCAOB for the decisive approach they are taking to implement the Holding Foreign Companies Accountable Act.

A great body of research documents the benefits that foreign private issuers obtain by issuing securities in the United States. Those benefits include a lower cost of capital than they would face in their home-country capital markets. The linchpin of these benefits is the binding commitment companies make to our standards, including high-quality financial reporting requirements and a reliable third-party audit. Enforcement of this commitment, rather

than relying on mere assertions of compliance, is what distinguishes U.S. listings and produces their capital market benefits.

PCAOB inspections are a critical component of our enforcement regime. Inspections examine whether third-party auditors are, in fact, holding companies to their commitments to produce high-quality and reliable financial reports. There is empirical evidence that capital markets find financial reporting more credible following introduction of PCAOB inspections in non-U.S. jurisdictions. That is, investors put more faith in financial reporting when the PCAOB is able to inspect.

China-based companies free-riding on U.S. markets, without complying with U.S. audit regulations, increases fraud risks for investors in those companies. But that is not the only reason why it is important to stop the free-riding. It also harms our markets more broadly. The benefits I have described exist because participation in our markets means something. It is a signal of the quality and reliability of the financial reporting of the companies that list here.

As we saw in the days of the Enron scandal, when any group of participants fails to comply with our standards, that sends a signal that weakens confidence in the whole market. For the benefits to continue to flow to compliant U.S. and non-U.S. companies, it must be clear that we enforce our standards across-the-board.

In conclusion, audit regulators around the world cooperate in PCAOB inspections of registered firms' audits of companies that offer securities in the United States. The PRC is the only government that blocks them. This causes serious harm to both investors in such companies, as well as our public capital markets more broadly.

I commend the work you have done to put an end to these harms, as well as the work the SEC and the PCAOB have done to implement the Holding Foreign Companies Account Act. Based on the heightened risks evident from a string of frauds that have already been revealed, it will also be important to ensure that China-based companies that are prohibited from trading on our public markets do not turn to other ways to access U.S. capital. And therefore, I commend your continued vigilance.

Thank you.

[The prepared statement of Ms. Ross can be found on page 77 of the appendix.]

Chairman SHERMAN. Thank you for your testimony.

Ms. Chu, you are now recognized for 5 minutes.

STATEMENT OF CLAIRE CHU, SENIOR ANALYST, RWR ADVISORY GROUP

Ms. CHU. Chairman Sherman, Ranking Member Huizenga, and distinguished members of the subcommittee, thank you for the opportunity to testify before you today.

I am a senior analyst at RWR Advisory Group, a research and advisory firm based here in Washington, D.C., where I specialize in the geopolitical and national security risk implications of China's commercial activity and overseas engagement.

I have been asked to provide some context on the nature of Chinese corporate actors and their role in China's state-led economy.

I will also lay out several risks to investors and the United States, followed by recommendations.

The Communist Party of China's (CCP's) involvement, influence, and control over the commercial sector means that Chinese companies are beholden to the party-state and can be compelled to sacrifice corporate interests for government favor. Corporate actors are directed to meet state planning targets, and CCP officials are embedded within the operations of large companies to ensure regulatory compliance.

The government essentially has the power to determine whether a company is allowed to raise capital, provide goods and services, or even continue to operate as a for-profit enterprise. There are clear incentives for companies to welcome CCP guidance and to operate in ways that are conducive to the state's interests. Companies can also be subjected to coercive and arbitrary punishment for crossing party-state lines.

The heavy-handed, reactive nature of the Chinese regulatory apparatus can sometimes undermine its own companies and, by extension, American investors in those very companies. China's recent regulatory broadside has left the U.S. financial industry grappling with the challenge of quantifying the effect of government corporate intervention. This kind of uncertainty has a material adverse impact on companies and investors, who cannot be sure if IPOs will go ahead or if entire industries will be banned from raising funds in the capital markets.

What really amplified the impact of this latest spate of regulatory action and made it front-page news was the high level of global financial exposure to the stocks of those affected companies. The Chinese government prioritizes state stability and social control over commercial gains. The more intertwined the U.S. and Chinese markets become, the more acutely U.S. investors will feel the aftershocks of Beijing's politically driven market interventions.

The U.S. commitment to high-quality, reliable disclosures and financial reporting is a key element of its ability to protect investors and market participants.

The Chinese party-state's sweeping bureaucratic authority, opaque legal system, and complex corporate structures obscure, often intentionally, a Chinese company's beneficial ownership and financial realities. Beijing also uses lack of transparency as an economic advantage, creating information asymmetries to control and moderate foreign flows into the Chinese market. These China-specific risk factors make it particularly challenging for U.S. regulatory authorities to conduct proper due diligence and can prevent U.S. investors from being able to make informed investment decisions.

Variable interest entities (VIEs), for example, are legally ambiguous corporate structures used by Chinese companies to list on U.S. exchanges. VIE shareholders have no recourse. The operating company's underlying assets and the moral hazard risks are substantial.

Chinese companies seeking to issue unregistered securities in the United States are able to circumvent strict standards by taking advantage of the SEC safe harbors, like Regulation S and Rule 144A.

With the rapid inclusion of China A-shares into major stock indices, the expansion of Stock Connect schemes, and the quadrupling of A-share weighting in certain benchmarks, U.S. investor access to the publicly-traded Chinese companies has expanded dramatically over the past few years. Index providers like MSCI and FTSE Russell have become a power force, serving as intermediaries and gatekeepers between Chinese companies and U.S. markets, exercising virtually unchecked, unregulated authority over the volume of U.S. capital flows to China.

The criteria evaluated by index providers to support inclusion and weighting decisions are limited to standardized attributes, like market cap and liquidity, and neglect to consider the reputational and China-specific factors like state-sanctioned human rights abuses or financial exposure to party-state policymaking.

U.S. retail and institutional investors are consequently exposed to a wide range of Chinese companies engaged in activities that are contrary to the national security and foreign policy interests of the United States. Many are already sanctioned by the U.S., but not subject to any capital markets restrictions, no investment restrictions, or divestment mandates, and are thus able to continue raising capital in the U.S. markets.

The current U.S. securities regulatory framework will need to evolve with greater, more targeted oversight, disclosure enforcement, China-specific due diligence, and sanctions alignment to respond in kind to the unique risk associated with this influx of securities listed overseas in institutional environments where the disclosure requirements and corporate governance practices don't offer the same protections for investors as in the United States.

Thank you, and I look forward to your questions.

[The prepared statement of Ms. Chu can be found on page 44 of the appendix.]

Chairman SHERMAN. Thank you.

And Mr. Lorber, you are now recognized for 5 minutes.

STATEMENT OF ERIC LORBER, SENIOR DIRECTOR, CENTER ON ECONOMIC AND FINANCIAL POWER, FOUNDATION FOR DEFENSE OF DEMOCRACIES

Mr. LORBER. Chairman Sherman, Ranking Member Huizenga, and distinguished members of the committee, I am honored to appear before you today to discuss the risks to investors and the United States posed by Chinese issuers in U.S. markets.

I come before this committee as a sanctions and compliance professional, having worked at the U.S. Department of the Treasury, and advised financial institutions, corporations, humanitarian organizations, and individuals on ensuring they operate in compliance with their legal sanctions obligations. As part of my work in both the public and the private sectors, I have seen firsthand the power of U.S. economic sanctions in furthering U.S. foreign-policy objectives, and while sanctions are not a panacea, they can be used in narrow and targeted ways to great effect.

One area where the United States has increasingly used this tool is in the global competition with China. As Congress and the Biden Administration consider ways to protect U.S. markets from abuse and push back against certain Chinese activities that threaten U.S.

national security, sanctions remain one of the top policy levers to consider pulling.

Safeguarding transparency in the global financial system and in U.S. markets is critical to protecting U.S. national security and the strength of the U.S. financial system. A core part of providing this transparency is ensuring that U.S. investors have access to relevant material information about foreign companies in order to make informed decisions. Over the last few years, the United States has taken important steps to ensure that Chinese companies attempting to access U.S. markets must play by the same rules as U.S. companies, and do not produce significant material risk in U.S. investors' portfolios due to their lack of financial transparency.

At the same time, we must balance those considerations against the risk of creating an onerous set of disclosure requirements that deter companies from seeking to access U.S. markets or that make it overly burdensome to do business here in the United States. Such burdens can deter legitimate companies from seeking financing on U.S. capital markets. This is a delicate balance to strike.

As Congress and the Administration weigh whether to create new reporting and disclosure requirements and determine how to best protect U.S. investors, they should likewise consider the use of narrowly-targeted sanctions which offer a well-established tool to ensure U.S. companies and U.S. national security are protected from certain threats.

The United States has a range of sanctions tools to target specific Chinese companies whose activity it believes poses national security risks. In particular, over the last few years, the United States has deployed limited, but powerful, prohibitions on trading in public securities of certain Chinese companies allegedly associated with the People's Liberation Army, or otherwise alleged to be involved in China's civil military fusion program.

Likewise, for companies or individuals who are alleged to engage in particularly egregious actions, this targeted approach may be a narrow and effective way to limit these companies' or persons' access to U.S. markets and to U.S. capital more broadly.

In addition to sanctions designations, the U.S. Department of the Treasury also has effectively promulgated advisories and guidance warning the private sector of doing business with certain companies or in certain sectors, including in Chinese industries. For example, the Treasury Department, along with its interagency partners, issued a supply chain advisory designed to warn the private sector about the risk of human rights abuses and forced labor in Xinjiang.

These tools could provide a narrow, targeted way to warn U.S. companies and investors of the risks of doing business with certain Chinese companies or in particular industries, as well as limit the ability of those Chinese companies that threaten U.S. national security from securing capital on U.S. markets.

I look forward to your questions, and thank you again for the opportunity to testify.

[The prepared statement of Mr. Lorber can be found on page 68 of the appendix.]

Chairman SHERMAN. I want to thank all tof he witnesses for their testimony.

I now recognize the Chair of the Full Committee, Chairwoman Waters, for 5 minutes for questions.

Chairwoman WATERS. Thank you very much, Mr. Chairman.

Ms. Sutter, it is reported that many China-based companies desire to be listed on the U.S. stock exchanges not only because our markets are large and liquid, but because our stock exchanges permit initial public offerings, or IPOs, with something called dual class share structures. Dual class structures allow elite shareholders, most often company founders and executives, to have a disproportionately large portion of the company voting power.

This structure has been used by many companies from Mainland China. In fact, at least 5 of the top 10 U.S.-listed China-based companies have dual class structures. What I find interesting is that China's own exchanges, or the London Stock Exchange, for example, ban the practice of dual class structures for IPOs.

Ms. Sutter, how does the dual class share structure permitted by our stock exchanges create risk to our investors? Why do China-based companies make use of this structure? Should our exchanges limit China-based companies' ability to offer dual class share structures?

I find this situation very interesting, and I question whether or not we can question China, when we use the same structures? And if we are questioning them because, as I am told, China has more control over these big business, these owners, these top business people, and they direct them and they can tell them what to do, and somehow that is a difference between what they do and what we do, can you help me out with this discussion?

Ms. SUTTER. Sure. Chairwoman Waters, thank you very much for the question.

I think with the dual class share issue, generally there are broader considerations that I do not focus on. I will narrow in on the China element in particular.

As you mentioned, the Chinese companies do take advantage. They do use the dual class share structure. This has also become a competitive issue within China. Since 2018, the Hong Kong exchange, and then, starting in 2019, the China exchanges have started to consider and adopt this dual structure.

The one thing I would highlight in considering how the Chinese companies may use this structure is that in addition to this legal element, this formal element of dual class shares, that within the Chinese system itself, not all shareholders are equal. I would highlight to you that in looking at the government restructuring of companies like the property developer Evergrande, or the restructuring of companies like HNA Group, at the end of the day, the government is also often a shareholder or has a direct economic interest in a lot of these companies. It does not always play kind of a disinterested role, shall we say, and so I think it is important that even if the dual class share issue were to be resolved, that underlying this structure are these inherent asymmetries in the role of the state in a lot of Chinese companies.

In the case of HNA, basically what they determined is that although there were 300 or more subsidiaries that had been created for the company, at the end, the Chinese government was the actual controlling shareholder.

Chairwoman WATERS. Do you think that dual class share structures are basically good for us, as opposed to China, and that we should support what we do because somehow it advantages our economy in some way or it advantages the way that we treat investors? Do you think it is good?

Ms. SUTTER. I don't have a specific opinion on the structure itself. I think the main point I would emphasize is that in addition to the formal structure, there is an informal structure in Chinese companies that, regardless of how they list, this influence of the state and actual controlling shareholders and ultimate beneficiaries is embedded within the corporate system, either formally or informally, separate from even how they list in China or then how they might list on a foreign market such as the United States.

Chairwoman WATERS. Thank you very much.

Mr. Chairman, I am going to yield back my time, but I think this is an issue that needs a lot more discussion. I yield back.

Chairman SHERMAN. I couldn't agree with you more.

And I now recognize the ranking member of the subcommittee, Mr. Huizenga, for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

Before I get into my time, I do have a parliamentary inquiry. It is the Minority's belief that the inclusion of this list that your staff had sent over to us of three bills that do not even have bill numbers at this point actually doesn't qualify as congressional testimony. It is not properly noticed for us, and frankly, even more important, not properly noticed to the public and those affected by that.

I guess I would just note that these bills were not properly noticed because, at least at this point, it looks like they don't even have bill numbers, and do you then intend to have an actual hearing on these bills?

Chairman SHERMAN. It is the practice of the committee to circulate discussion drafts. Of course, discussion drafts do not have bill numbers. Some of the most important legislation, I believe, has been discussed as drafts without H.R. numbers.

Discussion drafts of bills at today's hearings do satisfy the McGovern Rule, which requires that a bill has a legislative hearing before it goes to the Floor. That being said, it is my expectation that either the full committee or more likely the subcommittee will have a more general hearing on capital markets issues, which will provide a second opportunity to discuss these bills before they go to the Floor.

Mr. HUIZENGA. Furthering my parliamentary inquiry, the rules do state a 3-day notice. That was not what happened, just so we are clear, and all on the same page with that. So, at this point, I guess I would like to—unless you have something more to add on the parliamentary inquiry, I am happy to take my time for the questioning now.

Chairman SHERMAN. You are recognized.

Mr. HUIZENGA. Thank you.

Mr. Lorber and others, you have made some interesting notes on what has been happening with China. Obviously, we have seen large tech companies like DiDi and Ant Group, Chinese companies that either have or were planning to go public in the U.S., have

been targeted by Beijing. It is clear that China believes it is ready to directly compete with U.S. markets for the title of premier global economy.

What I am curious about is your take on how serious is the CCP at all on this crackdown, and are we looking at kind of a financial version of Tiananmen Square here with their entrepreneurs and their folks that have been innovative? And along those lines, what can we do here in the U.S. to improve the market situation to make sure that we are competitive?

I don't want to be Gulliver among the Lilliputians, with a whole bunch of other people who have terrible policy and we have slightly better policy. I want to have the gold standard, the U.S. dollar gold standard of policy here in the U.S. to make sure that we are the leading economic force.

Mr. LORBER. Thank you, Ranking Member Huizenga.

I agree with your assessment and the assessment of other members of this panel when they suggest that you have seen a tightening of control over certain companies within China, and it appears to be led in part by the government or in full by the government.

But I want to focus on the second part of your question because I think that is exactly right. Ensuring that the U.S. capital markets space remains robust has all types of downstream economic, positive economic impacts for the United States. It increases innovation. It ensures that the cost of borrowing here in the United States is low. It incentivizes non-U.S. companies to come and work in the United States. And so, I think from sort of a perspective of ensuring that the U.S. financial system remains strong, trying to keep our financial markets as streamlined and as attractive as possible is an incredibly important goal.

Mr. HUIZENGA. I am curious, and along those lines, do increased mandatory SEC disclosures not related to financial or investment risk—I believe this has been a significant part of our conversation on the subcommittee, and there was one of those that is proposed here today that applies to all U.S.-listed companies, not just those from China. What does that do to encourage U.S. economic growth, or does it discourage it?

Mr. LORBER. It is a good question. I do think that there is a risk of, if requiring nonmaterial disclosures, that the burdens and the obligations that are imposed on U.S. and non-U.S. issuers will certainly create some degree of additional compliance obligations and some degree of deterrence for companies seeking to find financing on U.S. markets. So, I do think that there is a risk in particular of requiring, again, disclosure related to nonmaterial information.

Mr. HUIZENGA. Ms. Ross, in your introductory materials and biography and those types of things, you talk about materiality of disclosure. I am curious if you could very quickly touch on that as well?

Ms. ROSS. Thank you so much, Ranking Member Huizenga.

Yes, I agree. With respect to these issues with China, it is really not a matter of needing more new disclosures. The problem is that these China-based companies are not even complying with our existing rules. So, I don't think adding new disclosures will address it. I think what we need to do is to actually enforce the existing

rules and send the signal to Chinese companies and the Chinese government that these are rules that pertain to our markets that they must adhere to when they are in our markets.

Mr. HUIZENGA. What about a targeted sanction or something along those lines to address the weaker situation, would you view that more effective versus a blanket sort of SEC? Quickly, if you want to answer that, and then I want to get to Mr. Lorber.

Ms. ROSS. Yes, sure. I agree with Mr. Lorber's testimony that targeted sanctions can be very effective tools. I also think when we are talking about these China-based companies that are listed in the U.S. markets, across-the-board they are not complying with our rules. So, I do think across-the-board enforcement of our rules against all of them is appropriate.

Mr. HUIZENGA. Mr. Lorber, enforcement, quickly, in my last seconds.

Mr. LORBER. Yes, I agree with the assessment of sanctions. I think you saw—particularly in the Xinjiang region, you saw the designation in 2020, I believe, of the XPCC, the Chinese paramilitary organization that was involved or alleged to be involved in those activities, as well as the publishing of guidance to warn about the supply chain, and I think that had a major impact on sourcing of goods, in particular from that area.

Mr. HUIZENGA. My time has expired, but I just do want to commend the Chair. I am glad we are having this conversation. This is a conversation we need to have. We have had it in the past, but I think the seriousness of this issue has become more crystal clear for everyone, and I am encouraged to have this ongoing conversation.

I yield back.

Chairman SHERMAN. The gentleman has gone over time, but if he wishes more time to praise the Chair, he will be yielded it.

Mr. HUIZENGA. The gentleman is obviously a good-looking, wealthy, serious-minded person who is—keep going? Okay. I think I—

Chairman SHERMAN. The gentleman's time has expired. I now recognize myself for 5 minutes.

Ms. Sutter, I want to pick up on your comment about selective access, because this is one way in which China has so much power here in the United States. I represent the movie industry in my district, and they only allow 40 movies into China, so if you run a studio, you want to be one of those 40 movies. And you know that if you make a movie about Tibet, that movie isn't getting into China. And you know if you make a movie about Tibet, none of your movies are getting into China.

If you are Morgan Stanley, and you want to do banking in China, you know that you may be one of the banks that gets into China if your global index includes Chinese companies to a sufficient degree, and if you officially notify all of your customers that they should include China to the 15-percent level or whatever level in their portfolios.

You know that you will be allowed to do business in China if your lobbyist is here on the Hill lobbying for China. China doesn't need to hire a lobbyist. They have all of them through this selective access system.

I want to thank Ms. Ross for focusing on the importance of the already-passed Holding Foreign Companies Accountable Act, and the need for us to pass the officially, definitely, explicitly-noticed Accelerating Holding Foreign Companies Accountable Act that is pending before this committee, and point out that the original bill passed the Senate in light of Luckin Coffee and that it was so—and people wonder, is there a benefit to short-selling? There is at least one, and that is short-sellers, in this case Muddy Waters, LLC, that focused on Luckin Coffee, and discovered the problem there, that there was $300 million of fraudulent sales. They brought that to their attention. They, of course, made money by discovering that, and that short-selling can be a way to discover those issues.

Ms. Chu, I want to thank you for pointing out to us clearly that when you invest—we in the United States grow up with this idea that you buy a share in a company that owns assets. Those assets are managed in the interest of shareholders by a board of directors loyal to the shareholders, and those assets are controlled by the corporation, and their property interests are protected by the courts. That is 300 years, 400 years of common law. We just assume that. oh, that is what a corporate share is.

Whereas in China, the board may or may not be loyal to shareholders, may be more loyal to the goals of the Chinese Communist Party, and the courts may or may not enforce the property rights of the corporation vis-a-vis expropriation or arbitrary punishment or seizure. And yet, I don't think Americans instinctively—they just look at earnings per share and say oh, that company is doing well, it must be a good investment.

Ms. Sutter, I want to focus on including VIEs in indexes and the deceptive name. If I wanted to raise some money, I would call my company, "GameStopped." I would add an, "E–D." It is a hot company. A lot of people like GameStop.

You can call a company, "Alibaba of Cayman Islands," and register shares here, and everybody thinks that is, "Alibaba of China." But what you are really buying is a Cayman Islands company that owns a Chinese company that has some sort of contractual relationship with Alibaba. Everybody in China has a contract with Alibaba, if you have them on your phone.

Should we allow these phony names—should we allow people to use the name Alibaba if they are not Alibaba, and should we allow people to say that you are in an index because you are a big company when you are really just a Cayman Islands shell?

Ms. SUTTER. Thank you for the question. Would you like me to answer—

Chairman SHERMAN. Yes.

Ms. SUTTER. Okay, I just wanted to be sure. It is interesting, when you read a Chinese company disclosure that is submitted to the SEC, they often will talk about the VIE structure and risks associated with the VIE structure, sometimes going on for 5 or 10 pages, and it is an interesting question about, is, "Baidu, Inc.," "Baidu," or is, "China Mobile, Inc.," "China Mobile," in the sense of how the company is advertising to investor? So, that is an interesting question to consider. I think the other—

Chairman SHERMAN. I am going to have to ask you to respond for the record. My time has expired. It is my fault, but I have to go on to the next questioner.

Ms. SUTTER. Okay.

Chairman SHERMAN. I now recognize the gentlewoman from Missouri, Mrs. Wagner.

Mrs. WAGNER. Thank you, Mr. Chairman, and on that point, I think maybe that is why we have copyright laws, and perhaps it is up to the private entity and the company to exercise their copyright laws.

Mr. Chairman, I think today's hearing topic is extremely timely and necessary. America faces continued health challenges and an economic crisis that was brought on by the Chinese government suppressing, misrepresenting, and falsifying information concerning the spread of COVID-19 in the beginning of 2020. We must hold China accountable for their actions, which is why I have introduced H.R. 3882, the Compensation for Americans Act.

I also have authored an essay with Representative Andy Barr, whom I know will be speaking on this topic later on, which outlines the need to strengthen the U.S. sanctions regime, which is a key tool to denying our adversaries the resources they need to continue their illicit behavior.

The increased mandatory risk disclosures being discussed today will not change China's behavior. Instead, we should be focusing on how to better use a more targeted tool, such as sanctions or export controls.

Mr. Lorber, America's ability to counter China's global dominance is only effective if we focus on our strengths and leverage America's economic might to counter malign Chinese activities. As has been discussed today, using our securities disclosures to advance foreign policy goals can be counterproductive.

Specifically, I think adding excessive reporting and compliance burdens not based on information that is material to investors' investment risk calculus typically undercuts companies' ability to expand, innovate, and generate jobs. Will you describe, sir, how the use of U.S. investment disclosures rules to accomplish certain policy goals compromises the strength and credibility of America's capital markets?

Mr. LORBER. Thank you for the question, Representative Wagner. It is a good one.

I think to a certain extent, if there are additional nonmaterial reporting requirements put into place for companies, it will, as I mentioned earlier in the conversation, potentially reduce companies' willingness to list—companies that want to list on U.S. financial markets or to access U.S. financial markets to seek that access. So, I do think there can be a direct impact on the competitiveness of those markets if there are nonmaterial reporting requirements and obligations that are put into place.

Mrs. WAGNER. Will you comment, sir, also, on why the strength of the U.S. economy and our capital markets is key to our effectiveness abroad?

Mr. LORBER. Absolutely. As we were talking about earlier, and as I believe Ms. Ross mentioned in her testimony, U.S. capital markets are something of a crown jewel of the U.S. economy, right?

They allow for low-cost capital to be accessed. They are attractive for companies that are abroad. They increase innovation here in the United States. They bolster our economy here.

And so, I think that to a certain extent, especially when viewed vis-a-vis the sort of control that the Chinese government is now exercising over its companies and some of the crackdowns that we have seen, those markets are increasingly attractive, and I think we should do everything we can to bolster them.

Mrs. WAGNER. Mr. Lorber, the Holding Foreign Companies Accountable Act was enacted last year because the Chinese government has actively not allowed Chinese companies listed on U.S. exchanges to comply with our securities laws. Is it just naive to think that Chinese companies will comply with the Democrats' mandatory SEC disclosure discussion drafts proposed today?

Mr. LORBER. I do think that additional disclosure requirements may not be impactful in compelling Chinese companies to comply. That is why, with the Holding Foreign Companies Accountable Act, the 3-year cutoff enforcement mechanism, I think is an appropriate mechanism, and for those companies that the U.S. believes pose serious national security threats, so maybe not just misleading on their financials but are actually involved in, for example, the Chinese civil military program, I think targeted securities sanctions would make sense for policymakers—

Mrs. WAGNER. In my limited time, how do other tools like sanctions and export controls eliminate the question of whether or not our rules will be, in fact, followed by the Chinese Communist Party?

Mr. LORBER. It is a great question. I think sanctions are a natural tool that have been employed by both of the last two Administrations, the Trump Administration and the Biden Administration, to target companies that the U.S. Government believes pose a national security threat. And in addition to that, one other thing I would say is guidance. The Treasury and other interagency partners have been really, really good in the last few years about putting out informative guidance to private sector actors to warn them of sanctions in illicit activity risks, and those companies that have read that guidance take that into account when making risk-based decisions.

Mrs. WAGNER. Thank you, Mr. Lorber. My time has expired. I yield back.

Chairman SHERMAN. I now recognize the gentleman from Georgia, Mr. Scott, who is also the Chair of the House Agriculture Committee, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman.

This is an extraordinarily important hearing. Right now, China's role in the global economy is just massive. China is the largest exporter of goods in the world, with 9.6 percent of the entire global share, and while the country's GDP grew at its slowest pace last quarter, expanding just 4.9 percent from the previous year, China's $15 trillion economy remains the second-largest in the world, second to us in the United States. Ours is number one.

In your testimony, Ms. Sutter, you cite several factors regarding China's attempt to reduce debt and curtail market risk among several large firms. Here is the question for you that I think the na-

tion and the world is waiting on: Can you explain what the impact would be for not just us, but for all of the global markets if a Chinese economic collapse were to occur?

Ms. SUTTER. Thank you, Congressman, for the question.

I think there is a lot of attention right now on the situation of China's second-largest property developer, Evergrande. Their total debt is about 2 percent of China's national debt. I think it provides some insight into some overcapacity and China's continued dependence on fixed asset investment for growth, that this is a systemic weakness in the economy.

A lot of people argue that right now, the U.S.'s potential risk exposure is manageable, but we are looking at a situation where a lot of financial firms now having new licenses to move into China—it has been discussed, putting more Chinese companies into fund indices—what comes ahead. So, I think Evergrande is a case study to look at the potential systemic risks in the market, how U.S. exposure could grow over time, and what would be the U.S. recourse in these types of situations.

Mr. SCOTT. Let me ask you this. How exactly is the dramatic slowdown in Chinese construction projects and manufacturing, those two things, how are they related to the growing warning signs that we are getting of a possible shock to the global financial markets?

Ms. SUTTER. I would say in response, I think the main thing to keep in mind is the trouble that Evergrande and other property developers have in China arguably was started by the Chinese government. These are highly-leveraged companies. Evergrande's assets, 60 percent are unbuilt, unsold properties, and these companies rely on money to continue to flow so that they can continue to pay. So, when the government stops the ability for new fundraising, it creates crisis in the system.

I think what you see the Chinese government doing now is trying to avoid market contagion in property, the market more broadly, but they are also trying to avoid moral hazard. They don't want to signal to companies like Evergrande that they can continue business as usual.

The local government in China is very dependent on these property developers for income for local government mandates. So there is a symbiotic relationship. In the case of Evergrande, the Xinjiang government is a direct shareholder in Evergrande.

So, I think it is the interrelationship, it is a challenge for China to get out of this situation, and I would say the situation for the United States is less our current exposure, it is more about we seem to be at a juncture where there is a lot of discussion about increasing financial exposure in areas like this in the economy. What would that look like going forward?

Most people seem to think the current exposure, if the Chinese are able to handle the situation, is fairly contained at this point, although that depends on how the Chinese government handles it going forward. It is an issue-to-watch type of scenario right now.

Mr. SCOTT. Thank you very much. That was very good information. Thank you.

Chairman SHERMAN. Thank you. I now recognize the gentleman from Arkansas, Mr. Hill.

Mr. HILL. I thank the chairman, and I appreciate your work in preparation of this hearing. It is certainly a topic of interest, strong interest to Members of both parties, and I appreciate our witnesses' preparation and being here personally. It is good to see witnesses in person, Mr. Chairman, and not on a Zoom screen.

In the late 1980s, I spent a lot of time traveling in Asia, including in China, and I can remember distinctly John Phelan's famous trip to Beijing in 1986 trumpeting the New York Stock Exchange as a potential place for Chinese companies to list. Americans had seen the success of the Asian Tigers by the 1980s, and I think U.S. policymakers really believed that if we demonstrated and modeled good behavior and opened up our markets, capital markets to China, that we would get a good response.

And in fact, China's capital markets did grow, access to capital was there, and there is no doubt that free markets and capitalism and the open trading system allowed China to create hundreds of millions of people and move them into the middle class, and certainly, China has benefitted from this past 3 decades.

But that 30 years of progress from the open door is now seeing that door slam shut since President Xi has turned his country into a more authoritarian state, and turned his back on the norms in capital markets. Consumers are no longer benefiting, but they are now pawns in a surveillance state. The business sector is no longer benefiting as much because markets are volatile, rules are inconsistent, and the state demands full control of entrepreneurship.

I don't know if investors are benefiting or not. I think the purpose of this hearing is to demonstrate that maybe they are not, because they are not getting the kind of information that a good market like the American markets provides. The third world and emerging markets are not benefiting due to the predatory neocolonial belt-and-road policies of China, and finally, their attitude about the capital markets would make the founders of Enron blush.

So, I want to say thank you to our ranking member and our chairman for calling this hearing.

I want to start with Ms. Sutter. You have provided excellent testimony. You brought a lot of good information to the committee on the VIE structure, and also using an ADR structure, which we have done for years and years successfully in many markets, we have allowed liquidity for foreign companies. Tell me what you think we ought to do that is fair-minded, and that is compliant with WTO obligations on improving disclosure for the use of a VIE or even the ADR structure.

Ms. SUTTER. Congressman, thank you for the question.

There has been a lot of interest around the challenges the United States faces with China, not just in this area, but across-the-board, and an interest in looking at greater transparency. There are a couple of ideas that I hear discussed that may be of interest for consideration for you and the committee: the issue of requiring a 20-F or 10-K equivalent for all firms, not just those who list, but also those who have secondary listings; the issue of more detail on the corporate structure; all of the beneficial owners, all of the different contracts and ties across the owners is another area that

some have discussed; the issue of quarterly as opposed to only annual reports on a company's financial situation—

Mr. HILL. Let me interrupt you there. Do you think if that were the status, it would make America a less effective market, say, for American depository receipts, or would you think—not just China, but as a general matter, would that be something that would be met with appropriately, since companies want access to U.S. retail investors?

Ms. SUTTER. I would say that I believe the issues I just raised are the same for what a U.S. lister would have to do—

Mr. HILL. Right. Thank you for that.

Ms. SUTTER. Sure.

Mr. HILL. Now, let me turn to Ms. Chu. You made, again, an excellent presentation. You commented on SEC Commissioner Hester Peirce's speech where she was open to additional disclosure for index providers and exchange-traded funds (ETFs). Tell me what you think would be appropriate there?

Ms. CHU. Thank you for the question.

At present, the criteria used by index providers who, again, exert overwhelming power over where U.S. investors are able to invest in China, which companies have access to U.S. capital, the criteria that they use is based on market factors. They have no consideration for reputational risks like human rights or national security, sanctions regimes, or trade conflict, and these are all things that pertain—

Mr. HILL. Thank you. If you would, submit for me your additional thoughts on that to the record.

Mr. Chairman, I yield back to you.

Ms. CHU. Okay.

Chairman SHERMAN. The gentleman from Connecticut, Mr. Himes, who is also the Chair of our Subcommittee on National Security, International Development and Monetary Policy, is recognized for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman, and a big thank you to our witnesses for really compelling and interesting testimony.

I want to use my 5 minutes to really zero in on the China issue here. Look, there is a long list of things that concern us all about China that have to do with strategy and geopolitics and military and IP theft, and it goes on and on and on. But this is the Financial Services Committee, and I am not a priori persuaded that variable capital arrangements are inherently problematic. Lots of U.S. companies, as the chairwoman points out, use variable capital structures. We are hearing about Luckin Coffee. I had never heard of Luckin Coffee, but dodgy accounting leading to bankruptcy is hardly a uniquely Chinese problem.

Let me start with you, Ms. Ross, because you did enforcement. If I am wrong about that variable capital or particular intensity of bankrupt companies in China, I would be interested to know, but I am sensing that there is an allegation floating around that perhaps the Chinese are getting special treatment in the face of the sanction mechanisms that the markets already have. In other words, hundreds of companies are delisted every couple of years. The specific question is, are the Chinese somehow getting special treatment with respect to bad behavior not leading to delisting?

And more generally speaking, what is the narrowly Chinese issue within capital markets, or are they more broad capital markets issues that we should be focused on?

Ms. ROSS. Thank you for that question, Congressman Himes.

I think there is an uniquely Chinese issue here, which is that we have investor protections in this country that require inspections of audits of companies that are listed here. These protections are known to have economic benefits both for our markets, our investors, and the companies that are listed here.

Almost all non-U.S. companies that are listed here are subject to and cooperating with those protections, and the jurisdictions that they are in are cooperating in those protections. The People's Republic of China (PRC) is the sole jurisdiction in the world that is blocking that investor protection. So in that respect, companies from Mainland China and Hong Kong that are listed here are getting a different deal than all other companies both in the U.S. and non-U.S. jurisdictions. That is what needs to be fixed, and that is why I commend your Holding Foreign Companies Accountable Act.

Mr. HIMES. And what is the right way to address that? There are well-established pathways—SEC action, private rights of action, delisting. What is the right way to address that?

Ms. ROSS. Right. You have mentioned delisting. That is the pathway that is embodied in the Holding Foreign Companies Accountable Act. What you have done is put forward a very straightforward and orderly process for managing these companies if they don't come into compliance within the next 3 years, and if you enact the Accelerating Holding Foreign Companies Accountable Act, that will be 2 years. You have given ample time for companies and for the Chinese government to understand what the pathway is, and we are already seeing investors in markets and even the Chinese government taking that seriously.

Mr. HIMES. And what about the exchanges, who ultimately would do the delisting, are they particularly hesitant to take this up with Chinese issuers?

Ms. ROSS. In this case, it is actually the SEC that would issue orders prohibiting trading in these companies, and that is a very standard procedure, as you have mentioned.

Mr. HIMES. Okay. And so, again, trying to get at the uniquely Chinese problem here, this is not an unusual action for the SEC. Is the SEC somehow—has it been hesitant to take this action with respect to Chinese companies, or should this committee be tightening up across-the-board SEC enforcement against failure to be sufficiently transparent?

Ms. ROSS. Great question. These are traditional tools the SEC uses, which is why I think they are going to be very useful in this case. What is unique about this situation is that the PRC has resisted inspections of audits of all China-based companies that are listed here. That is a unique situation. You have designed this act to take advantage of longstanding, well-understood SEC processes to address it.

Mr. HIMES. And just in my remaining moments, I was actually interested to learn that, I guess, the London Stock Exchange prohibits variable capital companies. Is that an idea that would have

support amongst these witnesses for adoption here in the United States?

Ms. ROSS. I do think there are risks associated with variable interest enterprises. I think that they are very opaque. I do not think that the average investor understands that when they are investing in a VIE, a listed company that is based on a VIE, they are not investing in the operating company that is based in China. They have no voting rights, and they have no say over what management does and no rights to information. That is very different from most U.S.-listed companies, and I think that presents very big risks to investors.

Mr. HIMES. Thank you. My time has expired.

Chairman SHERMAN. The gentleman from Ohio, Mr. Davidson, is now recognized.

Mr. DAVIDSON. I thank the chairman, and I thank our witnesses. And I appreciate your testimony, both written and oral.

And Ms. Ross, I just want to say thanks for your dialogue there with Mr. Himes. I think you did a great job of highlighting the specific problems where China really is getting a different set of rules, and the disclosure regime, and hopefully, how legislation passed here could change that and apply an evenhanded set of policies that are already in the standard toolkit for the SEC. I hope we see some real results towards that. So, thank you for your dialogue.

I am concerned about the Office of Foreign Assets Control (OFAC). Frankly, we have done a lot of sanctioning since 1975 when this law was applied, and I am also concerned about China and, frankly, the conflation of market risk, which our committee dealt with and Ms. Ross highlighted really well, with policies that are really foreign policy, for example, the treatment of Uyghurs.

And Mr. Lorber, I in particular just want to know how effective has OFAC been at identifying and addressing national security risks, and is OFAC a more appropriate way to deal with China's human rights abuses than the Securities and Exchange Commission, for example?

Mr. LORBER. Thank you, Representative Davidson. It is a great question.

I will say that OFAC has been particularly effective both generally, but also specifically related to human rights. After the passage by Congress of the Global Magnitsky Act and the implementation of that Act in December 2017, the Treasury Department and OFAC have targeted a wide range of human rights abusers and oftentimes caused them to lose hundreds of millions of dollars in assets. So, there has been a real impact that OFAC has achieved with the use of human rights-related sanctions.

I do think that to your second question of whether or not OFAC should be, for example, the body that goes after human rights abusers versus something like the SEC, I do think OFAC has expertise and the Treasury Department, more generally, has expertise. They have an intelligence collection function, for example, that allows them to identify and successfully target human rights abusers.

Mr. DAVIDSON. Yes, thank you. And frankly, it is a national security problem dealt with by America's Government with the people with the toolkit and the intelligence to do it, and the passive ap-

proach is to say, well, these publicly traded companies are going to do it.

That is what was done on conflict minerals, for example. And at the time, I remember one of the companies had about 30 employees, and I am filling out forms on conflict minerals when I buy steel. A small business in Western Ohio isn't really in a position to assess the supply chain risk of steel mills, and so everyone just signs off on the form. It is a very passive approach versus a very active approach to diplomacy.

And in general, that has been kind of the challenge, hasn't it? With China, America has been a little too passive. We have hoped for all of these good things from China, but in spite of the fact that we see China's abuse of the World Trade Organization (WTO), for example, we haven't forced them to honor their existing commitments, and we haven't forced them to play by a standard set of rules.

And that is what I love about the idea that if you want to stay listed, you have to be subject to our accounting policies just like anybody else, and if you want normal trade relations, you have to be compliant with human rights standards around the world. I think it is long overdue that we apply that to China.

Now, inside China, of course China is concerned about their own domestic market, and they have lots of attention focused on Evergrande, for example. But we are watching a meltdown in China that may be similar to a real estate meltdown in the United States. They had a massive boom. They have definitely inflated asset prices in many of their real estate markets, and Evergrande has been at the center of that.

Ms. Sutter, I just wanted to maybe finish with you. Your testimony does an excellent job of laying out the development surrounding Evergrande. As you state, about 60 percent of their assets are unbuilt and unsold properties, and the firm counts loan interest payments as assets. This has empowered Evergrande to become shockingly leveraged, and now Evergrande owns about $305 billion in debt, 2 percent of China's GDP.

We have already seen developments where Evergrande has failed to repay some of its obligations. However, there hasn't been contagion effects we would expect when an entity of this size goes into default. Why do you believe that is? Is China actually subsidizing it directly, or do you anticipate things by the People's Bank of China to deal with it?

Ms. SUTTER. Congressman, thank you for your question.

I think the government is directly involved in restructuring Evergrande. They have set up a committee, and it is very similar to what they have done with other companies that have gotten into financial trouble—Anbang, HNA, Fosun—and I think what they are trying to do is discipline the company while not having contagion in the broader markets, property market and broader markets. And so, I think it is a little bit of push-pull—

Mr. DAVIDSON. Thank you, and—

Chairman SHERMAN. Thank you.

Mr. DAVIDSON. —if we can follow up in writing, my time has expired, and I appreciate the chairman.

Chairman SHERMAN. The gentleman from Illinois, Mr. Foster, who is also the Chair of our Task Force on Artificial Intelligence, is now recognized for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman, and thank you to our witnesses.

There are three functions of our capital markets—to allocate capital, to do so efficiently, and to control risk—and the opacity of Chinese financial products puts at risk all three functions.

American capital markets are the premier venue for issuers due to our deep liquidity and broad investor base, both of which are substantially the products of the high information transparency established by our regulatory regime. Essentially, here, more than anywhere else, you know what you are buying into. We must uphold these standards, and there should be consequences for not complying with transparency measures, which is why I was a proud co-sponsor of Chairman Sherman's Holding Foreign Companies Accountable Act, and I look forward to further bipartisan action on this front.

Now, when we take action, one key question is whether the U.S. should act unilaterally, bilaterally, or multilaterally. If we unilaterally start delisting China-based companies, per the Holding Foreign Companies Accountable Act implementation, do we risk triggering a regulatory race to the bottom where the delisted companies would just relist in London, Germany, Singapore, Hong Kong, or even dodgier locations? Or are we better off acting multilaterally, very much like President Biden's recent successful negotiation of global minimum corporate tax rates?

And so my question is, I guess, to all of our witnesses, is there any significant discussion of multilateral agreements on minimum transparency standards for listed companies, and if so, what are the venues in which these are discussed, at least among the free democracies of the world?

Ms. Sutter, do you want to take a swing at it?

Ms. SUTTER. Sure. Thank you, Congressman, for the question.

There is competition among exchanges, and that is a consideration about when one market takes moves, how companies shift potentially to another. I would mention that under China's leader, Xi Jinping, there has been a big push for Chinese companies to come home to list either on Hong Kong and China, either as their only listing or as a dual listing.

One issue for consideration could be to look at U.S. standards with like-minded, open, transparent markets that lean on the rule of law in the sense that we do and to compare those standards—

Mr. FOSTER. My question is, what are the venues at which those might be discussed or could be being discussed now? Are there groups that are looking into this sort of thing?

Ms. Ross, did you want to—

Ms. ROSS. I agree with Ms. Sutter's description of this situation, particularly in China, that the Chinese government is actually pulling the companies home. But to your question, Congressman, the SEC is a very active member in the international organization of securities regulators known as the International Organization of Securities Commissions (IOSCO). IOSCO includes almost all major securities regulators around the world, and has many committees

that develop all kinds of model rules, model legislation, and share information. That has proven to be a very proactive and successful forum to raise standards across-the-board and address some of these risks that you are talking about, for example, a race to the bottom.

Mr. FOSTER. Yes, is China a member of this? And what would be their reaction if we raised standards that would effectively delist their companies in the United States? Would they insist on letting those lower standards still apply in China?

Ms. ROSS. None of the members of IOSCO are obligated to follow the requirements of IOSCO. IOSCO is really a body to share and develop best practices, and the members then have—

Mr. FOSTER. They pick and choose, right?

Ms. ROSS. They pick and choose, but it is still a very good forum to—

Mr. FOSTER. To discuss, and there would have to be a separate new group that said, okay, we are all going to agree to common standards to avoid this sort of regulatory race to the bottom.

Ms. ROSS. If you wanted to do that, yes.

Mr. FOSTER. Yes. Ms. Chu?

Ms. CHU. I would just like to jump in to note that the EU recently enacted a regulatory framework for index providers. I think that is the first time they have done anything of the sort, and I would encourage the United States to consider enacting similar legislation, similar regulatory policy, or to seek out commonality.

Mr. FOSTER. Mr. Lorber, any comments, sir?

Mr. LORBER. I don't have information on whether or not there is a multilateral body to prevent the sort of regulatory arbitrage that you are mentioning. I will say I do think at a high level while, honestly, regulatory arbitrage of this nature would be a potential issue and a concern, there would be certain companies that I think pose national security risks that even if they were to say we are going to go to another exchange, we would want to prevent them from accessing U.S. capital markets in any event.

Mr. FOSTER. Understood. I will yield back.

Chairman SHERMAN. Mr. Hollingsworth is now recognized for 5 minutes.

Mr. HOLLINGSWORTH. I am excited to be here and I appreciate all of the testimony that has been given thus far throughout the course of this hearing. There are a lot of issues on the table, and in this constellation of issues before us, I wanted to break a few things apart and better understand both the aims which we are trying to accomplish and the means by which we might get there.

It seems in my conversations with colleagues on my side of the aisle and colleagues across the aisle as well, that there are a couple of different things that are being talked about.

Number one, there is deep concern that China may be appropriating technology from U.S. private firms, and certainly from the U.S. Government as well, for use in its own design.

Number two, there is some concern about protecting U.S. investors from Chinese companies that may list here but, in fact, not be engaged in the business practices that they say they are or not be audited in the manner in which we believe they should be.

Number three, there are some concerns that firms that might be gaining the advantage of U.S. capital are deploying that in unethical ways—Uyghurs, for example—that probably isn't specific to China, but around the world, no matter where it may be and what its geography may be, of which we would disapprove.

Number four, there is also this lingering sense that is hard for me to shake that perhaps we are just out to deprive Chinese companies of U.S. capital, period, instead of U.S. technology. And I want to make sure that I understand all of those different aims so that the mechanisms by which we might accomplish that truly get us there.

Mr. Lorber, I wanted to talk about one of those specifically with you, which is the deprivation of technological transfer from U.S. firms to Chinese firms that we believe may be a threat to our national security, and the means we have currently in place in law by which to stop that. Could you speak a little bit about that?

Mr. LORBER. Yes, thanks. It is a great question, Representative Hollingsworth, and I like your sort of framing it in the bucket system that you have approached us with.

On the first bucket, which is the concern that China may be appropriating technology and what we have in place to prevent that, I think there are a couple of different mechanisms that exist. One is surely private causes of action. So, this may not be a U.S. Government approach, but there are lawsuits that can be filed.

Likewise, there are criminal causes of action, too, that the Department of Justice can pursue, and part of this process during the last Administration was undertaken with the Department of Justice's, I believe the China Espionage Unit was the name of it, or something akin to that.

The second primary body that you can think about when it comes to technology theft or concerns about technology appropriation could be in the context of the Committee on Foreign Investment in the United States (CFIUS), and of course, this body's revision of CFIUS with the passage of the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018.

Mr. HOLLINGSWORTH. Right.

Mr. LORBER. And then, there could also be potential targeted sanctions that could be focused on particular Chinese companies if the Administration decided to do so—

Mr. HOLLINGSWORTH. Is there a gap today that exists that we should solve for in the prevention of that important technology transfer?

Mr. LORBER. I think I would have to go back and take a little bit of a deeper look at it. I think one of the concerns is that on the private cause of action front, there are challenges. I know there have been instances where Chinese companies that have been accused of IP theft have employed certain legal measures here in the United States, like the Foreign Sovereign Immunities Act, as a way to try to prevent private litigants from accessing it, and I know there has been a major debate about that over the last few years in the legal community.

Mr. HOLLINGSWORTH. But much of that work is ex post facto, right? The technology transfer has already occurred, and they are trying to recoup their losses as a private enterprise or private per-

sons, right? Much of our work up here is the prevention of that rather than the putting together of Humpty Dumpty.

I wanted to better understand, is there any area where we need to do work from a legal standpoint in the prevention of technological transfer that threatens our national security?

Mr. LORBER. I take your point that it is kind of an ex-post thing, but I think that even if it is solved for ex-post, it could have a deterrent impact moving forward, for example, if companies are thinking about stealing U.S. IP and they recognize that if they do so, there is a decent chance that not only will they get sued, but that they will—

Mr. HOLLINGSWORTH. Yes. Well, that only counts if that suit renders a judgment, and that judgment is collected upon, which is a real challenge—

Mr. LORBER. Yes, 100 percent.

Mr. HOLLINGSWORTH. I think what I am trying to make sure I understand is, I don't believe that we should solve these problems in the financial sector, but I believe we should solve them with very vigorous laws that prevent this and real penalties in the event those laws are broken. Call the sheriff if someone is stealing, don't call the local bank to try to prevent them from depositing it in their bank account.

With that, I will yield back.

Mr. CASTEN. [presiding]. Mr. Vargas is now recognized for 5 minutes.

Mr. VARGAS. Thank you very much, Mr. Chairman.

Mr. Chairman, I have to say that I think today's hearing has been excellent. I agree with most of the things that have been said on both sides of the aisle. However, I also think that whenever we talk about China, there is a great disconnect between what we say and what we do.

For example, I fully agree with everything that Mr. Hill said today. Mr. Hill is a good friend, and I know he has great experience in this, and I think he is absolutely right that China has become very aggressive, has become an authoritarian state, and they collect a whole lot of data that they shouldn't be collecting.

However, at the same time, I am from California, and I can tell you that we have ships way out in the ocean now waiting to be unloaded. With all of the Chinese products coming to the United States, we can't seem to buy enough. It is incredible that we say that they cheat, they do all of these things, we have a great nation competition, yet at the same time, we don't seem to say that, well, we are not going to buy all their stuff.

We do, in fact, do that, whether they come here and they cheat, or they treat Uyghurs terribly and abuse them and have horrible human rights issues and spy on all of their people. It doesn't matter. We still buy their stuff. I try not to. I try very hard. But at the same time, it even drives me crazy that my iPhone is not manufactured there necessarily, but it is put together there.

We say one thing, and we do another, when it comes to China. And I think we have to understand that they are not only competing with us, but they are becoming a real threat, and we have to do more than what we are doing. That is why I think it is very good that we are looking at them frankly, and looking at them ho-

listically, and saying, wait a minute, first of all, okay, a lot of our companies, as Mr. Sherman said quite well, want to be in China because of the market there. I get that. In fact, it seems that every time a movie goes there from the United States, they make more money in China than they do in the United States.

So, I get that. But at the same time, we have to understand that they are not only our competitor, but they cheat. And when they want to access our capital markets, they don't want to play by our rules. We have to change the rules. We have to go after them. I think that is a good thing. But at the same time, we don't seem to; we say that we will, but we don't.

Ms. Ross, they don't play by our rules, so what should we do?

Ms. ROSS. Thank you, Congressman, for that question. I couldn't agree with you more.

When the PCAOB was first formed in 2003, the PCAOB—as I said in my testimony, the PCAOB undertook the task of reaching out to countries around the world who had foreign private issuers who were listed in our markets to work out arrangements so that we could make sure that the PCAOB could implement its own responsibilities in an appropriate way, and that has worked out. It has taken many years, but it has worked out in every single jurisdiction where we have U.S.-listed foreign private issuers based in other countries.

The sole outlier is the PRC. Mainland China and Hong Kong firms are not complying with our rules. We have had ample time—many, many years—to resolve these differences, and I think that the actions that Congress has taken with the Holding Foreign Companies Accountable Act are critical to signaling that we have to put a stop to that situation and enforce our rules across-the-board with all companies. So, I think that was a very positive step that you took.

Mr. VARGAS. Thank you. And again, I just believe we have to get more aggressive and understand the situation that we are in now.

Certainly, it is a terrible thing that we had the Cold War, but we understood we had a fight at the end of the day, and we won. We are in a situation now with China where they are quite aggressive all around the world, and even militarily now, when they team up with Russia, they surround Japan militarily, they are doing things that are very belligerent, and we have to understand that and we have to push back.

I know that our companies want to be there, I know that they are a big player, but at the same time, we can't continue down this road and think things are going to be okay. So, again, I appreciate what everyone has said today. I think that there is a great discussion going on, but I also think that there are a lot of things that we can do together here, because I think both sides see Communist China somewhat the same, not completely. I think there is a lot we can do.

And again, I thank the chairman, and I thank the ranking member. And I see that I have 7 seconds left, so I will yield back. Thank you.

Chairman SHERMAN. I thank my fellow Southern Californian, and I now yield 5 minutes to the gentleman from Ohio, Mr. Gon-

zalez, whom, I might add, was the Republican lead on the Holding Foreign Companies Accountable Act.

Mr. GONZALEZ OF OHIO. Thank you, Chairman Sherman, and thank you for your leadership on that important issue. And thanks for this hearing, and to our witnesses, I think this is a tremendously important topic that, frankly, we are going to be dealing with for a very long time.

I want to start my questions with Ms. Chu. In this subcommittee, we often talk about how the U.S. capital markets are the envy of the world, and I think that is accurate. And there are a lot of reasons for that—the liquidity, the access to various different types of investors, et cetera. One argument we hear against cracking down on China in a meaningful way is that companies and investors will flee, that they will go to other jurisdictions, and therefore, we shouldn't do anything because we put at risk that incredible U.S. capital market structure.

Ms. Chu, where do you fall on that? And then, what sort of steps, if any, do you see China taking in order to replicate the U.S. markets and to try to keep Chinese companies from listing in the United States?

Ms. CHU. Thank you for the question.

On the first point, with regard to Chinese companies fleeing the U.S. markets, of course, we have seen a couple of companies already leave. There are four—China's four AI dragons who are known for surveillance technology. I think at least three of the four were planning to IPO in the United States as of the end of last year, and after the entity list designations, have decided to either go to the Shanghai STAR market or to the new Beijing exchange.

So, yes, that is a possibility, but at the same time, I believe that enforcing capital market sanctions and restrictions on investment is critical to U.S. foreign policy objectives. At the end of the day, incongruent policy is ineffective policy.

When you have a company that has been identified as, for example, building missiles in China or building hypersonic missiles, and we decided that U.S. companies are not allowed to supply them technology or services or knowledge, and then you are allowing the U.S. investors to invest in those same companies so they can build up those R&D capabilities, that is a significant flaw and a significant gap in our ability to enforce any sort of policy goal.

Mr. GONZALEZ OF OHIO. Thank you. Just to interrupt quickly, I couldn't agree more. I think there is sort of a question which is, if somebody is on the entity list, and the company is designed essentially to give China a competitive advantage militarily against the United States, should we really be that upset if they decide to list in Shanghai? My view is, no, we should not. Thank you for that.

Mr. Lorber, I want to switch to you. In your testimony, you mentioned targeted blocking sanctions against specific individuals. What has been the overall effectiveness in these situations where the U.S. has targeted specific people?

Mr. LORBER. Obviously, it depends on the target, but there have been many situations in which the targeted blocking sanctions that we have employed have been particularly impactful. In the example I mentioned earlier, the XPCC, the way that OFAC sanctions

regulations work is that essentially, if you target an entity, anything that entity owns 50 percent or more is also, by law, sanctioned. And in the context of the XPCC, it actually had I think hundreds of subsidiaries spread around the world that were all blocked, so if there was U.S. jurisdiction, you couldn't do business with them. So, it actually had a major impact on the entity.

Mr. GONZALEZ OF OHIO. Great. So, that's definitely something to consider going forward.

Ms. Chu, back to you, I want to talk about DiDi and the Chinese government's crackdown, ranging from their security overreach into the company and their efforts to exert more state control. Is this a sign of a new trend by China, and how do you see that trend playing out vis-a-vis the capital markets?

Ms. CHU. I would respond that these are not new trends necessarily. The Chinese government has always exercised its regulatory apparatus to crack down on social ills, crack down on companies posing threats to state control, and also to address problems that maybe have been festering under the surface of Chinese society for a long time and have just now come to a head, and they are forced to take brisk and just really strong action, maybe capricious action to address them.

What has happened is that U.S. investors are now exposed to these companies, are increasingly exposed, and are, therefore, increasingly exposed to these regulatory risks and crackdowns.

Mr. GONZALEZ OF OHIO. Quickly, do you think we need to do more from a disclosure standpoint to help U.S. investors understand when a DiDi or another Chinese company is compromised in various ways as they come public in U.S. markets?

Ms. CHU. Yes, I think that is absolutely necessary, and beyond that, I do think that disclosure requirements would serve as a deterrence for Chinese companies that are involved in serious human rights abuses or national security problems. For example, in the Hong Kong Stock Exchange, in I think 2015, China Communications Construction Company's dredging entity sought to IPO. When they were asked at that point if they were involved in South China Sea militarization activities, after a period of time they postponed, and I think they ultimately withdrew their IPO application, because in the Communist Party of China's party-state, you can't disclose, and you are not supposed to acknowledge that these are risks.

Mr. GONZALEZ OF OHIO. Thank you, Ms. Chu. I will follow up directly, and I yield back.

Chairman SHERMAN. Thank you.

I now recognize the gentleman from Illinois, Mr. Casten, who has received so many honors in his life, but none more important than being Vice Chair of this very subcommittee.

Mr. CASTEN. Nothing prouder than being under your leadership, Mr. Chairman. Thank you so much, and thanks to all of our witnesses.

Ms. Sutter, I want to start with you and just pick up on some things that you had mentioned about Evergrande. The headlines, and I think you have said this, their $300 billion of debt, potentially a default, 2 percent of China's GDP, 2 percent of, I guess their debt as well, national debt, real estate exposure, maybe 30

percent of Chinese markets. And if I am doing the math correctly, 190 Chinese-based companies, $2.4 trillion of market cap, so maybe 10 percent of the New York Stock Exchange (NYSE) is exposed there.

Maybe that is too much. What do you think is the systemic risk to financial markets we should be thinking about if Evergrande were to default on their $300 billion? Are those about the right metrics? Are we thinking about possibly 10 percent of the U.S. stock market exposed? Is it bigger? Is it smaller? What do you think about the systemic risk there?

Ms. SUTTER. Thank you for the question.

I have not done the math on the stock exposure, but I think that, to me, the important issue that it raises is kind of what it shows about how the Chinese government gets involved when a company is in trouble, because it shows what are the rights of investors vis-a-vis the Chinese state when you have exposure to a Chinese company.

I think, as I mentioned earlier, right now the parameters of exposure seem somewhat manageable, but there is an issue about who gets paid, in what priority order, how are you paid. We have looked at this in China since the failure of the Guangdong Trust, Gzitic, in 1999, as far as just trying to preference domestic or international investors, and I think, to me, it highlights something to watch about how the government is a direct investor in Evergrande as much as it is a regulator of Evergrande.

Mr. CASTEN. I want to sort of put this somewhat more qualitative version of the question to you, Ms. Ross. In the absence of our ability for the PCAOB to go in and audit the auditors, how confident are you of our ability to answer the fundamental question, whether for Evergrande or someone else, what is our systemic exposure in the U.S. economy to situations like Ms. Sutter described, the specific case of Evergrande, how confident are you—what are the error bars around that in your view?

Ms. ROSS. Thank you for that question, Congressman Casten. It is a very important question.

Our understanding of systemic risk comes largely from our access to information so that we can analyze those risks. That is what Ms. Chu does everyday, trying to access the information. But when companies list in our public markets, we depend on those disclosures to understand the risk, and then on a whole basis of all companies from a particular jurisdiction or in a particular industry, we use the disclosures, investors use the disclosures, markets use the disclosures to assess the systemic risk.

Mr. CASTEN. Yes. Okay.

Ms. ROSS. We can't fully do that without compliance, and that is why it is so important that we be able to enforce our accounting and auditing rules.

Mr. CASTEN. Okay, and I am sorry to cut you off, but I want to get to a question with enough time to answer it.

We have talked a lot about the Holding Foreign Companies Accountable Act as being targeted at China, but I think it is important for us to be clear that it doesn't actually say China. It says if the PCAOB can't go in and audit the auditors for 3 years, they have to be delisted. And of course, you are nodding, this only ap-

plies right now to China, right? But in theory, if another country decided to do that—but right now, we are just limited to that exposure in China.

So, here is my question that I am building to. I want to make sure we are not playing whack-a-mole. Let's say that all the provisions of the Holding Foreign Companies Accountable Act get implemented. All of the good ideas that both sides of the aisle have run up here are addressed. It seems to me that we still have this huge gap because all of these rules don't apply to get into these questions of exempt offerings. Right? Because if a company is going to list under one of these exempt offerings, all of a sudden, all of these other rules of SEC disclosure and what have you don't get there.

So, how should we be thinking about—because if we address this all for sort of conventional, old-timey offerings and China still wants to do all of the things we are talking about doing that they do do in these hearings, don't they just have a back door to come in there through these exempt offerings?

Ms. ROSS. Absolutely. I agree with your line of thinking there. We not only have to protect our markets for public securities, but we also have to be concerned that if the companies are delisted, they will take advantage of our system of exempt offerings that allows companies to sell securities here to specific kinds of investors under different circumstances and not follow our normal disclosure rules.

Mr. CASTEN. I am out of time, but maybe just for the record afterwards, what I would like to understand is if the Holding Foreign Companies Accountable Act only applies to China, how much does that potential back door apply to a lot of countries beyond China that have a way to back-door in through our exempt offering rules?

And I would welcome a response in writing for the record. Thank you, and I yield back.

Chairman SHERMAN. I thank the Vice Chair.

The gentleman from Texas, Mr. Taylor, is now recognized for 5 minutes.

Mr. TAYLOR. Thank you, Mr. Chairman. I appreciate the testimony today.

One thing that I think we may want to get a more detailed taxonomy on, and Mr. Lorber, I will start with you, what did the Trump Administration do vis-a-vis China? In terms of securities, China sanctions, there has been some mention of the Holding Foreign Companies Accountable Act, S. 945, which he signed into law last year. What did the Trump Administration do?

Mr. LORBER. The Trump Administration did quite a bit on China when it came to sanctions. In terms of securities and publicly traded securities, in November of 2020, the Administration issued Executive Order 13959, which essentially prohibited U.S. persons from trading in specific publicly traded securities of identified companies that were considered Communist Chinese Military Companies (CCMC), an identified list of Chinese entities that the Trump Administration determined posed a national security threat.

In addition, there are a range of other sanctions that the Trump Administration imposed related to Hong Kong, as I mentioned with the XPCC related to activities in Xinjiang, and a host of other spe-

cific blocking sanctions and designations. But the one specific item which related directly to securities was that Executive Order.

And then, finally, in addition, the Administration put out a range of guidance and advisories to warn U.S. companies of the sanctions and illicit finance-related risks that it assessed were emanating from China, and particularly there was, as I mentioned, a Xinjiang supply chain advisory that they put out, among a series of others as well.

Mr. TAYLOR. One of the bills that showed up on my desk when I walked in here this morning was H.R. 2072, which deals with Xinjiang and the Uyghurs. What did the Trump Administration do on this, and which company did they target?

Mr. LORBER. They designated the XPCC in, I think again, it was July 2020, and the XPCC is, according to the Treasury Department, the paramilitary organization that runs many of the camps, the forced labor institutions within Xinjiang. And so, as I mentioned, when they designated them, that entity had hundreds of subsidiaries spread around the world, and so there was a major impact on companies that were sourcing products from Xinjiang to realize, well, we may not be able to source that product anymore because it could expose us to U.S. sanctions. And in addition to that, they also released the supply chain advisory to make clear to companies that were sourcing from that area that there were real sanctions and other risks associated.

Mr. TAYLOR. Are we aware of other companies that should have been sanctioned, that the Trump Administration perhaps missed?

Mr. LORBER. I am not personally aware of others that were not sanctioned, that the Administration missed.

Mr. TAYLOR. Ms. Chu, do you want to—

Ms. CHU. Thank you.

The 13949, and I think 14032, the two bills that give legislative authority to the China company sanctions program, the lists under those, as well as the Department of Defense's Section 1260H list, include a total of maybe 80-something individual unique companies that are designated as Chinese military companies. I have identified hundreds more.

That includes subsidiaries and direct parents of these companies, many of which are directly involved in weapons programs and high-tech surveillance, but also in just generally China's military modernization drive. That includes companies that are building missiles, companies that are developing unmanned aerial vehicles (UAVs) in the South China Sea that are directly countering U.S. forces.

So, yes, there are significant gaps in the implementation of those sanctions, especially because I think the text of both suggested that they would be living, breathing documents updated regularly with new information. But neither of those lists—the annex of the recent Executive Order, nor the DOD Section 1260H list—have been updated since they were released this past June. So, I would like to see a consistent effort to keep those updated to include new companies and make sure that the U.S. goal of sanctioning and prohibiting Chinese military companies from accessing U.S. capital is enforced throughout.

Mr. TAYLOR. I would appreciate getting that list and working with you on that, making sure that we are updating that. But I will point out that I think the Trump Administration did a good job of going after Chinese military companies, working to try to help the Uyghurs. The Trump Administration really deserves a lot of credit for what they have done, and I appreciate, Mr. Chairman, that we want to build on that success.

I yield back.

Chairman SHERMAN. Thank you. I ask unanimous consent to put in the record a letter from Muddy Waters Capital, LLC, highlighting their work to research fraud involved in Chinese publicly traded companies, including Luckin Coffee, that I mentioned earlier. Without objection, it is so ordered.

The Chair now recognizes the gentleman from Wisconsin, Mr. Steil, for 5 minutes.

Mr. STEIL. Thank you very much, Chairman Sherman and Ranking Member Huizenga, for holding today's hearing.

The rise of China is one of the most serious economic and geopolitical challenges we face. The Chinese Communist Party has embarked on an aggressive campaign to expand its influence around the world. A key part of the campaign is Made in China 2025. Through this initiative, the CCP aims to make China the dominant player in high-tech manufacturing.

Thinking of the important goods that power our modern economy—cars, computers, IT, aircraft, agriculture, technology, and medical devices—China wants to dominate all of those industries. In order to do this, Beijing is prepared to deploy subsidies, back foreign acquisitions, and impose forced technology transfer agreements. It is a direct challenge to American workers and manufacturers, but it is a challenge that we can overcome.

I find it interesting, though, that we are holding this hearing as my colleagues across the aisle are considering massive tax increases on American workers and on American manufacturers. This Made in America tax will make it even harder to outcompete China.

If we are concerned about Made in China 2025, the last thing we should do is impose a Made in America tax. My colleagues across the aisle are putting forward policies to destroy jobs in America, weaken the U.S. economy, and put us at a further disadvantage to Communist China.

Let me shift gears. Mr. Lorber, I want to reference an op-ed published by my colleagues, Mr. Luetkemeyer and Mr. Huizenga, in which they argued that capital controls and delistings alone won't change China's behavior. They argued that we need to bring sanctions into the policy toolkit specifically for dealing with China.

In your testimony, you described some of the ways our Government has sanctioned China-based individuals and companies engaged in activity that the U.S. opposes. In targeting sanctions, could you add some color as to how we should draw the line between truly benign companies and those actually involved in activities against U.S. interests?

Mr. LORBER. Yes, it is a great question, and candidly, it can be a challenging line to draw.

For example, companies that don't provide sufficient financial information or financial disclosure, frankly, may not be the best target of targeted sanctions because they are not engaged in potentially, actual national security threatening activity, whereas other companies, for example, as assessed by both the Trump and the Biden Administrations, and as Ms. Chu was talking about, are involved in the Chinese civil military fusion program and are working to bolster the Chinese military. And in that situation, I think sanctions would be potentially a more appropriate use of the tool—

Mr. STEIL. I appreciate your point and context. Looking at the U.S. sanctions regime in particular, to hold some of these types of companies accountable, are there any tweaks or changes that you would recommend in the sanctions regime under U.S. law?

Mr. LORBER. I don't think I would recommend specific tweaks or changes. I think the question is, are there other entities that the U.S. Government believes pose national security threats, to Ms. Chu's point from earlier, that may justify targeting? I think that would be the way I would frame it.

Mr. STEIL. Let me shift gears once again. As you are well aware, China is the largest official creditor in the world, and although the Chinese development finance hasn't yet eclipsed the World Bank or the IMF, a heavily U.S.-influenced institution, I think it does pose a pretty significant geopolitical and economic challenge. What are the steps that you think Congress should be taking to counter Chinese influence in developmental finance?

Mr. LORBER. I apologize, but I probably need to defer on that question and get back to you. That is not my area of expertise in development finance, so I would want to take a look at that question a bit more deeply.

Mr. STEIL. We will continue the discussion offline. I appreciate you all being here today.

Mr. Chairman, thank you for holding today's hearing. I yield back.

Chairman SHERMAN. Thank you.

I now recognize Mr. Mooney, the gentleman from West Virginia.

Mr. MOONEY. Thank you, Mr. Chairman.

One of the great problems of today is how free-market societies should confront the rising threat of China, a Communist authoritarian state with increasing power on the world stage. Our trade deficit with China was $310 billion last year, an alarming reflection on China's economic power.

What makes China such a unique adversary is that, unlike the Soviet Union, their leadership has not been as ideologically rigid. China's leadership has been willing to manipulate market forces to their geopolitical advantage.

My question is for Ms. Sutter. In your testimony, you wrote about how American investors have limited access to passive investments in China. You talk about the differences between an American investor holding passive Chinese investments, and a Chinese company and a Chinese investor holding shares directly in the same company. Do passive investments give Americans the same control as a typical shareholder?

Ms. SUTTER. Thank you, Congressman, for the question.

I think in my remarks what I was trying to emphasize is that China is highly restricted and closed in strategic sectors, a lot of the areas of growth in the economy, and that they may be using financial investment in tandem with technology licensing to get the capital and know-how they know without having to let U.S. competitors actually compete within the Chinese market.

The other point I would like to make on passive investment that we haven't talked about is under Made in China 2025, the government's use of government guidance funds, which is a private equity model, in how the Chinese government, the Ministry of Finance basically pushes state money into the Chinese economy, which is also used in the overseas markets, including for acquisitions and investments in other firms. I think this private equity model is something to think about as it touches the U.S. economy.

Of course, financial investment, portfolio investment is by nature passive, but I think the concern I was trying to raise for consideration is, is China using this as a substitute for allowing productive U.S. competition on the ground in the Chinese market?

Mr. MOONEY. Okay. As a follow-up to that, in your testimony, you wrote at length about how China seeks U.S. capital to fund its strategic interest. So, how does that work? Can you explain that further?

Ms. SUTTER. Yes, and this has been raised in various areas of concern that a lot of the Chinese companies who list on U.S. exchanges or who are included in U.S. funds increasingly are participants in the Made in China 2025 and other Chinese industrial policies. So, U.S. capital going into these companies could be supporting these programs more broadly.

And I would like to raise for consideration that because China's Made in China 2025 policies are codeveloped by the People's Liberation Army (PLA), by the party, and by the state, that it poses a challenge for the United States to delineate what is truly a company that is military, what is truly a company that is of concern. Especially as you get into dual use and strategic and emerging technologies, I think this becomes increasingly grave potentially.

Mr. MOONEY. Thank you. Let me just say in conclusion that free-market competition is what leads to growth and prosperity. Those who succeed in a free market are tested by the rigors of their competitors and how they serve their clients and they serve the people.

China does not believe in capitalism. China does not believe in free markets the way we understand them in America, but China is willing to use our financial markets against us. They are more than willing to steal our intellectual property and tap into our wealth in order to further their nationalistic designs.

On the surface, China is one to make it seem as though they are merely participating in the global markets as equals, but in reality, they are manipulating our openness for their own ends. So to understand how to best react to China's threats, we must first come to terms with who they are. They are a geopolitical adversary that is always looking for a weakness to expose in order to gain an edge.

Thank you, Mr. Chairman, and I yield back.

Chairman SHERMAN. Thank you.

I now recognize the gentleman from Kentucky, Mr. Barr.

Mr. BARR. Thank you, Mr. Chairman, and I appreciate the chairman allowing me to waive on to this subcommittee.

As a member of the National Security, International Development and Monetary Policy Subcommittee of this Full Committee, the Ranking Republican on the National Security Subcommittee, a member of the House China Task Force, and a member of the Asia, the Pacific, Central Asia, and Nonproliferation Subcommittee of the House Foreign Affairs Committee, this topic is of acute interest to me, and I want to thank the witnesses for the outstanding testimony. It has been very, very helpful as we consider a legislative response to the challenge of China and Western capital flows to China.

Earlier this year, I introduced the Chinese Military and Surveillance Company Sanction Act, which has received broad support from my colleagues on both the Financial Services Committee and the Foreign Affairs Committee. The bill seeks to address one of the problems we are discussing here today, malign Chinese entities using American capital to fuel efforts that directly counter U.S. national security interests.

The bill expands on President Trump's Executive Order targeting Chinese military companies as amended by President Biden's Executive Order, and my bill takes it a step further. Instead of simply banning investment in public equity issued by these companies, it directs the President to actively sanction them.

Mr. Lorber and Ms. Chu, can you each elaborate on why a bill like mine, which leverages the U.S. sanctions regime, is preferable to a ban on public equity investment, as was the case with the Executive Orders, or enhanced disclosures such as the Holding Foreign Companies Accountable Act?

And by the way, Mr. Chairman, I supported your bill, the Holding Foreign Companies Accountable Act, because Chinese companies are not playing by the same rules as other foreign companies, and I support your bill to accelerate the timeline to 2 years. But that legislation is an investor-protection bill. It is not a foreign policy or national security bill.

So, what do sanctions achieve that these disclosures do not, Mr. Lorber?

Mr. LORBER. Thank you, Representative Barr.

The primary differences between the current Executive Orders that are in place that you referenced, and the proposed legislation, is the scope of the prohibition. Right now, under the current Executive Orders, the companies that are identified, U.S. persons are prohibited from transacting in publicly traded securities, but that is it.

By actually designating the entities that are contained on the list, you actually prohibit U.S. persons from transacting with them in any way. In addition, the scope of the Executive Order is limited to the specific companies that are identified on the list, but by blocking them by adding them to the SDN list, you would automatically include any companies that those listed entities own or control. So, the scope of it would be much, much broader.

Mr. BARR. And Ms. Chu, when you answer the question, could you also explain the mechanics of OFAC designations? In other words, take an index like MSCI or BlackRock's announcement on

August 30th that it would triple American investments in China, and explain how that might change and alter the composition of these index and these investments?

Ms. CHU. Thank you for the question.

In the past 3 years—I believe it was May 2018 when MSCI began or announced it was going to begin including Chinese A-shares in its indices. The exposure of U.S. investors to A-shares, which are companies listed on the Shanghai and Shenzhen exchanges, has shot up exponentially. There were none at that point, only eight shares in ADRs.

So, I believe that applying sanctions to Chinese military companies and Chinese surveillance companies in addition to existing restrictions on capital investment would be an ideal way to align national security objectives across sanctions programs.

Mr. BARR. If OFAC sanctioned these entities, the MSCI and the index would presumably have to pull out those designated firms from their index. Is that correct?

Ms. CHU. Right. I believe that the Executive Orders and the Office of Foreign Assets Control (OFAC) implementation require divestment by securities or exposure to the securities. But it was unclear, and there are a lot of index providers and investment companies that were struggling for a long time—it just ended last year—to figure out if they were supposed to implement this, if there were any sort of enforcement measures. So, I believe those factors should all be made more clear and potentially an amendment to the ways that these capital market sanctions and restrictions can be applied.

Mr. BARR. And Mr. Lorber, can you talk about the force multiplier of sanctions versus U.S. securities disclosures in terms of preventing a circumvention and a rerouting of capital to foreign exchanges?

Mr. LORBER. Yes, it is a good point. There is the usual occurrence where the U.S. Government, for example, OFAC, sanctions somebody. As long as there is U.S. jurisdiction, non-U.S. companies are obliged to follow those rules and regulations. So, what you would see is oftentimes non-U.S. persons, non-U.S. companies operating in foreign jurisdictions wouldn't touch those securities because they would be blocked property, so there would be a significant extension of the impact beyond just U.S.—

Mr. BARR. It would have a multilateral impact.

Mr. LORBER. Yes.

Mr. BARR. My time has expired. But Mr. Chairman, thank you very much, and I appreciate your leadership on the disclosures front. We are just making the point that OFAC is another important tool. I yield back.

Chairman SHERMAN. Thank you.

As is our tradition, I will be recognizing the ranking member, then myself, for very brief closing comments.

The ranking member of the subcommittee, Mr. Huizenga, is now recognized.

Mr. HUIZENGA. Thank you, Mr. Chairman, and I want to thank the panelists for being here today. It has been very illuminating and informative and helpful.

One special person I do want to recognize—I know Ms. Ross has a special guest assistant with her. And sorry, it is our jobs as par-

ents to embarrass our kids. I have kids about the same age, but I'm glad you have participated, and frankly, I will note that you had more stamina than most of the Members of Congress, making it through a 2 hour-plus hearing.

But this is why we are doing this. This is why we are all here, is to make sure our kids and our grandkids have a better future than what we have, and that is why this question, this issue is so important to what we are talking about, and that really is, I think, the common motivator for so many of us.

I did hear a couple of common themes today. Common theme one, China cheats. Not just China writ large—it could be the Chinese Communist Party, it could be the Chinese Army, it could be all of the business entities that are either shell or they might be partially related, or whatever they are, but we know that China does cheat.

Common theme two, we also know that China controls things as much as they possibly can. And common theme three, China is out for China. They are not out for their investors. They are not out for their citizens. They are not out for the world economy. They are out for China and their way of life and their governmental structure.

And I would think that if you can accept one, two, and three, then you have to ask the question, how will additional rules, requirements, demands, temper tantrums, whatever it is, how is that going to change China's actions? And that is what this is about, and I don't think those things will.

What does get China's attention is sanctions, economic pressure, sanctions and a strong, robust U.S. economy that can not just compete but can actually outdo, can offer even better options than what they can—not just in our country, but around the world. So, we need a positive environment for our entrepreneurs, our small innovators, our risk-takers, the things that have made the U.S. such a powerful force in this world, and a force for good, by the way.

There are more people who have been lifted out of poverty with capitalism versus socialism or communism. There are more opportunities that have happened across-the-board for every single citizen of any country that has taken that route, and we need to encourage that, and I just want to emphasize that as we are looking at lots of discussions outside of this committee as well, what is going to be getting done here in our economy. We need to be conscious of this.

What is separating us from other areas and other countries in the world like China, and how are we going to maintain our edge? And it is through creating an environment that allows others to succeed and for us to succeed.

With that, Mr. Chairman, I do appreciate you holding this hearing today, and I look forward to the conversation, and I look forward to learning more about your bills that you are in the process of drafting, and I look forward to this continuation.

Chairman SHERMAN. I look forward to working with you.

Mr. HUIZENGA. With that, I yield back.

Chairman SHERMAN. Before I took over this subcommittee, I chaired the Subcommittee on Asia over on the House Foreign Af-

fairs Committee, working with Mr. Barr. And I came to the conclusion that on the big issues that affect China across-the-board—South China Seat, belt and road, the running of a huge trade surplus for them with the United States, their theft of IP, the big things—nothing is going to change Chinese behavior except across-the-board tariffs on their entire economy, that even sanctions on one or two companies won't be enough to change their overall policy. But that is outside the jurisdiction of this Subcommittee, and the Full Committee, for that matter.

Focusing on the jurisdiction of this subcommittee, we have seen an illustration of the power that China has through selective access. By allowing some banks, some investment banks to have access to China but not others, they have control over what Morgan Stanley advises its clients and what Morgan Stanley publishes in its index, which then makes us wonder whether those who publish indexes should be required to register as investment advisers so that we get that fiduciary responsibility in that process to counterbalance the power that China would otherwise have.

I believe it was Mr. Gonzalez who pointed out that whatever we do in our markets, American investors can always go elsewhere. And that is true. We are a free country. You can take your life savings, sell your house, put all the money in a suitcase, go to Monaco, and put it all on double zero.

But the purpose of this subcommittee is to protect those investors who are investing in U.S. markets, U.S. exchanges, trust funds regulated by U.S. laws, ERISA plans and mutual funds, et cetera. Those who do that expect to have some investor protection. Those in Monaco, you are dependent upon the laws of that principality.

Mr. Himes points out that we have had accounting frauds in the United States. I was here for Enron and WorldCom. That is why we passed Sarbanes-Oxley and established the PCAOB. We needed it. That is why we passed it. We needed it to protect American investors.

And it isn't just China that didn't cooperate. Belgium didn't cooperate either. But we passed the bill last year, and we got tough with Belgium and, "big waffle" folded, and now we have the deal with Belgium. Hopefully, we will get the same out of China as well.

The purpose of that bill and the acceleration bill is to protect investors by getting the same kinds of controls that we found we needed after WorldCom and Enron, and that we clearly need for Chinese companies as well.

The VIE structure means that you are not a shareholder. People should understand that, and you are not one of the thousand biggest companies in the world if you are Alibaba Cayman Islands. You don't belong in indexes. You are not even a company. I don't know what you are. You are a shell that invests in another shell that has a contractual relationship.

When you invest in a Chinese company, you may not have any right to elect the board. Even with those who do elect the board, the board may put the interest of the Chinese Communist Party above those who elect them. And even if the board seeks to deploy the assets of the company to further the interest of the shareholders, the government is free to sanction, seize, and redirect, all

without the protections of a legal system designed to protect private property.

So, we have a lot to do to protect American investors who invest in China, and even more to do with the overall relationship with China.

The Chair notes that some Members may have additional questions for these witnesses, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is adjourned.

[Whereupon, at 12:23 p.m., the hearing was adjourned.]

APPENDIX

October 26, 2021

Testimony before the U.S. House Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

Taking Stock of "China, Inc.": Examining Risks to Investors and the U.S. Posed by Foreign Issuers in the U.S. Markets

Claire Chu
RWR Advisory Group

October 26, 2021

Chairman Sherman, Ranking Member Huizenga, distinguished members of the Subcommittee: thank you for the opportunity to testify today.

I am a senior analyst at RWR Advisory Group, a research and advisory firm based in DC. I specialize in the geopolitical and national security risk implications of Chinese commercial activity and engagement overseas.

I have been asked to provide some context on the nature of Chinese corporate actors and their role in China's state-led economy. I will also lay out several risks to investors and the United States, posed by Chinese issuers in the U.S. markets, followed by recommendations for policymakers and government stakeholders.

Risk: The CCP's involvement in and control of the private sector means that Chinese companies are beholden to the party-state and can be compelled to sacrifice corporate interests for government favor.

The Chinese government has the authority to direct the behavior of its commercial actors, including companies in the private sector, which are ultimately controlled or controllable by the government under national laws and regulations. The party-state is embedded in commercial

decision-making processes though the Communist Party of China (CCP)'s integration in corporate structures. And although state-owned enterprises remain central to China's planned economy, the Chinese government has called for the CCP to guide and develop the private sector enterprises as an important part of China's construction of a "socialist market economy."

The CCP has long called on its private sector to establish party organizations and strengthen the CCP's role in the private economy. Party organizations such as committees and branches are intended to link corporate activities with CCP policy frameworks and norms. According to government statistics, in 1999, only 1.5% of private sector enterprises in China had established internal party organizations.[1] By 2017, however, party organizations existed in 67.9% of China's private sector companies (and even 70% of foreign-owned firms).[2]

The CCP's current target is for all private sector enterprises with over 50 employees to have a formal CCP member on its staff. If a company has three or more Party members, then a separate Party organization must be established. If a private company has not yet established a Party organization, the CCP advises that it should still carry out Party work by assigning employees Party-building roles and by establishing Communist Youth League organizations.[3] Chinese government authorities at the provincial level also embed CCP officials and cadres (personnel) within the operations of large, privately-owned companies to ostensibly coordinate government policy and ensure regulatory compliance.

In September 2019, a government website announced that the Hangzhou Municipal Government planned to transfer 100 CCP officials to serve as government affair representatives at 100 "key enterprises" including tech giant Alibaba Group, automotive company Zhejiang Geely Holdings, and food and beverages producer Hangzhou Wahaha Group. Each official would be embedded in their designated company for one year to "conduct government affairs."[4] Similarly, the Henan Provincial Government dispatches CCP officials to private sector entities. As of September 2019, Hebi City had 161 such "service stewards" stationed at private companies. The deputy director of Hebi City's Development and Reform Commission, for example, was assigned to Hebi Baofa Energy Technology Co., Ltd. Other local governments

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[1] https://baike.baidu.com/reference/15116933/9859qLw8MDD0wx_48BjVkzU-ZRsampKsE0dk8rj0fLUwM2qK4E8FDn-C6lPRmqnenO82aq-7iUxvA0ME06ySem1JnsoLQTkXk8CiMRlYwe3z-v5B2Vd4n5FRcp0W

[2] http://cpc.people.com.cn/19th/n1/2017/1019/c414536-29596679.html

[3] http://www.samr.gov.cn/djzcj/scdjgz/wjfg/201902/t20190215_281570.html

[4] https://biz.zjol.com.cn/zjjjbd/zjxw/201909/t20190921_11055873.shtml.

have adopted "two-way" programs to exchange mid-level CCP cadres with mid-level company employees.[5]

There are clear incentives for companies in China's private sector to welcome CCP guidance, and to operate in ways that are conducive to state strategic interests. Studies have found that private entrepreneurs with Party membership are more likely to obtain loans from banks and other state institutions, and private companies with CCP organizations have an easier time obtaining administrative approval and government support.[6] Chinese corporate actors are directed to meet the targets of state planning through industrial policies, guidance catalogues, strategic sectors, and other measures. This results in an atmosphere that compels Chinese companies to behave differently from profit-seeking commercial businesses in the U.S. free market. On the other side of the coin, Chinese companies are subject to economic coercion and arbitrary punishment for crossing red lines laid down by CCP leadership.

This allegiance can be observed across companies in the private sector, including those that are publicly traded. China CITIC Bank Corp. Ltd. is listed on the Shanghai and Hong Kong exchanges. Despite being owned by state-owned CITIC Group, it is considered a non-public company (private sector). In an article published in September 2021, China CITIC Bank president Fang Heying said that the bank will "always put political construction in the first place" and integrate party decisions into the bank's strategic goals and corporate governance.[7]

Risk: The Chinese government prioritizes state stability and social control over commercial gains. China's financial markets are leveraged to serve the CCP's strategic goals and objectives.

The heavy-handed and reactive nature of the Chinese government's regulatory apparatus can sometimes undermine its own companies and, consequently, American investors in those companies. Index providers, fund managers, and other financial intermediaries that effectively control U.S. investor access to publicly traded Chinese companies should take into full consideration the reality that fluctuations in Chinese government policy can result in material

[5] https://finance.sina.cn/china/gncj/2019-09-22/detail-iicezzrq7690983.d.html
[6] https://www.sciencedirect.com/science/article/abs/pii/S0304387807000259?via%3Dihub.
https://qks.sufe.edu.cn/mv_html/j00002/202010/c68a3c4c-011e-4104-9eff-8301dbbdec99_WEB.htm
[7] http://xw.sinoins.com/2021-09/24/content_410440.htm

and quantifiable damage to a company's performance across a variety of indicators. Actions taken by the Chinese government to gain state control, protect the party's legitimacy, or target perceived societal ills – like its recent crackdown on the entertainment industry and heightened scrutiny of tech companies – can affect companies' business prospects, financial performance, and even survival.

China's authoritarian government exercises significant state control over pricing, production, investment, resource allocation, and administrative and regulatory transparency. It is against this background that China was classified as a non-market economy (NME) when it joined the World Trade Organization (WTO) in 2001. After Beijing launched a formal complaint in 2016 challenging the continued use of this classification, the U.S. Department of Commerce conducted a review in 2017 and concluded that China is very much still a NME because "the state's role in the economy and its relationship with markets and the private sector results in fundamental distortions in the Chinese economy."[8]

The Commerce Department's decision rested on several examples of Chinese state control. The National Development and Reform Commission (NDRC)'s legislative and regulatory authority extends to setting prices for commodities and services, and approving large domestic and foreign investment projects. The prevalence of state owned and controlled enterprises gives the government the ability to regulate the means of production and allocate resources to strategically or fundamentally important sectors. And mechanisms like investment approvals, guidance catalogues, quantitative restrictions, and sectoral-level planning grant the central government significant power to influence and direct resource allocations.[9]

Against this background, it has been increasingly evident that Chinese leader Xi Jinping is on a path to rein in the private sector and to steer the country towards new stage of socialist development, with greater government intervention, intended to consolidate state power. Under Xi, the CCP has developed and promoted a model that it calls a "socialist market economy with Chinese characteristics," in which the party-state retains effective control over key commercial actors and institutions, industrial policy, and economic direction. The Chinese government is ultimately in control of all its commercial actors and has the power to determine whether a company is allowed to raise capital, provide services and goods, or even continue to exist as a for-profit enterprise. China's financial markets are leveraged to serve the CCP's strategic goals and objectives.

[8] https://enforcement.trade.gov/download/prc-nme-status/prc-nme-review-final-103017.pdf
[9] https://enforcement.trade.gov/download/prc-nme-status/prc-nme-review-final-103017.pdf

According to a tally by *The Wall Street Journal* this September, Xi's socialist drive has generated over 100 "regulatory actions, government directives and policy changes" across industries.[10] China's recent regulatory broadside has left the U.S. financial industry faced with the challenge of quantifying the effect of government corporate intervention. The economic and financial effects of Chinese government regulation are not comprehensively measured by official sources.[11] The resulting uncertainty has a material adverse impact on companies and investors, who cannot be sure that IPOs will go ahead (like in the example of Ant Financial) or whether entire industries will be allowed to continue raising funds in the capital markets, resulting in unpredictable and unnatural losses to U.S. shareholders.

Industry targets of China's regulatory crackdown over the past few months have included financial technology, e-commerce, real estate, online gaming, liquor, private tutoring, overseas listings, and data security. When Chinese authorities ramped up restrictions on the private tutoring industry and private education companies in July by prohibiting stock listings and foreign capital investment, Chinese education stocks fell dramatically. Gaotu Techedu shares went down by 76.9%, TAL Education dropped by 70.8%, and New Oriental Education and Technology shares lost 54.2%.[12]

After China's new data privacy law was announced this past August, the Hang Seng Tech Index tracking the 30 largest tech companies on the Hong Kong exchange, including Tencent, Xiaomi, and Lenovo, dropped 2.5%. The shares of large-cap companies in the internet, e-commerce, and online services industries felt an immediate impact: Alibaba Group lost 3%, Meituan dropped 9%, Ping An Healthcare fell 14.5%, and Alibaba Health Information Technology sank 13%.[13] The CSI Overseas China Internet Index, which consists of U.S. and Hong Kong-listed Chinese internet and internet-related technology companies, dropped around 58% from its mid-February peak.[14]

The Nasdaq Golden Dragon China Index, tracking 98 of China's largest companies listed in the U.S., has plummeted nearly 53% in the six months since its peak in February, obliterating about

[10] https://www.wsj.com/articles/xi-jinping-aims-to-rein-in-chinese-capitalism-hew-to-maos-socialist-vision-11632150725.
[11] https://sgp.fas.org/crs/misc/RL32162.pdf
[12] https://www.cnbc.com/2021/07/23/us-listed-china-education-stocks-plunge-as-beijing-regulators-crack-down.html https://www.google.com/finance/quote/GOTU:NYSE?window=6M.
[13] https://fortune.com/2021/08/20/china-stocks-lows-regulation-tech-shares/
[14] https://www.google.com/finance/quote/H11137:INDEXNYSEGIS?window=YTD

$900 billion in market value.[15] And the MSCI Emerging Markets Index, in which China represents about 34% of the large and mid-cap stocks tracked across emerging markets countries, and which is tracked closely by passively managed public pension funds and endowment funds across the United States, fell 16% in that same period of time.[16]

It should be noted that although the intensity and velocity of China's recent regulatory crackdowns have been somewhat unprecedented, this type of regulatory targeting of industries and companies over the past year is not unusual for the Chinese government. As explained by CSIS Freeman Chair Jude Blanchette, the "massively disruptive" campaign-style targeting of sectors is a way in which the CCP fixes societal and other problems that have become so flagrant that they can no longer be ignored.[17] What has amplified the impact of this latest barrage of regulatory action is the high level of global investor exposure to the stocks of affected companies. The more intertwined U.S. and Chinese capital markets become, the more acutely U.S. investors will feel the aftershocks of capricious Chinese domestic policymaking.

In a recently published report on China's investment outlook, Goldman Sachs estimated that there are publicly traded Chinese companies totaling $3.2 trillion in market capitalization in "risky social sectors," such as consumer finance, pharmaceuticals, and real estate development, that could be "disproportionately exposed" to further regulatory attention by the Chinese government.[18] Index providers, fund managers, and investors should all be keenly aware that the greater U.S. investor involvement in Chinese markets, the greater the risk exposure to politically-motivated Chinese government intervention and market turbulence.

Risk: China's opaque bureaucratic and corporate structures prevent high-quality disclosure and transparency, preventing U.S. investors from making informed investment decisions.

The Chinese party-state's sweeping bureaucratic authority, opaque legal system that practices rule by law rather than rule of law, and the complexity of corporate capital structures can obscure (often intentionally) a Chinese company's beneficial ownership and financial information. Financial due diligence is already difficult to conduct on companies residing

[15] https://www.ft.com/content/c5572f5a-d086-4ca2-995a-7b559f4e1d32
[16] https://www.google.com/finance/quote/EFS:INDEXCBOE?window=YTD.
[17] https://www.goldmansachs.com/insights/pages/gs-research/is-china-investable/report.pdf
[18] https://www.goldmansachs.com/insights/pages/gs-research/is-china-investable/report.pdf

outside of the United States. These China-specific factors make it particularly challenging for U.S. regulatory authorities to conduct proper due diligence and be able to guarantee that the required investor protection measures have been taken.

Chinese corporate structures: shell companies, reverse mergers, and VIEs

In 2011, press reports revealed that Chinese companies were listing on U.S. exchanges through reverse mergers, which allowed them tobypass standard disclosure requirements. This ultimately cost American investors an estimated $18 billion due to several companies that not only used this approach as a backdoor, but to commit significant fraud – facilitated by the circumvention of the usual regulatory scrutiny that comes with going public.[19] Despite the scandal, Chinese companies have continued to list through backdoor methods.

The financial-services firm Wins Finance Holdings offers an illustrative example of this phenomenon. In 2015, Wins Finance Holdings was incorporated as a wholly-owned subsidiary of NASDAQ-listed Sino Mercury Acquisition Corporation. Sino was a special purpose acquisition company (SPAC), or a cash shell, registered in the Cayman Islands. Sino then merged into Wins Finance Holdings, allowing Wins to become a publicly-traded company through the reverse merger.[20] During an SEC investigation that concluded in March 2017, it was found that Wins had misrepresented its U.S. headquarters to gain Russell Index inclusion.[21] Wins faced imminent delisting after updating its SEC filings to change its offices from the U.S. to China, but successfully appealed and remained listed on NASDAQ until the fall of 2020 when it delisted for unrelated reasons.[22]

Variable interest entities (VIEs) are legally and functionally ambiguous corporate structures frequently employed by Chinese companies to list on U.S. exchanges, through which overseas listed entities control domestic Chinese business entities through agreements. A 2017 report by the Council of Institutional Investors (CII) found that VIE corporate structures are used by 62%

[19] https://www.forbes.com/sites/walterpavlo/2011/04/08/fraud-in-chinese-reverse-mergers-on-american-exchanges-and-were-surprised
[20] http://securities.stanford.edu/filings-documents/1061/WFHI00_01/201744_f01c_17CV02434.pdf
[21] https://seekingalpha.com/article/4059103-wins-finance-potential-sec-investigation-manipulation-russell-index.
[22] Wins Finance delisted for reasons unrelated to its use of backdoor listing approaches or misrepresentations. Its assets were arbitrarily frozen by a public security bureau in China for undisclosed other reasons. https://www.prnewswire.com/news-releases/wins-finance-holdings-announces-nasdaqs-withdrawal-of-delisting-determination-letter-300540582.html

of Chinese companies currently listed on U.S. exchanges, and by over 80% of Chinese companies that went public on U.S. exchanges between 2015-2017.[23]

Domestically, VIEs can circumvent China's foreign investment prohibitions on certain industries, and restrictions on "round-trip investments" by domestic entities via offshore special purpose vehicles (SPVs). Internationally, VIEs are able to meet the requirements of listing on U.S. and other foreign securities exchanges, allowing Chinese companies to raise funds overseas. Chinese analysts have suggested that the strength and speed of the Chinese Internet industry's development can be partly attributed to the VIE model.[24]

VIEs use two entities to raise money from foreign investors. The first is an offshore shell company, a new holding company registered overseas in locales such as Bermuda, the British Virgin Islands, the Cayman Islands, or the Dutch Caribbean, using the lowest possible capital investment. This process requires the Chinese company seeking to go public to own enough foreign exchange to register a new overseas entity. The process also requires patience, as it takes time from incorporation to listing to raising capital.[25] The holding company can then purchase a controlling stake in a domestic Chinese company and list itself on an overseas exchange, typically with the support of foreign banks.[26] The shell company is entered into an agreement-controlled relationship with a China-based company that owns the underlying business licenses to operate in China. This results in a separation between overseas registered, listed entities and business operating entities. The shell company has no operations but wields effective control over the business, operating enterprises, profits, decision-making, etc.

This model is complicated and its risks, including moral hazard and corporate governance risks, are numerous. ChinaCast Education (CEC) is a Chinese company that successfully listed on the NASDAQ through a reverse merger and using a VIE structure. In July 2007, special purpose acquisition company Great Wall completed its acquisition of a Bermuda-incorporated entity called ChinaCast Communication Holdings in a reverse merger acquisition and was renamed ChinaCast Education Corporation. After building out its VIE structure, ChinaCast Education

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[23] https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf

[24] http://www.1xuezhe.exuezhe.com/Qk/art/80666?dbcode=3&flag=2

[25] http://www.szse.cn/szseWeb/FrontController.szse?ACTIONID=15&ARTICLEID=1443&TYPE=0

[26] For example, Bermuda-incorporated China Yuchai International Limited was established in April 1993 to own a controlling 76.4% interest in Sino-foreign joint venture Guangxi Yuchai Machinery. By December 1994, China Yuchai International (NYSE:CYD) had listed on the New York Stock Exchange as a foreign company. https://www.sec.gov/Archives/edgar/data/932695/000095012309022447/u00272e20vf.htm

was able to make the leap from trading over the counter to NASDAQ in October 2007 and achieve its ultimate goal of listing on a U.S. exchange.[27]

In 2012, the chairman of ChinaCast Education embezzled millions in company cash and transferred all the equity assets of two subsidiary companies without the knowledge of the ChinaCast Education's board of directors.[28] This was made possible by ChinaCast Education's very complex holding structure, wherein the operating company is owned and controlled by offshore companies, making shareholder supervision extremely difficult.

U.S. investors have very shaky legal rights to the underlying assets of VIE-structured companies because in reality, they are holding shares of a shell company with no intrinsic value or operations, that only mirrors the performance and value of a domestic Chinese company. In the event of a delisting or an undervalued take-private deal, it is unclear what recourse is available to U.S. shareholders of Chinese companies with VIE structures. This past July, SEC Chair Gary Gensler introduced new guidance seeking VIE-related disclosures from all China-based operating companies seeking to issue securities, and to conduct targeted additional filing reviews for companies with significant China-based operations.[29] These enhanced disclosure requirements have not yet, but should be codified as an amendment to the Securities Act.

Exemptions from Securities Act disclosure requirements create information asymmetry

Further, Chinese companies seeking to issue securities in the United States are able to circumvent strict U.S. disclosure standards by taking advantage of several SEC "safe habors." The United States' commitment to high-quality, reliable disclosures, financial reporting, and other investor-oriented information is a key element of our ability to protect investors and market participants. The material information provided by disclosure documents is essential to an investor's ability to make informed investment decisions. These safe havens and exemptions were introduced two decades ago, before Chinese issuers began pursuing overseas and cross-border listings, dollar bond issuances, or other global financial activities at the velocity and volume that they are today.

Securities Act Rule 144A permits unregistered international firms to raise debt or equity capital from qualified institutional buyers (QIBs, or large U.S. institutional investors), without

[27] http://www.yidianzixun.com/article/0IqLEchk
[28] http://finance.sina.com.cn/roll/20120516/010012072410.shtml
[29] https://www.sec.gov/news/public-statement/gensler-2021-07-30

incurring any additional costs of meeting U.S. disclosure standards. Chinese firms are consequently able to gain access to U.S. institutional investors without having to meet rigorous disclosure and procedural requirements typically required of equivalent U.S. firms.

Regulation S provides a safe harbor from Securities Act registration requirements for securities offerings made outside the United States. This is based on the presumption that the securities laws and regulations of the issuer's origin nation in which an offering is conducted provide a sufficient safeguard, However, in the case of Chinese issuers, the regulatory disparities are significant. Although the SEC has clarified that Reg S "may not be used to circumvent the registration requirements of the Securities Act," the potential use for abuse still exists.[30]

Reg-S securities must be issued outside of the United States and direct marketing efforts inside the U.S. are prohibited, but a large gray area exists whereby issuers resell securities, or offshore U.S. investors purchase them, allowing U.S. investors to access a veritable flood of unregistered Chinese securities. For example, Chinese tech giant Huawei Technologies issued a $1 billion Reg-S bond offering on the Hong Kong Stock Exchange through its wholly-owned, BVI-incorporated subsidiary Proven Honour Capital in May 2015.[31] A banker close to the transaction claimed that the decision to issue the bond in the Reg-S format was not a decision "to steer clear of U.S. investors due to security issues."[32] Although neither the bonds nor the guarantee (by Huawei Investment & Holding) were registered under the Securities Act and technically could not be sold within the United States, a combined 23% of the bonds were allocated for sales to offshore U.S. and European investors, including asset managers, corporations, and private banks.[33]

Risk: The U.S. financial industry is not equipped to identify, understand, and act in response to the market and reputational risks posed by China's rapid integration into global capital markets.

The U.S. securities regulatory framework has not yet caught up to the increasing integration of China into the global capital markets, or to the growing exposure of U.S. investors to securities

[30] https://www.sec.gov/rules/final/33-7505.htm.
[31] https://secure.fundsupermart.com/main/bond/bond-info/downloadRelatedDocument.svdo?Category=bondDocument&DocumentNo=541
[32] https://www.reuters.com/article/asia-bonds/huawei-bond-signals-international-push-idUSL3N0Y50KI20150515
[33] https://www.reuters.com/article/asia-bonds/huawei-bond-signals-international-push-idUSL3N0Y50KI20150515

listed overseas in countries with vastly different institutional environments, listing and disclosure requirements, and corporate governance practices that may not offer the same protections for investors as the United States does. More specifically, the increase in U.S. investors' exposure to Chinese issuers has introduced new and highly complex elements of risk that are not sufficiently addressed by the SEC's existing disclosure requirements or the constituent inclusion criteria used by global index providers.

U.S. investor access to publicly traded Chinese companies has expanded dramatically over the past few years, with the rapid inclusion of China A-shares into major stock indices, the launch and expansion of China's Stock Connect schemes, and the subsequent quadrupling of A-share weighting in certain investment benchmarks. Retail investors and institutional investors that want to add emerging markets or global markets to their portfolios frequently opt to use exchange traded funds (ETFs), which are a convenient and popular way to invest in specific industries, gain targeted exposure to specific geographic areas, or to gain broad exposure to a wide array of high performing stocks. ETFs aim to parallel the returns of a target index as closely as possible through replication of their underlying securities, and so ETF providers (and fund managers using passive investment strategies) essentially delegate their investment decisions to index providers.[34]

Because an ETF seeks to minimize tracking error in replication of the underlying benchmark, index rebalancing and weighting adjustments (determined by the index provider) are reflected directly in the fund flows from the associated product. The nature of ETFs means that inclusion of Chinese A-shares into an index results in the automatic inflow of funds to those companies from all ETFs associated with the index. Each index may have an unlimited number of associated ETFs, and those with the highest market capitalization often have at least several billion dollars under management. By providing access to the funds of American investors, ETFs and indices provide unregulated access for Chinese issuers to U.S. markets, without having to meet the accounting and disclosure requirements associated with a direct offering on a U.S. exchange.

Index providers serve as independent arbiters of U.S. capital flow to China

Index providers have become a dominant and central force in global financial markets. They serve as intermediaries that provide Chinese companies with access to U.S. markets, and U.S.

[34] https://www.tandfonline.com/doi/full/10.1080/09692290.2019.1699147

investors with exposure to Chinese companies. In May 2018, after three years of deliberation and negotiations with Chinese regulatory authorities (and considerable arm-twisting from Beijing), MSCI released a list of large-cap China A-shares to be included in the MSCI China Index, Emerging Markets (EM) Index, and All Country World Index (ACWI) beginning in June.[35] The MSCI EM Index previously only included shares of Chinese companies listed in Hong Kong or the United States. As of June 2018, MSCI had over $1.8 trillion in assets benchmarked globally to its Emerging Markets Index suite, which was 30.99% comprised of China-based securities.[36]

By November 2019, MSCI had increased and expanded its index exposure to mainland Chinese companies significantly by including mid-cap China A-shares and quadrupling the inclusion ratio of China A-shares in the MSCI EM Index from 5% to 20%.[37] The total index weighting of China A-shares jumped from 0.7% to 3.3%, drawing in an estimated $80 billion in foreign inflows to the Chinese market.[38] As of August 2020, the overall weight of China A-shares in the MSCI EM Index had risen to 5.1%, where it currently remains. Over 1,500 China A-shares are available to U.S. investors at this point.[39]

FTSE Russell followed in MSCI's footsteps and was the second major index provider to include China A-shares in its indices. In June 2019, FTSE added 1,097 China A-shares into its FTSE Global Equity Index Series (GEIS, which covers the FTSE Emerging and All-World Indices) in the first stage of inclusion (20%), drawing an expected $10 billion from U.S. passive investors. FTSE added the remaining 80% of A-shares in two tranches between September 2019 and March 2020. As of June 2020, China A-shares represented approximately 6% of the FTSE Emerging Index.[40]

In September 2019, S&P Dow Jones Indices (DJI) began the process of adding China A-shares to its global benchmarks, including the S&P China BMI and S&P Emerging BMI, at a partial inclusion factor of 25%. The additions took effect at the market open on September 23 and

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[35] MSCI's initial negotiations with Chinese authorities have been characterized by sources as "akin to business blackmail" due to the coercive approach in which China's national stock exchanges allegedly threatened to withdraw MSCI's access to market pricing data after MSCI failed to add A-shares on an expedited timeline. https://www.wsj.com/articles/how-china-pressured-msci-to-add-its-market-to-major-benchmark-11549195201

[36] https://www.msci.com/documents/1296102/1362201/MSCI-MIS-EM-May-2018.pdf/b1b05adf-4bf3-9acc-404c-9865da3e9997

[37] https://www.msci.com/www/blog-posts/china-a-shares-what-have-we/02164045217

[38] https://www.reuters.com/article/us-china-stocks-msci/msci-to-quadruple-weighting-of-china-a-shares-in-its-global-benchmarks-idUSKCN1QH318

[39] https://www.msci.com/www/blog-posts/china-a-shares-what-have-we/02164045217

[40] https://www.ftserussell.com/press/ftse-russell-completes-landmark-inclusion-china-shares

included about 1,099 A-shares accessible via the northbound trading segments of the Hong Kong-Shanghai Stock Connect and Hong Kong-Shenzhen Stock Connect that met underlying index requirements.[41]

These and other planned inclusions have bolstered the Stock Connect's role as a leading channel for global investors to access the China A-share market. A report released by the Hong Kong Stock Exchange (HKEX) on September 30, 2019 highlighted that Stock Connect Northbound ADT saw a "record nine-month high for YTD Q3 2019, more than double the previous record achieved in YTD Q3 2018."[42]

While index providers exercise virtually unchecked authority to control how and where U.S. investors deploy their funds – which companies, countries, sectors and industries – they also operate outside of SEC regulation, without industry-wide rules on transparency or accountability. Calls for the SEC to introduce specific U.S. regulations covering index providers to ensure the accuracy integrity of benchmarks have ramped up lately, and SEC Commissioner Hester Peirce said in a statement earlier this year that she is open to exploring the need for a regulatory framework explicitly tailored to index providers.[43]

Index inclusion and weighting criteria lack China-specific risk considerations

Beyond the need for the SEC to create rules for index providers as it pertains to oversight of quality control and minimizing conflicts of interest, it is critical for index providers to reevaluate their index inclusion criteria, which currently expose U.S. investors to material, reputational, China-specific risks.

Each index provider maintains its own criteria to screen securities for inclusion in its global market indices, based on standardized attributes like company size, market capitalization, and liquidity. However, the criteria evaluated by index providers to support the selection and

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[41] The northbound trading segments allow Hong Kong and international investors to trade in equities on the Shanghai and Shenzhen Stock Exchanges, routed through Hong Kong.
https://www.spglobal.com/spdji/en/landing/investment-themes/china/
https://www.indexologyblog.com/2019/03/28/are-you-ready-for-china-a-share-inclusion/
https://www.globalinvestorgroup.com/articles/3694991/stock-connect-changing-the-game-for-financing-china-a-shares
[42] https://www1.hkexnews.hk/listedco/listconews/sehk/2019/1106/2019110600237.pdf
[43] https://www.nytimes.com/2019/02/18/opinion/index-fund.html
https://www.sec.gov/news/public-statement/peirce-statement-sp-dow-jones-indices-051721

weighting of index constituents do not consider the full range of market and reputational material risks to investors, including considerations for risks in relation to national security, trade conflict and sanctions regimes, human rights violations, or even full consideration of traditional environmental, social, and governance (ESG) factors.[44] MSCI's methodology for index inclusion, for example, screens potential constituents for minimum size, market-cap, liquidity, and length of trading requirements. FTSE's methodology is primarily concerned with availability of timely data, demonstration of international interest, and whether the potential constituent meets liquidity requirements.[45]

Risk: U.S. investors are inadvertently subsidizing Chinese companies involved in activities contrary to the national security and foreign policy interests of the United States.

Retail and institutional investors are exposed to a wide range of publicly traded Chinese companies engaged in business activities that ultimately threaten U.S. national security interests and infringe on U.S. human rights values and commitments. Most strikingly problematic are the companies involved in developing weapons systems, new technologies, and building infrastructure to facilitate China's military modernization goals; and companies involved in facilitating the ongoing genocide of Uyghurs and other Turkic Muslims in Xinjiang, the systematic intimidation and coercive assimilation of Tibetans, and the mass surveillance and government interference in people's lives in Hong Kong. Beyond these, additional risk factors to consider include U.S. sanctions designations, Multilateral Development Bank (MDB) sanctions and debarments, and any other blacklists that may present a material risk to investors.

Several of these companies have already been sanctioned by the United States under one or more targeted sanctions programs, including the Department of Commerce's Military End User (MEU) List and Entity List, but are not subject to any financial sanctions, capital markets restrictions, or divestment mandates under the scope of those sanctions authorities. Washington is equipped, through various sanctions programs, to impose economic and financial restrictions on corporate entities it identifies as being involved in activities contrary to the national security or foreign policy interests of the United States. But there is little-to-no alignment between different sanctions programs. Effective sanctions programs are linked to clear policy objectives, and effective policies are coordinated across federal agencies. The U.S. government cannot fully

[44] A constituent is a company whose shares are part of an index.
[45] https://institutional.vanguard.com/VGApp/iip/institutional/csa/investments/benchmarks/home

achieve those policy objectives if sanctions intended to achieve a similar outcome, like preventing Chinese high-tech companies from conducting military R&D using American resources, are applied inconsistently.

When the Commerce Department's Bureau of Industry and Security (BIS) identifies and publishes sanctions lists of Chinese companies and imposes restrictions on exports, it validates the fact that these companies are risky and damaging to U.S. interests. It signals that these companies are not suitable for U.S. economic engagement. Perhaps these companies should not be able to fundraise from U.S. investors in the U.S. markets. But presently, being added to the BIS Entity List doesn't automatically create any requirement to divest – even when the company is publicly traded. The U.S. government can designate a Chinese company as being implicated in human rights violations and abuses in Xinjiang, involved in acquiring U.S.-origin items for the Chinese military, or actively developing supercomputers for military end-use, but continue to permit these companies to raise funds from U.S. investors in the U.S. markets.

When MSCI released its final compilation of China A-Shares for inclusion in its Emerging Markets Index in May 2018, the list included companies that had been implicated in human rights abuses and violations; identified as active in Chinese military-civil fusion initiatives; involved in the implementation of high-tech mass surveillance; contracted for strategic infrastructure projects in disputed parts of the South China Sea; and targeted by U.S. sanctions programs in the past or were presently included on U.S. sanctions lists. The China A-shares added by FTSE Russell and other leading index providers included many of these same companies and same risk exposure, due to common inclusion criteria like market cap and liquidity. In effect, these index providers are steering U.S. financial flows to Chinese companies involved in activities that undermine U.S. national interests.

<u>Chinese military companies are ramping up their presence in global markets</u>

The frequency of asset-backed securitization within China's military industrial complex has accelerated significantly since sweeping economic reforms were introduced by the CCP in 2013. Publicly traded companies have continued to carry out asset restructuring, shedding irrelevant and inferior assets, and gradually injecting core military assets into publicly traded, civilian companies. According to a 2017 report produced by investment research firm Sinolink Securities, China's 12 major military industrial groups had a total of 111 publicly traded companies listed on the Shanghai and Shenzhen stock exchanges, the National SME Share

Transfer System,[46] and overseas stock exchanges as of the end of 2016.[47] Chinese financial data and information provider Wind Information stated that the number of companies within China's major military industrial groups that have listed on mainland exchanges has increased every year since 2016.[48]

The China Securities Regulatory Commission (CSRC) Vice Chairman Yan Qingmin said in a 2019 speech that publicly traded Chinese military companies have played a leading role in China's military-civil fusion program and helped accelerate industry-wide development. Yan also announced that in 2018, the asset securitization rates of China National Nuclear Corporation (CNNC), Aero Engine Corporation of China (AECC), and the Aviation Industry Corporation of China (AVIC) all surpassed 50% Asset securitization is an important financing vehicle through which Chinese companies raise funds and improve capital liquidity via the conversion of assets to securities.[49]

Chinese military companies have steadily increased issuances of not only stocks, but also bonds. China Shipbuilding Industry Corporation (CSIC) is presently working on China's third carrier and first nuclear-powered aircraft carrier with a speculative completion date of 2025, when China plans to launch its fully integrated and networked blue-water navy.[50] CSIC's nuclear ambitions were outlined in a company development strategy document released in February 2018.[51] CSIC issued a $1 billion U.S. dollar-denominated bond on the Frankfurt Exchange the same month as the release of this strategy document, with a maturity date that coincides with the expected completion date of the carrier.[52] The chances that the bond issuance and the carrier development plans are related is reasonably high, particularly as a Chinese press report years ago stated the intention to issue bonds for big-ticket naval purchases on international markets.[53]

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[46] The National SME Share Transfer System is an independent national securities trading counter regulated by the China Securities Regulatory Commission (CSRC). It's currently known as currently known as the National Equities Exchange and Quotations, will soon be transitioned into the Beijing Stock Exchange.

[47] Since the Sinolink report was published, China's 12 military industrial groups have been consolidated into ten military industrial groups that continue to operate in the present day. The groups are funded and directly managed by the State Council. They are responsible for national defense research, production, and operations, and engage in the R&D of various weapons and equipment for China's armed forces. http://pdf.dfcfw.com/pdf/H3_AP201706050625961204_1.pdf.

[48] http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201903/t20190327_353421.html

[49] http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201903/t20190327_353421.html

[50] https://www.popsci.com/china-nuclear-submarine-aircraft-carrier-leak http://mil.huanqiu.com/world/2018-02/11629945.html.

[51] http://www.globaltimes.cn/content/1091116.shtml

[52] https://www.popsci.com/china-nuclear-submarine-aircraft-carrier-leak

[53] https://thediplomat.com/2015/09/foreign-investors-and-chinas-naval-buildup

It is likewise reasonable to expect that some of this bond offering was subscribed to by U.S. institutional investors, which, in turn, moved it into the portfolios of average Americans.

U.S. capital markets sanctions target Chinese military companies… to an extent

In November 2020, President Trump issued Executive Order 13959, prohibiting U.S. persons from holding or transacting in the publicly traded securities of companies identified as "Communist Chinese military companies (CCMCs)" by the Department of Defense in accordance with the statutory requirement of Section 1237 of the NDAA for FY1999.[54] Section 1237 of the FY1999 NDAA had mandated that the Secretary of Defense determines and publishes a list of CCMCs in consultation with certain federal agencies and with ongoing additions or deletions.

In June 2021, President Biden issued E.O. 14032 to strengthen and expand the previous E.O. by prohibiting investments in not only Chinese military-industrial complex companies (CMICs), but also Chinese surveillance technology companies and the direct owners and subsidiaries of CMICs. Instead of using a preexisting list, the E.O. included in the Annex a new list of companies covered by the divestment mandate.[55] The Office of Foreign Assets Control (OFAC) of the Treasury Department is ultimately responsible for interpreting and administering the Chinese military companies sanctions program, which represents the implementation of multiple legal authorities, including executive orders and public laws passed by Congress.[56] Separately, Section 1260H of the FY2021 NDAA was signed into law earlier this year, supplementing Section 1237 with broader definitions of Chinese military companies (CMCs) and a clear timeline to identify and submit a list of all CMCs. Additions and deletions to the 1260H list are to be made on an ongoing basis, and published annually until December 31, 2030.[57] The initial list of CMCs was released on June 3, 2021, but there have been no further updates and no additions.[58]

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[54] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/

[55] https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/
https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/

[56] https://home.treasury.gov/policy-issues/financial-sanctions/sanctions-programs-and-country-information/chinese-military-companies-sanctions

[57] https://www.congress.gov/116/bills/hr6395/BILLS-116hr6395enr.pdf

[58] https://www.defense.gov/News/Releases/release/article/2645126/dod-releases-list-of-chinese-military-companies-in-accordance-with-section-1260/

The criteria for determining Chinese military companies is fairly expansive across legal authorities. E.O. 14032 defines a Chinese military-industrial complex company as one that operates in China's "defense and related materiel sector or the surveillance technology sector."[59] It includes parent and subsidiary companies (in accordance with OFAC's 50 Percent Rule), which significantly expands the universe of companies that could qualify for list inclusion and divestment. Section 1260H defines a Chinese military company as one that is owned or controlled by the People's Liberation Army (PLA) or any military service under the jurisdiction of the Chinese government's Central Military Commission, and any company involved in China's military-civil fusion program.[60]

The determination and official designation of Chinese military companies in practice, however, has been very constrained. There are currently 47 companies on the Department of Defense's 1260H Chinese Military Company List (CMC List) and 59 companies on the E.O. 14032 Annex of Chinese Military-Industrial Complex Companies (CMIC Annex).[61] Many of the names overlap, so there are only 86 unique companies that have been designated as Chinese military companies across the two different lists. Although both lists were intended by their creators to be living, breathing documents that are expanded and updated over time, not single tranches, there have not been any additions of company names to date. There are also no clarifications on the timeline or expected frequency of future updates.

Yet there are hundreds of other publicly traded Chinese military companies that qualify for and warrant inclusion in one or both lists, but have been left out. For example, the Aviation Industry Corporation of China (AVIC) is one of China's largest aerospace and defense conglomerates, and is included in both the CMC List and CMIC Annex. AVIC has a total of 25 publicly traded subsidiaries, most of which are directly involved in the development and production of aircraft and weapons systems for the Chinese military – but only eight subsidiaries are included in the two lists.[62] This omission is particularly glaring when considering the policy objective behind

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[59] https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/
[60] https://www.congress.gov/bill/116th-congress/house-bill/6395/text
[61] The 59 companies on OFAC's Non SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List) mirror exactly the CMIC List.
[62] The eight publicly traded subsidiaries of AVIC on the CMC List, CMIC Annex, and included in OFAC's NS-CMIC List are: AVIC Aviation High-Technology Co., Ltd.; AVIC Heavy Machinery Co., Ltd.; AVIC Jonhon Optronic Technology Co., Ltd.; AVIC Shenyang Aircraft Co., Ltd.; AVIC Xi'an Aircraft Industry Group Co, Ltd.; Jiangxi Hongdu Aviation Industry Group (HAIG); and Zhonghang Electronic Measuring Instruments Co., Ltd. (ZEMIC). https://www.treasury.gov/ofac/downloads/ccmc/nscmiclist.pdf

the Chinese military companies sanctions program: to prevent U.S. capital from flowing into the Chinese defense sector, including companies that support the Chinese military.[63]

The number of additional companies that do not qualify for list inclusion under the present criteria but should, for the purposes of achieving the sanction objectives, expands exponentially when considering the number of Chinese military companies that are not publicly traded, but have access to the U.S. capital markets through listed subsidiary units and investment vehicles. I would be happy to provide the Subcommittee with a more complete list of these companies in a separate addendum to this written testimony, for potential inclusion in future tranches of the CMC List and Annex List.

U.S. investors inadvertently invest in companies linked to human rights violations in Xinjiang

Over three decades of sweeping security measures and assimilationist policies enacted by the Chinese government in the Xinjiang Uyghur Autonomous Region (XUAR) have been aimed at repressing Uyghur religious beliefs and practices and erasing Uyghur ethnic identity and culture. The human rights violations that have taken place and continue to occur in Xinjiang have been designated as "genocide and crimes against humanity" by both the Trump and Biden administrations, and condemned by governments across the world.[64]

A supply chain business advisory issued by the State Department this past July acknowledged that Chinese surveillance tech companies receive support and funding from international investors, warning American businesses and individuals to be aware of the "significant reputational, economic, and legal risks of involvement with entities in or linked to Xinjiang that engage in human rights abuses, including but not limited to forced labor and intrusive surveillance."[65] The international business community, however, continues to engage with many of the Chinese corporate entities known to be complicit in the implementation of mass arbitrary detention, high-tech surveillance, and forced labor transfer practices in Xinjiang.

Wealth managers argue that U.S. regulatory authorities haven't actually imposed any investment restrictions that would prevent Americans from investing in companies, particularly

[63] https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/
[64] https://www.state.gov/reports/2020-country-reports-on-human-rights-practices/china/
[65] https://www.state.gov/wp-content/uploads/2021/07/Xinjiang-Business-Advisory-13July2021.pdf

large-cap companies, with ties to Chinese human rights abuses. They insist that it would be fiduciarily unwise to shift client portfolios for discretionary reasons like human rights. And even when index providers seek to incorporate environmental, social, and governance (ESG) criteria into specific indices, they defer to an internally produced set of metrics that rarely capture all aspects of ESG risk. MSCI's ESG rating process, for example, takes into account factors like health and safety and carbon emissions, but does not consider human rights as a standalone "S" factor.[66] Investment companies (ETF providers) and fund managers are beholden to benchmark index performance objectives and therefore have their hands tied in regards to ability to remove certain companies for human rights reasons without incurring legal risk.

If there are sanctions imposed by the U.S. government that explicitly prevent or restrict investment in certain companies on the basis on human rights, then there is a clear divestment mechanism in place that gives index providers and investment firms the option to sell those securities or remove to them from indices and investment products. It is clear that without a congressionally mandated targeted sanctions program, American retail and institutional investors will continue to unknowingly, and without recourse, invest in publicly traded companies implicated in China's ongoing campaign of genocide against Uyghurs and other minorities in Xinjiang.

U.S. investors are financing and contributing technology to China's mass surveillance network

Over this past year, Congress has established new legislative frameworks in regards to the issue of forced labor in Xinjiang, seeking to implement greater regulatory scrutiny of U.S. companies' global supply chains. In June 2020, President Trump signed into law the Uyghur Human Rights Policy Act of 2020, which calls on U.S. companies and individuals that sell goods or services, or otherwise operate in Xinjiang to take steps, "including in any public or financial filings," to ensure that "their commercial activities are not contributing to human rights violations in [Xinjiang] or elsewhere in China," and "their supply chains are not compromised by forced labor."[67]

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[66] https://www.msci.com/documents/1296102/17835852/MSCI-ESG-Indices-Factsheet.pdf/3b449b87-d470-977a-3b56-77095b8d8fc7
https://www.msci.com/our-solutions/esg-investing/esg-ratings/materiality-map
[67] https://www.congress.gov/bill/116th-congress/senate-bill/3744/text

In June, the House of Representatives passed the ESG Disclosure Simplification Act of 2021 (Corporate Governance Improvement and Investor Protection Act) along with an amendment that includes the text of Congresswoman Wexton's Uyghur Forced Labor Disclosure Act. The amendment requires U.S. publicly traded companies to "review and actively audit supply chains" manufactured goods and materials produced by Uyghur forced labor.[68] This focus on addressing and combatting Uyghur forced labor sets a welcome precedence for requiring U.S. companies to disclose certain risky corporate engagements in Xinjiang. It demonstrates that Congress has the intent, ability, and authority to protect Chinese investors from unknowingly supporting the Chinese government's ongoing genocide. However, it only tackles one element of the Chinese government's campaign of repression in Xinjiang, and does not address the ways in which publicly traded American companies also support and profit from China's high-tech surveillance industry.

The Chinese government wields its high-tech surveillance apparatus – including facial recognition cameras, digital monitoring systems, and biometric tools – to monitor, censor, and control the populations not only in Xinjiang, but also in Tibet, Hong Kong, and elsewhere in China. Many of the Chinese tech companies that have reportedly equipped residential areas, cultural and religious spaces, reeducation facilities, and public security forces in Xinjiang with high-tech and biometric surveillance equipment include publicly traded companies Hangzhou Hikvision Digital Technology, FiberHome Technologies, Dongfang Netpower Technology, Zhejiang Dahua Technology, Xiamen Meiya Pico Information, Iflytek. Hikvision, for example, has equipped several detention facilities in Xinjiang and won hundreds of millions of dollars-worth of security contracts in the region, including Uyghur-specific projects at a paramilitary base in Urumqi.[69] Iflytek has supplied voiceprint collection systems to Kashgar police and partnered with the Xinjiang Public Security Bureau and telecommunications companies to integrate voice pattern data into surveillance systems.[70]

Large cap U.S. tech giants like Intel, Dell, and Microsoft have also been identified by researchers as having provided components, financing, or knowledge to China's vast and growing surveillance network linked to human rights abuses in Xinjiang.[71] An earlier investigation by *The Wall Street Journal* named Intel, Seagate Technology, Western Digital, and Hewlett Packard among U.S. tech companies involved in China's surveillance industry via financing,

[68] https://wexton.house.gov/news/documentsingle.aspx?DocumentID=566
[69] https://ipvm.com/reports/hik-xj-pap
[70] https://www.reuters.com/article/us-china-xinjiang-mit-tech-insight/risky-partner-top-u-s-universities-took-funds-from-chinese-firm-tied-to-xinjiang-security-idUSKCN1TE04M; https://www.hrw.org/news/2017/10/22/china-voice-biometric-collection-threatens-privacy
[71] https://www.hrw.org/news/2020/12/09/china-big-data-program-targets-xinjiangs-muslims#

commercial, or supply-chain relationships. According to company marketing materials surfaced by the *Journal*, Hewlett Packard sells computer network components to the government of Aksu, a city in Xinjiang that conducts broad surveillance of Uyghur residents and is known for arbitrary detention practices.[72]

Recommendations

Align U.S. economic and financial sanctions programs that have similar policy objectives, and introduce cross-debarment authorities, in order to achieve maximum impact and effectiveness.

- Congress should pass new legislation to grant different sanctions implementation authorities the ability to cross debar entities for the same misconduct. Entities that have been sanctioned by one U.S. sanctions implementing authority should be sanctioned for the same misconduct by other implementing authorities within the U.S. government. A Chinese company that is blocked from exporting U.S. tech components under the Entity List due to its involvement in developing state surveillance systems should also be prevented from raising capital in U.S. markets to fund R&D for state surveillance systems.

  This would encourage consistency across sanctions programs, promote greater information sharing and coordinated investigations, amplify the impact of sanctions, and bolster joint messaging. It would also prevent abnormal situations where U.S. investors are able to freely purchase or transact in the securities of an entity that the Treasury Department has separately determined poses significant investor risk and placed under sectoral sanctions.

Codify and expand the use of capital markets sanctions to prevent the outflow of U.S. capital to Chinese companies involved in China's military, intelligence, and security activities.

- Congress should pass legislation to codify existing executive orders (13959 and 14032) that provide the president with the authority to impose capital markets sanctions on

[72] https://www.wsj.com/articles/u-s-tech-companies-prop-up-chinas-vast-surveillance-network-11574786846

Chinese military-industrial companies, surveillance tech companies, and parent/subsidiary entities. The legislation should require the Secretary of Treasury, in consultation with the Secretary of State and the Secretary of Defense, to produce a quarterly review of list additions and updates.

Congress should also introduce language to expand and refine the sanctions, specifically to expand the divestment mandate to indices, index funds, mutual funds, and exchange traded funds; as well as public funds such as state and local pension systems, endowment funds, and domestic sovereign wealth funds. This would explicitly lay out actions for index providers, investment companies, and institutional investors that have previously been confused about their divestment obligations under the two executive orders.

Introduce a framework for regulatory oversight of index providers to review index governance practices and benchmark decision methodologies.

- The unanimous passage of the Holding Foreign Companies Accountable Act (HFCAA) introduced by Chairman Sherman in the House means that the SEC will be able to prohibit the trading of securities of Chinese companies with public accounting firms in foreign jurisdictions that the PCAOB is unable to inspect, on U.S. exchanges.[73] Following years of noncompliance with PCAOB audits, Chinese issuers on U.S. exchanges will finally be held to the same standards of transparency and disclosure as American issuers. I look forward to the Accelerating Holding Foreign Companies Accountable Act (AHFCAA) being signed into law.

  I also urge Congress to consider that in order to fully protect investors who purchase securities in the U.S. capital markets, it is imperative to pass legislation that would increase regulatory scrutiny of index providers and their methodology for constituent inclusion and weighting. Index providers exercise virtually unchecked authority to control how and where U.S. investors deploy their funds

[73] https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket048/2021-004-hfcaa-adopting-release.pdf?sfvrsn=f6dfb7f8_4

Protect U.S. investors from investing in companies implicated in serious human rights abuses by requiring annual public disclosures and public reporting.

- Congress should pass legislation requiring U.S. issuers to disclose involvement with China's surveillance technology industry and, in particular, the provision of related technologies and services in Xinjiang. Recent successes like the passage of the Uyghur Human Rights Policy Act of 2020 and the Uyghur Forced Labor Disclosure Act's inclusion in the ESG Disclosure Simplification Act of 2021 have set a precedence for requiring U.S. companies to disclose certain risky corporate entanglements with Xinjiang. They have also demonstrated Congress's ability and authority to protect Chinese investors from unknowingly supporting the Chinese government's perpetration of serious human rights abuses in Xinjiang.

  If the U.S. government's objective is to constrain the Chinese government's ability to expand its mass surveillance apparatus by blocking the inflow of U.S. components and financing, then tech companies listed in the U.S. are more likely than companies listed on overseas exchanges to comply with requests for information from stakeholders like the SEC and index providers, participate in corporate engagement efforts, and ultimately follow through with risk mitigation proposals like moving supply chains or switching manufacturer contracts away from Xinjiang end-users.

- The Uyghur Human Rights Policy Act of 2020 requires the Director of National Intelligence, in coordination with the Secretary of State, to submit a report with a list of Chinese companies involved in the construction or operation of detention facilities in Xinjiang. This list of Chinese companies was to be submitted no later than 180 days after the Act was signed into law, in which case the deadline was December 14, 2020.

  Congress should request the U.S. government to publicly release an unclassified version of the report, which would be hugely beneficial for the ability of U.S. investors and market participants to conduct due diligence and screen their investments for Chinese companies involved in the arbitrary detention, forced re-education, and abuse of Uyghurs in Xinjiang.

CONGRESSIONAL TESTIMONY: FOUNDATION FOR DEFENSE OF DEMOCRACIES

House Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

Taking Stock of 'China, Inc.'

Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets

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Eric B. Lorber October 26, 2021

I. Introduction[1]

Chairman Sherman, Ranking Member Huizenga, Representative McHenry, and distinguished members of the committee, I am honored to appear before you today to discuss the risks to investors and the United States posed by Chinese issuers in U.S. markets.

I come before this committee as a sanctions and compliance professional, having worked at the U.S. Department of the Treasury and advised financial institutions, corporations, humanitarian organizations, and individuals on ensuring they operate in compliance with U.S., EU, and UN sanctions obligations. As part of my work in both the public and private sectors, I have seen firsthand the power of U.S. economic sanctions in furthering U.S. foreign-policy objectives. While sanctions are not a panacea, they can be used in narrow and targeted ways to great effect.

One area where the United States has increasingly used this tool is in the global competition with China. As Congress and the Biden administration consider ways to protect U.S. markets from abuse and push back against certain Chinese activities that threaten U.S. national security, sanctions remain one of the top policy levers to consider pulling.

Safeguarding transparency in the global financial system and in U.S. markets is critical to protecting U.S. national security and the strength of the U.S. financial system. A core part of providing this transparency is ensuring U.S. investors have access to relevant, material information about foreign companies in order to make informed decisions. Over the last few years, the United States has taken important steps to ensure that Chinese companies attempting to access U.S. markets must play by the same rules as U.S. companies and do not introduce significant, material risk into U.S. investors' portfolios due to those Chinese companies' lack of transparency.

At the same time, we must balance those considerations against the risk of creating an onerous set of disclosure requirements that deter companies from seeking to access U.S. markets or that make it overly burdensome to do business here in the United States. Such burdens can deter legitimate companies from seeking financing on U.S. capital markets. This is a delicate balance to strike.

Likewise, we must make sure that any additional disclosure requirements would be impactful. Implementing broad-based disclosure requirements on Chinese issuers seeking access to U.S. capital markets may not have the intended effect if those issuers are already refusing to comply with relevant rules and regulations. And if those disclosure requirements are overbroad, they may impact non-Chinese issuers that we want to attract to U.S. capital markets.

As Congress and the administration weigh whether to create new reporting and disclosure requirements and determine how to best protect U.S. investors, they should likewise consider the use of narrowly targeted sanctions, which offer a well-established tool to ensure U.S. companies — and U.S. national security — are protected from certain threats.

The United States has a range of sanctions tools to target specific Chinese companies whose activity it believes poses national security risks. In particular, over the last few years, the United States has deployed limited but powerful prohibitions on trading in public securities of certain

Chinese companies associated with the People's Liberation Army or otherwise alleged to be involved in China's "military-civil fusion" program.

Likewise, for companies or individuals who are alleged to engage in particularly egregious actions, such as sanctions evasion, crackdowns on human rights in Hong Kong, or mistreatment of the Uyghur population in Xinjiang, the United States maintains powerful sanctions authorities to block such persons. This targeted approach may be a narrow and effective way to limit these companies' access to U.S. markets and to U.S. capital.

In addition to sanctions designations, the U.S. Department of the Treasury also has effectively promulgated advisories and guidance warning the private sector of doing business with certain companies or in certain sectors, including in Chinese industries. For example, the Treasury Department, along with its interagency partners, issued a supply chain advisory designed to warn the private sector about the risks of human rights abuses and forced labor in Xinjiang.[1]

Furthermore, the Treasury Department and the Financial Crimes Enforcement Network routinely issue detailed guidance highlighting financial-crime risks in certain foreign jurisdictions and industries.[2] Providing such targeted information to U.S. persons operating in the capital markets space, including in conjunction with relevant regulatory agencies, such as the Securities and Exchange Commission (SEC), could be an effective way to warn U.S. investors of specific risks posed by particular Chinese persons.[3]

These tools could provide a narrow, targeted way both to warn U.S. companies and investors of the risks of doing business with certain Chinese companies or in certain Chinese industries, as well as to limit those Chinese companies' ability to secure capital on U.S. markets while threatening U.S. national security.

Nevertheless, sanctions are not a silver bullet for protecting U.S. investors from Chinese companies that are subject to lax regulatory controls in their home jurisdiction. For example, sanctions may not be a good policy tool for targeting Chinese companies that do not adhere to international standards of good governance and financial stewardship and do not provide that information to U.S. investors. Rather, sanctions are an appropriate tool for targeting specific Chinese companies that threaten U.S. national security.

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[1] U.S. Department of State, Department of the Treasury, Department of Commerce, Department of Homeland Security, Department of Labor, and the Office of the Trade Representative, "Updated Xinjiang Supply Chain Business Advisory," July 13, 2021. (https://home.treasury.gov/system/files/126/20210713_xinjiang_advisory_0.pdf)
[2] See, for example: U.S. Department of the Treasury, Financial Crimes Enforcement Network, Advisory, "Updated Advisory on Widespread Public Corruption in Venezuela," May 3, 2019. (https://www.fincen.gov/sites/default/files/advisory/2019-05-03/Venezuela%20Advisory%20FINAL%20508.pdf).
[3] For a recent example of how the SEC has raised these considerations for investors, see: U.S. Securities and Exchange Commission, CF Disclosure Guidance: Topic No.10, "Disclosure Considerations for China-Based Issuers," November 23, 2020. (https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers)

II. Ensuring Investor Protections and U.S. Economic Competitiveness

U.S. regulatory and enforcement agencies have an important role to play in ensuring U.S. investors and companies have relevant, material information when making investment decisions. To date, Congress and the SEC have expressed serious concerns about the amount of information Chinese issuers routinely provide. In particular, the SEC, which relies on China's less stringent reporting and disclosure rules, has noted that the Chinese government prohibits the Public Company Accounting Oversight Board (PCAOB) from inspecting the work of auditors based in mainland China or Hong Kong. According to the SEC, "China has not provided the PCAOB access to inspect or investigate these registered public accounting firms with respect to their audits of China-based Issuers." While the SEC recommends asking Chinese issuers a range of questions to properly assess material information and relevant risks, these companies may not be forthcoming.[4]

The challenge in securing relevant, material information from Chinese companies about their financial information and potential risks to investors has, in certain instances, created significant negative impacts on U.S. investors. For example, last year Nasdaq delisted the Chinese company Luckin Coffee after it was alleged to have fabricated sales.[5]

To address these concerns, the SEC has directed China-based issuers to disclose certain risk factors, such as whether they are subject to an auditing firm under PCAOB oversight or rely on a Variable Interest Entity structure. Likewise, last year Congress passed the Holding Foreign Companies Accountable Act, which requires foreign issuers that rely on audit firms that cannot be reviewed by the PCAOB to make annual disclosures about their relationship to the Chinese government. The new law also prohibits foreign companies from listing their securities on U.S. exchanges if the companies have been unavailable for PCAOB inspection or investigation for three consecutive years. Furthermore, as part of this process, these companies will need to disclose the percentage of their shares owned by government entities, as well as certain information on their board members who are Chinese Communist Party (CCP) officials, among other information.[6]

As Congress and the administration consider taking additional actions to require foreign issuers to provide more information, they should keep in mind two key considerations. The first is whether the Chinese companies will actually provide additional, credible information if they are subject to increased due diligence or reporting requirements. While requiring such information can be an important way to help U.S. investors judge risk, the additional requirements may have little impact if those companies refuse to provide it or if they stonewall effectively. In such a situation, focusing on enforcement, to include delistings, will create additional leverage and should be pursued. Second, Congress and the administration should ensure that any options under consideration are narrowly targeted to provide investors with relevant, material information about the issuers while not unnecessarily increasing due diligence and reporting requirements.

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[4] Ibid.

[5] Jing Yang, "Nasdaq Moves to Delist China's Luckin Coffee," *The Wall Street Journal*, May 19, 2020. (https://www.wsj.com/articles/nasdaq-moves-to-delist-chinas-luckin-coffee-11589896619?mod=article_inline)

[6] Holding Foreign Companies Accountable Act, Pub. L. 116-222, 134 Stat. 1063, codified as amended at 15 U.S.C. §7201.

III. U.S. Economic Sanctions Related to China

Beyond disclosure requirements and delistings from U.S. exchanges, the United States currently has powerful sanctions authorities in place to prevent certain Chinese companies from accessing U.S. capital markets and raising funds from U.S. investors. Likewise, the United States has blocking authorities that can be used to sanction particularly egregious actors in China for a range of activity that may pose a threat to U.S. national security. These tools have been — and can continue to be — used to target specific Chinese companies or individuals the United States determines are engaged in China's military build-up, surveillance state, human rights abuses, sanctions evasion, or other malign activities.

Transaction-Specific Sanctions Limiting Financing

Beginning under the Trump administration in November 2020, the United States prohibited certain transactions in publicly traded securities of certain "Communist Chinese military companies." The purpose of this prohibition was to ensure that Chinese companies closely linked to the Chinese military — particularly those involved in China's military-civil fusion program — could not raise capital in U.S. markets.[7]

Citing Beijing's efforts to leverage China's private sector to support military research and development, Executive Order 13959, titled "Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies," sought to restrict those companies' access to U.S. capital by barring U.S. persons from conducting certain transactions involving publicly traded securities of "any Communist Chinese military company." As part of this effort to prevent Communist Chinese military companies from gaining access to U.S. capital markets, the U.S. government identified a few dozen such entities.[8]

Building on this initial effort, the Biden administration issued a new executive order to further refine these prohibitions. Like Executive Order 13959, Executive Order 14032 aims to prevent certain companies in the Chinese defense and surveillance technology sectors from benefiting from U.S. investment, and to prevent China's military-industrial complex from accessing U.S. capital

[7] See, for example: Emily de La Bruyère and Nathan Picarsic, "Defusing Military-Civil Fusion: The Need to Identify and Respond to Chinese Military Companies," *Foundation for Defense of Democracies*, May 27, 2021. (https://www.fdd.org/analysis/2021/05/26/defusing-military-civil-fusion)

[8] Executive Order 14032, "Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," June 3, 2021. (https://home.treasury.gov/system/files/126/eo_cmic.pdf). Two listed companies, Luokung Technology Corporation and Xiaomi Corporation, challenged their designations, arguing that the U.S. government failed to develop a sufficient factual record to establish a linkage between them and the Chinese military. Both companies were successful in their challenges and were delisted shortly thereafter.

markets.[9] The new executive order is more narrowly tailored than Executive Order 13959 in a number of ways.[10]

This approach — identifying specific Chinese entities the United States believes pose national security threats and preventing them from raising capital on U.S. markets — is narrowly tailored to limit those entities' ability to benefit from robust U.S. capital markets, while minimizing the risk that other companies will be unduly prevented from accessing U.S. markets. While these Chinese companies are not blocked persons and U.S. persons can continue to engage in certain business with them, they are now effectively cut off from U.S. capital markets.

Denying access to U.S. capital markets by specific Chinese companies or economic sectors that policymakers believe pose a national security threat provides the United States with a powerful tool to protect U.S. markets and U.S. national security. Expanding these types of prohibitions to cover additional Chinese military companies or economic sectors determined to pose national security threats could provide policymakers with another way to limit these actors' access to U.S. capital markets.

Blocking Sanctions Against Certain Chinese Persons

The United States also has authorities in place to target individuals and entities with powerful blocking sanctions, which not only cut those persons off from U.S. capital markets but also prohibit U.S. persons from conducting any transactions with them. In recent years, the United States has used its authorities under the Global Magnitsky Human Rights Accountability Act,[11] signed into law in 2017, as well as authorities related to Hong Kong,[12] to target Chinese individuals and entities alleged to have engaged in human rights abuses or the suppression of rights.

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[9] Executive Order 14032, "Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," June 3, 2021. (https://home.treasury.gov/system/files/126/eo_cmic.pdf). For a discussion of these restrictions, see: "Biden Revises Ban on U.S. Investors Buying Certain Chinese Securities," *K2 Integrity*, June 7, 2021. (https://www.k2integrity.com/en/knowledge/policy-alerts/biden-revises-ban-on-us-investors-buying-certain-chinese-securities)

[10] For example, when Executive Order 13959 was issued, it caused considerable confusion in the markets due to ambiguity surrounding the application of the prohibitions to targeted companies and their subsidiaries. In particular, the prohibitions under the original executive order applied to entities whose name exactly or "closely" matched the name of an entity identified under the executive order. Executive Order 14032 leaves no room for ambiguity by removing the "closely matching" prohibition. In addition, Executive Oder 14032 includes the full English-language names of the targeted companies rather than the shorthand English-language names that caused confusion following the issuance of Executive Order 13959. For a full analysis of both executive orders, see: "United States Prohibits Investment in Chinese Companies with Military Ties," *K2 Integrity*, November 19, 2020. (https://www.k2integrity.com/en/knowledge/policy-alerts/united-states-prohibits-investment-in-chinese-companies-with-military-ties); "Biden Revises Ban on U.S. Investors Buying Certain Chinese Securities," *K2 Integrity*, June 7, 2021. (https://www.k2integrity.com/en/knowledge/policy-alerts/biden-revises-ban-on-us-investors-buying-certain-chinese-securities)

[11] See: Executive Order 13818, "Blocking the Property of Persons Involved in Serious Human Rights Abuse or Corruption," December 20, 2017. (https://home.treasury.gov/system/files/126/glomag_eo.pdf). This executive order implements the legislation.

[12] See, for example: Hong Kong Autonomy Act, Pub. L. 116-149, codified as amended at 22 U.S.C. §5701.

For example, in July 2020, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) designated the Xinjiang Production and Construction Corps (XPCC) and two affiliated CCP officials under Executive Order 13818, the implementing executive order for the Global Magnitsky Human Rights Accountability Act.[13] The XPCC is a quasi-governmental paramilitary entity that is instrumental in Beijing's economic development plans for Xinjiang. According to international human rights groups[14] and UN experts,[15] the Chinese government prevents the Uyghurs, ethnic Kazakhs, and ethnic Kyrgyz, among others, from freely exercising their religion and subjects them to arbitrary detention and systematic forced labor, particularly in the Xinjiang region. According to the U.S. government, the XPCC is involved in human rights abuses, including surveillance and detention of ethnic minorities. The XPCC is involved in a variety of economic activities in the region, such as cotton cultivation, and often operates through subsidiaries and front companies.

Likewise, the U.S. government has targeted individuals in Hong Kong under Executive Order 13936, which authorizes the president to impose sanctions on non-U.S. persons involved or complicit in, inter alia, undermining democratic processes or institutions in Hong Kong; threatening the peace, security, stability, or autonomy of Hong Kong; censoring, prohibiting, or limiting the freedom of expression or assembly by citizens of Hong Kong; or limiting access to free media.[16]

On August 7, 2020, the Treasury Department imposed its first set of sanctions under Executive Order 13936, designating Hong Kong Chief Executive Carrie Lam and 10 other high-ranking Hong Kong or CCP officials for their role in implementing China's National Security Law and orchestrating the arrest of demonstrators.[17] Then, on December 7, 2020, the U.S. State Department announced the designation of 14 vice-chairs of China's National People's Congress Standing Committee who voted unanimously to adopt the National Security Law, thereby undermining "the ability of the people of Hong Kong to choose their elected representatives."[18] OFAC simultaneously added these individuals, designated pursuant to EO 13696, to the Specially Designated Nationals and Blocked Persons (SDN) List.

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[13] U.S. Department of the Treasury, Press Release, "Treasury Sanctions Chinese Entity and Officials Pursuant to Global Magnitsky Human Rights Executive Order," July 31, 2020. (https://home.treasury.gov/news/press-releases/sm1073)
[14] "Eradicating Ideological Viruses: China's Campaign of Repression Against Xinjiang's Muslims," *Human Rights Watch*, September 9, 2018. (https://www.hrw.org/report/2018/09/09/eradicating-ideological-viruses/chinas-campaign-repression-against-xinjiangs)
[15] UN News, "Rights Experts Concerned about Alleged Detention, Forced Labour of Uyghurs in China" March 29, 2021. (https://news.un.org/en/story/2021/03/1088612)
[16] Executive Order 13926, "The President's Executive Order on Hong Kong Normalization," July 14, 2020. (https://www.federalregister.gov/documents/2020/07/17/2020-15646/the-presidents-executive-order-on-hong-kong-normalization)
[17] U.S. Department of the Treasury, Press Release, "Treasury Sanctions Individuals for Undermining Hong Kong's Autonomy," August 7, 2020. (https://home.treasury.gov/news/press-releases/sm1088)
[18] Secretary of State Michael R. Pompeo, U.S. Department of State, Press Statement, "Designations of National People's Congress Officials Undermining the Autonomy of Hong Kong," December 7, 2020. (https://2017-2021.state.gov/designations-of-national-peoples-congress-officials-undermining-the-autonomy-of-hong-kong/index.html)

Imposing targeted blocking sanctions against specific Chinese persons could likewise be a way to ensure that companies the United States believes pose national security threats are unable to access U.S. markets, including capital markets.

Guidance for the Private Sector

Beyond sanctions, the U.S. government has published a range of advisories designed to warn the private sector about specific risks of doing business in particular Chinese economic sectors and jurisdictions.

For example, in July 2020, the U.S. departments of State, the Treasury, Commerce, and Homeland Security issued a joint advisory warning U.S. businesses of the reputational, economic, and legal risks arising from their supply chain exposure to the Xinjiang Uyghur Autonomous Region in China.[19]

The advisory recommends that U.S. businesses implement human rights-related due diligence measures to manage their risk exposure. The advisory focuses on three activities of concern: assisting in developing surveillance tools that China could use to monitor and control populations in Xinjiang; buying goods produced by laborers based in Xinjiang or from factories elsewhere in China that use laborers originally from Xinjiang; and aiding in the construction of facilities within Xinjiang that house or employ forced laborers. The advisory links to resources provided by the U.S. departments of Labor, State, and Justice to guide businesses in ensuring supply chain integrity in the face of these risks.[20]

The advisory recommends U.S. businesses be aware of the methods China uses to obfuscate its forced labor practices. According to the advisory, the Chinese government refers to many camps used to forcibly imprison or re-educate Uyghurs as "educational centers" or "vocational training centers." According to the advisory, Chinese firms using this labor also uses shell companies to export the items produced in these camps, which can often obscure the goods' origins in Xinjiang.[21]

Likewise, in July 2020, the U.S. departments of State, Commerce, Treasury, and Homeland Security issued a Hong Kong Business Advisory detailing the risks of continuing to do business in Hong Kong after the implementation of the National Security Law.[22] According to the U.S. government, these risks fall into four primary categories: risks for businesses following the imposition of the National Security Law; data privacy risks; risks regarding transparency and

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[19] This advisory was subsequently updated in July 2021. U.S. Department of State, Department of the Treasury, Department of Commerce, Department of Homeland Security, Department of Labor, and the Office of the Trade Representative, "Updated Xinjiang Supply Chain Business Advisory," July 13, 2021. (https://home.treasury.gov/system/files/126/20210713_xinjiang_advisory_0.pdf)
[20] Ibid.
[21] Ibid.
[22] U.S. Department of State, Department of the Treasury, Department of Commerce, and Department of Homeland Security, "Hong Kong Business Advisory," July 16, 2021. (https://home.treasury.gov/system/files/126/20210716_hong_kong_advisory.pdf)

access to critical business information; and risks for businesses with exposure to sanctioned Hong Kong or mainland Chinese entities or individuals. Since the issuance of this advisory, additional risk related to Chinese countersanctions has also increased.

These advisories provide U.S. businesses — including those operating in financial markets — with clear indications of which specific Chinese companies and which sectors of the Chinese and Hong Kong economies pose real and regulatory risks. Providing U.S. companies with additional information, building on prior, high-level guidance issued by the SEC, could be an effective way to allow U.S. investors better understand their risks.

IV. Conclusion

Ensuring U.S. investors have access to relevant, material considerations about Chinese companies is important to ensuring that they have the opportunity to make informed decisions. Likewise, preventing companies that pose national security threats to the United States from accessing our financial markets is critical. While protecting U.S. investors from Chinese issuers who refuse to abide by U.S. standards is an important objective, we must be cautious to ensure we do not inadvertently raise reporting and disclosure obligations too high and chill the attractiveness of those very financial markets we aim to protect and foster.

Narrowly targeted sanctions on certain Chinese companies or Chinese industries that the United States determines pose national security threats can be a way to protect both U.S. investors and U.S. national security. However, Congress and the administration should clearly understand the limits of such sanctions. While they can prevent malign actors from accessing our financial markets, they may be less effective at protecting U.S. investors from non-U.S. issuers who do not provide sufficient material information.

I look forward to your questions and thank you again for the opportunity to testify.

Taking Stock of 'China, Inc.': Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets

Testimony of Samantha Ross

Founder
AssuranceMark

Before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the
Committee on Financial Services
United States House of Representatives

October 26, 2021

Chair Sherman, Ranking Member Huizenga, and Members of the Subcommittee:
I am pleased to appear before you today to discuss risks to investors and the U.S. posed by foreign issuers in U.S. markets. In particular, I will address the significant risks investors face from Chinese companies that benefit from access to U.S. markets but do not comply with the important investor protections provided under U.S. law.

In continuing to block routine inspections of the financial audits of Mainland China and Hong Kong-based companies that sell securities in the United States, the People's Republic of China (PRC) is an outlier among nations. All other jurisdictions where issuers of U.S. securities are domiciled allow such inspections, and in many cases the local audit regulator cooperates in them. Allowing Chinese companies to continue to evade audit inspections not only weakens protections for investors in those companies, but it also harms U.S. markets more broadly. The actions this Subcommittee, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have taken to protect U.S. investors and markets through the Holding Foreign Companies Accountable Act are appropriate. The U.S. must remain vigilant to ensure that China-based companies and individuals do not access capital in the U.S. if they refuse to comply with our laws and standards.

My testimony is informed by my experience over a period of 18 years serving as staff in the Division of Enforcement at the SEC, where I gained first-hand knowledge of fraudulent accounting practices by foreign private issuers, and at the PCAOB. As Chief of Staff to the PCAOB's first Chair, the late William J. McDonough, I helped design audit oversight rules and initiatives that laid a framework to protect investors in foreign companies that issue securities in U.S. markets. Those measures, which remain in force today, provide demonstrable benefits to investors and our markets, as I'll explain in detail in a moment. Since leaving public service, I've continued to serve investors through education and initiatives to promote high quality audits of corporate disclosure.

I want to commend the Subcommittee for its longstanding, bipartisan support for protecting both U.S. investors and U.S. capital markets. Our markets are a national treasure that make it possible for savers and entrepreneurs to realize their dreams. They are a fundamental mechanism for U.S. economic growth. And they have proven to be an enormously successful form of soft power, by affording equal protections to foreign investors in our markets and equal access to foreign companies who commit to our high standards for investor protection. Twenty years ago, the financial reporting scandals relating to Enron, Adelphia, WorldCom, and other U.S. and non-U.S. companies rocked investor trust in our markets and threatened to put these benefits in jeopardy. As these problems were emerging, the House Financial Services Committee and the Senate Banking Committee acted swiftly and decisively in a bipartisan way to restore public confidence in U.S. markets with the Sarbanes-Oxley Act of 2002. The law passed by votes of 423-3 in the House of Representatives, and 99-0 in the Senate.

Title I of the Sarbanes-Oxley Act established the PCAOB to oversee the auditors of U.S. issuers that have registered securities with, or file reports with, the SEC in order to access

the U.S. capital markets. [1] The Act explicitly provides that the PCAOB's authority applies to any foreign public accounting firm that has registered with the PCAOB "in the same manner and to the same extent as" it applies to U.S.-based public accounting firms.[2]

As of September 2021, 840 non-U.S. accounting firms from more than 80 jurisdictions have registered with the PCAOB in order to be able to prepare or participate in the preparation of audit reports that attest to financial statements submitted to the SEC.[3] This includes 36 firms based in Mainland China and 28 firms based in Hong Kong.[4]

One of the most important powers of the PCAOB is to conduct inspections of public accounting firms that prepare or participate in the preparation of audit reports for U.S. issuers.[5] Initially, there were many foreign jurisdictions that objected to the PCAOB's powers to inspect firms that were based in their jurisdictions, even though the firms issued or participated in the preparation of audit reports on the financial statements of U.S. issuers. Some of the reasons given at the time were that the PCAOB's authority conflicted with local blocking statutes or local secrecy laws, such as those in France and Switzerland. Other countries objected based on a concern that PCAOB inspections could infringe on cultural and legal prohibitions, including important privacy protections in some jurisdictions, such as Germany, against collecting certain information on individuals.

These were formidable objections, but from the beginning, the PCAOB pursued a strategy to engage with its counterparts to raise awareness of the significant risks that investors in both the U.S. and the local jurisdiction faced; impart deeper understanding of the PCAOB's inspection process; develop cooperative approaches to partner with local regulators to mitigate their concerns; and, where necessary, identify legal and other impediments in the local jurisdictions that could be removed with local legislative or other action.

As an example, since many of the objecting jurisdictions were members of the European Union, one of the first acts of the PCAOB's first chair, Bill McDonough, was to embark on a deep engagement with the European Commissioner and Director General for Internal Markets. In May 2004, I was pleased to testify before the full Committee on the constructive working relationship the PCAOB established with the European Commission

[1] Under Section 2(a)(7) of the Sarbanes-Oxley Act, the term "issuer" includes public companies that have either registered, or are in the process of registering, a class of securities with the SEC or are otherwise subject to Commission reporting requirements.
[2] Sarbanes-Oxley Act, Section 106(a)(1).
[3] PCAOB Release No. 2021-004, *Rule Governing Board Determinations Under the Holding Foreign Companies Accountable Act* (Sept. 22, 2021).
[4] These figures are derived from an interactive map maintained by the PCAOB showing jurisdictions where the PCAOB has access to inspect and jurisdictions where it is denied access. PCAOB Website, *International* available at https://pcaobus.org/oversight/international (accessed Oct. 23, 2021).
[5] Sarbanes-Oxley Act, Section 101(c).

to further our mutual objectives to restore confidence in our respective capital markets.[6] The EC's Director General for Internal Markets also testified at that hearing, attesting to our mutual interests in promoting audit quality through cooperation in regulatory oversight. That relationship proved to be the foundation for European member states, over a period of years, to work through and address impediments to the PCAOB conducting required inspections.

While these negotiations were ongoing around the world, the PCAOB began inspecting non-U.S. registered firms in 2005, where it could gain access. Over time, the PCAOB increased the number of non-U.S. firms it inspected, as it resolved impediments and reached formal cooperative agreements with foreign audit regulators. These arrangements both minimized administrative burdens and provided mechanisms to resolve potential legal or other conflicts that non-U.S. firms might face in the foreign jurisdiction in question.

Generally speaking, the PCAOB carries out its non-U.S. inspections in two ways:

- First, in some cases, the PCAOB conducts the inspections on its own, with the knowledge and acquiescence of local authorities.

- Second, other cases, the PCAOB conducts the inspections jointly with the home country regulator.

Although the PCAOB was able to work out cooperative arrangements with some of the objecting jurisdictions early on, the pace of such arrangements increased significantly after the financial crisis, which I believe instilled a sense of heightened urgency amongst some jurisdictions to resolve even the thorniest of legal impediments. As I mentioned already, some jurisdictions had to amend their laws before they were able to cooperate in PCAOB inspections, which took considerable time. Ireland and Belgium are two examples. In many cases, local authorities went to great lengths to remove these impediments.

At present, the PCAOB has conducted inspections of one or more firms in more than 50 non-U.S. jurisdictions,[7] and it maintains cooperative arrangements with 25 foreign audit regulators. These arrangements enable the PCAOB to inspect audits of U.S. issuers in all jurisdictions where PCAOB-registered public accounting firms are domiciled, with two exceptions, Mainland China and Hong Kong. As the sole authority that blocks cooperation with PCAOB inspections of audits of U.S. issuers, the PRC is the outlier.

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[6] Testimony Concerning the Regulatory Dialogue Between the Public Company Accounting Oversight Board and the European Commission (May 13, 2004), available at http://archives-financialservices.house.gov/media/pdf/051304sr.pdf.
[7] PCAOB Website, *Non-U.S. Jurisdictions Where the PCAOB Has Conducted Oversight* (as of June 30, 2021), available at https://pcaobus.org/oversight/international/international/pcaob-inspections-of-registered-non-u-s--firms (accessed Oct. 20, 2021).

The PCAOB reports that, in the 13-month period ended June 30, 2021, 15 PCAOB-registered firms in mainland China and Hong Kong signed audit reports for 194 public companies with a combined global market capitalization (U.S. and non-U.S. exchanges) of approximately $2.4 trillion. [8] The ten largest of these companies had a combined market capitalization of approximately $1.6 trillion.[9]

Unfortunately, our markets are being tested by a string of frauds by China-based companies that obtained capital from our markets but failed to comply with our investor protection rules. Last year, Luckin Coffee announced that its chief operating officer had fabricated billions of yuan in sales for 2019, after obtaining more than half a billion dollars by selling American Depository Receipts (ADRs) in an IPO in May of that year.[10] On the heels of the Luckin Coffee revelations, another China-based company – TAL Education Group – revealed that it had inflated sales by forging contracts.[11] TAL is a tutoring business that listed ADRs on the New York Stock Exchange in 2010 and whose success turned its founder into one of China's richest people.[12] In September 2020, another China-based, U.S.-listed education company – Gaotu Edutech Inc. – announced that it too was under investigation by the SEC for possible accounting improprieties.[13] These are just a few of the more prominent, recent announcements related to China-based, U.S.-listed companies.

As Paul Zarowin, professor of accounting at the Stern School of Business at New York University, put it:

> The basic problem is that they don't have the same auditing standards that we do here . . . . And compounding that problem is that the PCAOB [Public Company Accounting Oversight Board] which oversees the auditing firms, generally can't get access to audit the Chinese auditing firms. So a lot of firms go public from China into Western capital markets that don't meet the same disclosure and auditing standards that we would here.[14]

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[8] PCAOB Website at https://pcaobus.org/oversight/international/china-related-access-challenges (accessed Oct. 20, 2021).

[9] Id.

[10] Sofia Horta e Costa, *Two Accounting Scandals in China in One Week Burn Investors,* Bloomberg (Apr. 8, 2020).

[11] Venus Feng, *Chinese Tutoring Mogul Loses $1.8 Billion After Revealing Fraud*, Bloomberg (April 8, 2020).

[12] Lynn Cowan, *TAL Education IPO Surges 50%,* Wall Street Journal (Oct. 21, 2010); Sofia Horta e Costa, *Two Accounting Scandals in China in One Week Burn Investors,* Bloomberg (Apr. 8, 2020).

[13] Bloomberg News, *SEC Probes Chinese Education Firm Amid Tighter U.S. Scrutiny* (Sept. 2, 2020).

[14] Therese Poletti, *Luckin Coffee Shows How Risky Chinese IPOs Can Be, But Investors Just Aren't Listening*, Marketwatch (May 20, 2020) (noting that after the IPO, Luckin Coffee's market capitalization topped $4.4 billion after investors sent shares more than 40% higher in its first day of trading on the Nasdaq, making losses by investors who bought in after the IPO even greater than IPO-purchasers losses, when the fraud came to light).

By enacting the Holding Foreign Companies Accountable Act, and by holding hearings such as this one, Congress is playing a critical role in signaling that companies that seek access to capital from U.S. markets must adhere to our rules.

I also commend the SEC for the decisive approach it is taking to implement the Holding Foreign Companies Accountable Act, under which it is preparing to prohibit trading in about 270 China-related companies by early 2024.[15] I also commend the PCAOB for its rulemaking, concluded last month. That rulemaking establishes a framework for the PCAOB to use to determine whether it is unable to complete an inspection or investigation because of a position taken by one or more authorities in that jurisdiction.[16]

The SEC has announced that it has paused new offerings from both Chinese operating companies who list directly and their shell-company affiliates.[17] It has also signaled its readiness to accelerate the trading prohibitions to 2023, if Congress enacts the Accelerating Holding Foreign Companies Accountable Act. The SEC is also focused on the risks that investors face from the confusing and unusual corporate structures that many China-based companies seeking capital in the U.S. take. Chairman Gensler has directed the SEC staff to "ensure that these companies provide full, fair and transparent disclosure of their risks and corporate structures, among other factors, if they wish to offer securities in U.S. markets."[18] These are all important steps that will not only strengthen protection of investors in China-based companies, but also strengthen protection of our markets more broadly.

A great body of research documents the benefits that foreign private issuers obtain by issuing securities in the United States, which binds them to high quality disclosure and audit standards.[19] Those benefits include a lower cost of capital than they would face in their home-country capital markets. The linchpin of these benefits is the binding commitment companies make to our standards, including high quality financial reporting requirements and a reliable third-party audit. Enforcement of this commitment – rather than relying on companies' assertions of compliance – is what distinguishes U.S. listings and produces their capital market benefits.

PCAOB inspections are a critical component of our enforcement regime. Inspections examine whether third-party auditors are in fact holding companies to their commitments

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[15] SEC Chair Gary Gensler, *Chinese Firms Need to Open Their Books*, Wall Street Journal (Sept. 13, 2021)("Gensler Op-ed").
[16] PCAOB Press Release, *PCAOB Adopts Rule to Create Framework for HFCAA Determinations* (Sept. 22, 2021). This rule must be approved by the SEC in order to go into effect.
[17] Gensler Op-ed.
[18] Id.
[19] See, e.g., John C. Coffee, Jr., *Racing towards the top? The impact of cross-listings and stock market competition on international corporate governance*, 102 Columbia Law Review 1757–1831 (2002); Rene M. Stulz, Globalization of equity markets and the cost of capital. 12 J. Applied Corp. Fin., 12: 8–25 (1999); Craig Doidge, Andrew Karolyi, and Rene Stulz, *Why are foreign firms listed in the U.S. worth more?* 71 J. of Fin. Econ. 205–238 (2004).

to produce high quality and reliable financial reports. For example, empirical evidence suggests that capital markets find financial reporting more credible following introduction of PCAOB inspections in non-U.S. jurisdictions.[20] That is, investors put more faith in financial reporting when the PCAOB is able to inspect.

There is a basis for this trust: research has also found that auditors in jurisdictions where the PCAOB can inspect provide higher quality audits as measured by more going concern opinions, more reported material weaknesses, and less earnings management, relative to auditors in jurisdictions where the PCAOB cannot inspect.[21] Inspection access is also associated with higher-quality analyst forecasts, which suggests that the PCAOB gaining access to inspect "reduces information risk for market participants."[22]

This higher level of trust translates to benefits for companies. Researchers have found that foreign SEC registrants with auditors from countries that allow PCAOB inspections enjoy a lower cost of capital, relative to foreign SEC registrants with auditors from countries that prohibit inspections.[23] With this evidence, it should be no surprise that most jurisdictions found ways to accommodate PCAOB inspections.

China-based companies' free-riding on U.S. markets, without complying with U.S. audit regulations, increases fraud risks for investors in those companies. But that is not the only reason why it is important to stop the free-riding. It also harms our markets more broadly. The benefits I've described exist because participation in our markets means something; it is a signal of the quality and reliability of the financial information of the companies that list here. As we saw in the days of the Enron scandal, when any group of participants fails to comply with our standards, that sends a signal that weakens confidence in the whole market. Thus, for the benefits to continue to flow to compliant U.S. and non-U.S. companies, it must be clear that we enforce our standards across the board.

If China continues to block PCAOB inspections, then China-based issuers that are prohibited from U.S. public securities markets may attempt to access U.S. capital through private markets for exempt offerings that do not have reporting requirements. The theoretical foundation for such exemptions is that sophisticated private investors have superior access to information through their ownership stake. But this is not the case when it comes to China-based companies. To get around Chinese regulatory requirements,

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[20] Brandon Gipper, Christian Leuz, and Mark Maffett, *Public Oversight and Reporting Credibility: Evidence from the PCAOB Inspection Regime,* The Review of Financial Studies (Dec. 26, 2019).
[21] Phillip T. Lamoreaux, *Does the PCAOB Inspection Process Improve Audit Quality? An Examination of Foreign Firms Listed in the United States,* J. Acc. Res. (2016) (On the other hand, there is no observable difference between the two sets of auditors prior to the PCAOB inspection regime.).
[22] Id.
[23] Phillip T. Lamoreaux, Landon M. Mauler, and Nathan J. Newton, *Audit Regulation and Cost of Equity Capital: Evidence from PCAOB's International Inspection Regime,* Contemporary Acc. Res. (Winter 2020).

China-based private companies seeking capital outside of China adopt complex structures through contracts with shell companies in foreign jurisdictions, which break the chain of ownership. U.S. investors buying into such structures have no control over the China-based company's management or assets and no rights to information about them. The SEC is right to be concerned about these risks, whether the investor is accredited to make direct purchases in exempt private offerings or is indirectly exposed through shares in a mutual fund or other pooled investment vehicle that invests in private companies.[24]

In conclusion, audit regulators around the world cooperate in PCAOB inspections of PCAOB-registered firms' audits of companies that offer securities in the U.S. The PRC is the only government that blocks them. This causes serious harm both to investors in such companies as well as our public capital markets more broadly. I commend the work you have done to put an end to these harms, as well as the work the SEC and PCAOB have done to implement the Holding Foreign Companies Accountable Act. Based on the heightened risks evident from a string of frauds that have already been revealed, it will also be important to ensure that China-based companies that are prohibited from trading on our public markets do not turn to other ways to access U.S. capital, and therefore I commend your continued vigilance as well as the SEC's work to ensure these companies provide full, fair and transparent disclosure of their risks and corporate structure.

[24] See, e.g., Andrew Ross Sorkin, *Main Street Portfolios Are Investing in Unicorns*, N.Y. Times (May 11, 2015).

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TESTIMONY

Statement of

Karen M. Sutter
Specialist in Asian Trade and Finance

Before

Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
U.S. House of Representatives

Hearing on

"Taking Stock of 'China, Inc.': Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets"

October 26, 2021

Congressional Research Service
7-5700
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Chairman Sherman, Ranking Member Huizenga, and distinguished members of the subcommittee,

Thank you for inviting the Congressional Research Service to testify today. I am Karen M. Sutter, a Specialist in Asian Trade and Finance at the Congressional Research Service. My statement provides an overview of U.S.-China financial ties, and discusses some potential economic, political, regulatory, structural, and strategic issues and some potential risks for U.S. investors. I also identify several issues for potential congressional consideration.

In particular, I would like to raise six points for your consideration today:

- One, China is selectively opening its financial markets in limited ways to certain U.S. investors. The Chinese government has recently granted licenses or expanded the terms of licenses to allow a few U.S. investment firms to expand offerings in China. These firms see potential growth opportunities in China as a large and important market. U.S. market participation, however, is still curtailed by Chinese government controls, regulations, and competition from large state banks and other state firms. U.S. financial firms may profit from their investments in China. Similarly, some U.S. investors may benefit from the opportunities to invest in companies and industries that China might otherwise restrict. These transactions do not appear to give U.S. investors control, however. As holders of passive financial investments, U.S. investors do have the ability to leverage the productive industrial or technological capabilities that may be developed with the support of U.S. capital. Moreover, the terms of these financial investments do not appear to open China's economy further to U.S. participation on reciprocal terms in a range of sectors that passive U.S. financial investment might support. China's ability to attract passive capital—in combination with its separate but related efforts to secure technology licensing—could diminish its interest or need to further open its economy to U.S. participation and competition.
- Two, the limited and targeted nature of China's financial investment openings to date appears designed in part to attract U.S. capital to areas of China's economy where the government may seek to compensate for weaknesses, such as bad assets and debt.[1] This raises questions about how increased U.S. capital flows to China could create not only growth opportunities but also greater risk exposure for U.S. investors. While there is an element of risk in all investments, the Chinese government's current actions to address building debt in its property sector— including with regard to its second largest developer, Evergrande Group—highlights some specific potential risks for U.S. investors, particularly should U.S. exposure to China's debt markets increase.
- Three, the Chinese government appears to be seeking U.S. capital to fund its strategic and emerging industries, strengthen China's capital markets, and position Chinese firms as global leaders and competitors.[2] The Chinese government is also supporting the investment in U.S. companies that have relevant technologies and operate in sectors identified in its industrial policies such as *Made in China 2025.*[3] China's financial investments in U.S. firms may contribute to the economic viability of some U.S. firms and U.S. economic growth in the short term, but many of these investments appear to be strategic in nature and could over the longer term develop competitive Chinese capabilities.

[1] See CRS In Focus IF11953, *Evergrande Group and China's Debt Challenges*, by Karen M. Sutter and Michael D. Sutherland.

[2] "2021 Investment Climate Statements: China," U.S. Department of State.

[3] See CRS In Focus IF10964, *"Made in China 2025" Industrial Policies: Issues for Congress*, by Karen M. Sutter.

- Four, the growing role of the state in China's economy and business ecosystem has increased dramatically since 2014 under China's leader Xi Jinping, intensifying the potential challenges and risks for U.S. companies and the United States more broadly.[4] The beginning of what could be a significant increase in two-way financial investment is now occurring within this context, potentially giving the Chinese government the ability to exert greater control over Chinese and U.S. companies and the Chinese and global marketplace.
- Five, the corporate structures that Chinese firms are using to expand overseas and invest in U.S. capital markets—such as the variable interest entity (VIE) structure— are complex. These structures arguably make it difficult for U.S. investors to assess potential risks.[5] While U.S. underwriters, accountants, or legal counsel may have insights into these risks, they may not share this knowledge fully with U.S. investors who ultimately bear the costs of these risks. These complex corporate structures also separate the underlying company (and its operations and assets) from U.S. investors. This potentially limits the ability of U.S. investors to exercise their rights, including the right to seek full legal recourse if necessary.
- Six, there is a lack of transparency on deals and an absence of publicly-available data on the main and growing pathways for two-way investment, which include private equity, venture capital, and private placements. U.S. and Chinese monies appear to be increasingly comingled through the use of funds that operate in both the United States and China. Without further transparency, it is difficult to assess how some financial deals may also support related agreements that are strategic and involve the transfer of technology or know-how. Transparency gaps also potentially affect the ability of the U.S. government to assess aggregate U.S. financial and economic exposure to China and potential risks.

Overview of Financial Ties

Financial ties between the United States and the People's Republic of China (PRC or China) have expanded significantly over the past few years. The PRC government has created limited openings in China's debt and equity markets, while China's firms have expanded into U.S. capital markets.[6] The Rhodium Group, a U.S.-based research group, estimates that, as of December 2020, U.S. investors held $100 billion of Chinese debt and $1.1 trillion in Chinese equities, while Chinese investors held $1.4 trillion in U.S. debt and $720 billion in U.S. equities.[7] As of August 2021, China and Hong Kong held $1.05 trillion and $219.4 billion, respectively, in U.S. Treasury securities, making China the second-largest foreign holder after Japan. These figures may understate China's actual holdings because of the government's purchases of securities through offshore financial centers (e.g., Cayman Islands).[8]

U.S. stock exchanges offer China's firms access to deep capital markets and paths to earn hard currency, build brand recognition, and expand overseas. As of May 2021, 248 Chinese firms were listed on the three

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[4] See CRS Report R46915, *China's Recent Trade Measures and Countermeasures: Issues for Congress*, by Karen M. Sutter.

[5] See CRS In Focus IF11803, *U.S. Capital Markets and China: Issues for Congress*, by Michael D. Sutherland and Karen M. Sutter.

[6] Nicholas R. Lardy and Tianlei Huang, "China's Financial Openings Accelerate," Policy Brief 20-17, Peterson Institute for International Economics, December 2020.

[7] Adam Lysenko, Mark Witzke, Thilo Hanemann, and Daniel H. Rosen, "US-China Financial Investment: Current Scope and Future Potential," Rhodium Group, January 26, 2021.

[8] See CRS In Focus IF11283, *U.S.-China Investment Ties: Overview*, by Andres B. Schwarzenberg and Karen M. Sutter.

major U.S. stock exchanges—up from 217 in December 2020—with a combined market capitalization of $2.1 trillion, according to the U.S.-China Economic and Security Review Commission.[9] Initial public offerings (IPOs) in the United States have been particularly popular with Chinese firms in emerging industries, such as electric vehicles. Chinese firms raised an estimated $15 billion in U.S. IPOs in 2020.[10]

U.S. investors also invest in Chinese firms that are listed on China's exchanges, including through investment funds and dual listings on both U.S. and PRC exchanges. Five major index fund managers include Chinese bonds and A-shares of firms listed on China's exchanges in their funds; three major funds include government debt.[11] U.S. pension funds are exposed to China's economy through these indices and direct holdings in PRC firms. Many U.S. financial investors seek China exposure with an eye to potential higher returns. These investments indirectly benefit other U.S. investors by providing ways for them to invest in China's large market and economic growth. There is growing interest in China's market since the PRC government recently approved a few U.S. financial firms, including Goldman Sachs, JP Morgan, and BlackRock, to increase their equity stakes in joint ventures with Chinese firms and to operate wholly-owned funds.[12] BlackRock is the largest money manager globally. It has $9.5 trillion under management as of July 2021, but does not publicly disclose its China assets.[13]

Available data likely understates U.S.-China bilateral financial flows, which appear to be expanding.[14] Chinese firms have many ways to invest in the United States and attract U.S. capital—such as venture capital, private equity, and private placement transactions. Financial flows through these pathways are not captured in most data sets and there is limited transparency as to specific transactions. In private equity and venture capital, monies from U.S. and Chinese sources appear to be difficult to disaggregate using public information.[15] The PRC government's use of a private equity model to channel state funds into domestic and foreign companies, projects, and investments through its use of Government Guidance Funds (GGFs) adds an additional layer of complexity in understanding and assessing potential risks in U.S.-China financial flows. In this model, China's Ministry of Finance is channeling state funds to GGFs and sub-funds. This state money is also routed through SOEs, pensions, state banks, and venture capital firms.[16]

Role of the PRC State in Business

A key aspect of potential risk in U.S. investments in Chinese companies centers on the role of the state—including the PRC government, the Communist Party of China (CPC), and the People's Liberation Army (PLA)—in China's economy and business ecosystem. This role blurs lines between China's government authorities and business operations. The Chinese state is directly involved in advancing China's national economic development and related industrial policy goals and in promoting national corporate

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[9] "Chinese Companies Listed on Major U.S. Stock Exchanges," U.S.-China Economic and Security Review Commission, May 5, 2021.

[10] Julia Fioretti and John Cheng, "Chinese Firms Are Listing in the U.S. at a Record-Breaking Pace," *Bloomberg*, April 24, 2021.

[11] A-shares represent publicly-listed PRC companies that trade on China's stock exchanges in China's currency, the renminbi.

[12] "JPMorgan Gets Beijing's Approval for First Fully Foreign-owned Brokerage," Reuters, August 6, 2021; "Goldman Sachs Moves to Full Ownership of China securities JV," *Reuters*, October 17, 2021.

[13] Dawn Lim, "BlackRock Closes In on the Once Unthinkable, $10 Trillion in Assets," *The Wall Street Journal*, July 14, 2021.

[14] Nicholas Lardy and Tianlei Huang, "Despite the Rhetoric, US-China Financial Decoupling is not Happening," *IR Magazine*, July 20, 2020.

[15] Sean O'Connor, "How Chinese Companies Facilitate Technology Transfer from the United States," Staff Research Report, U.S.-China Economic and Security Review Commission, May 6, 2019.

[16] Tianlei Huang, "Government-Guided Funds in China: Financing Vehicles for State Industrial Policy," PIIE, June 17, 2019; U.S. Chamber of Commerce, "Made in China 2025: Global Ambitions Build on Local Protections, "2017; "Four Things to Know about Chinas $670 billion Government Guidance Funds," *Caixin*, February 25, 2020.

champions, sometimes setting commercial terms and influencing corporate decision-making.[17] This overlap between government and business interests has increased since 2006, when China enacted its Medium- and Long-Term Plan in Science and Technology (2006-2020). In the context of that plan, the PRC government has reenergized the role of industrial planning and state financing to advance its goals through commercial or quasi-commercial actors.[18] Since 2006, China has given its companies a central leadership role in advancing national industrial policy and technology goals. The government has sought to maximize the benefits of market flexibilities—including greater operating agility in recruiting talent, fundraising, acquiring foreign technology, and operating offshore—while retaining certain state controls.[19]

China's government has supplemented forms of direct state ownership with hybrid forms of state control that involve channeling state funding through government guidance funds and venture capital and private equity firms.[20] The CPC has strengthened its representation and influence within firms through the establishment and reinvigoration of corporate Party committees with individual firms, changes to companies' Articles of Association, and influence through supervisory boards and trade unions that fall under state control.[21] While the number of formally declared state firms managed by the central government declined due to corporate consolidation, arguably the financial and policy influence of the Chinese state expanded into a wider array of sectors and companies through these hybrid models, particularly in strategic and advanced technology sectors.[22]

Within this context, China's government frequently distorts the commonly accepted premises and use of economic and trade policy tools by other governments to promote market competition. These distortions arise in part because of how the government applies these tools to seek particular advantages for China's industry and national champions.[23] For example, China's government is not an independent or impartial

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[17] Mark Wu, "The 'China, Inc.' Challenge to Global Trade Governance," *Harvard International Law Journal*, Vol. 57, (2016): 1001-1063.

[18] Cong Cao, Richard P. Suttmeier, and Denis Fred Simon, "China's 15-Year Science and Technology Plan," *Physics Today*, December 2006; *The National Medium- and Long-Term Program for Science and Technology Development (2006- 2020)*, State Council of the People's Republic of China, https://www.itu.int/en/ITU-D/Cybersecurity/Documents/National_Strategies_Repository/China_2006.pdf.

[19] Ibid.

[20] Barry Naughton, *The Rise of China's Industrial Policy 1978 to 2020*, Universidad Nacional Autonoma de Mexico, 2021 (See Chapters 4 and 5); Ngor Luong, Zachary Arnold, and Ben Murphy, "Understanding Chinese Government Guidance Funds: An Analysis of Chinese-Language Sources," Center for Security and Emerging Technology, March 2021; Yifei Gong, Peiyue Li, and Ziqiao Shen, "Research on Operating Efficiency of Government Industry Guidance Funds," *Theoretical Economics Letters,* February 2020.

[21] Jennifer Hughes, "China's Communist Party Writes Itself Into Company Law," R*euters*, August 14, 2017; Scott Livingston, "The Chinese Communist Party Targets the Private Sector," CSIS, October 2020; Christopher Balding and Donald Clarke, "Who Owns Huawei?;" April 19, 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3372669.

[22] "State-Owned Enterprise Policy Reform," The China Dashboard, Asia Society Policy Institute and the Rhodium Group, Winter 2020 (Note: China's National Bureau of Statistics data on SOEs does not include data for stock companies or other types of ventures that involve SOEs or are state financed or tied. See Edimon Ginting and Kaukab Naqvi, Reforms, Opportunities, and Challenges for State-Owned Enterprises," Asian Development Bank, July 2020, pp. 190-224); Karen Jinrong Liu, Xiaoyan Lu, Junsheng Zhang, and Ying Zheng, "State-Owned Enterprises in China: A Review of 40 Years of Research and Practice," *China Journal of Accounting Research,* Volume 13, Issue 1, March 2000; Lingling Wei, "China's Xi Ramps Up Control of Private Sector," *The Wall Street Journal*, December 10, 2020; Scott Livingston, "The New Challenges of Communist Corporate Governance," CSIS Brief, January 15, 2021.

[23] China's national champions are firms that have a dominant or leadership position in China's market and receive certain government support, preferences, and market protections. They are not always formally depicted as such, but in certain instances they are identified to play particular roles in China's economic and industrial policy plans. U.S. Chamber of Commerce, "Competing Interests in China's Competition Law Enforcement: China's Anti-Monopoly Law Application and the Role of Industrial Policy," August 2014.

market regulator, and has direct financial and policy interests in the market segments and companies in which it invests and favors. China uses an interplay of trade and investment protections combined with targeted market openings to incentivize the transfer of foreign technology and advanced production capabilities to China and PRC entities.[24] The PRC government enjoys informal influence in setting market conditions and terms for companies.[25] Unlike the United States, where the legal and regulatory system aims to protect individual rights, including from government interference, the regulatory and legal system in China is oriented toward protecting and advancing the interests of the state.[26] China's actions introduce new considerations for U.S. policies, laws, and regulations because the CPC has strong levers of influence among its top firms and controls the court system in China, making it difficult for U.S. companies to seek redress in China.[27]

Corporate Structures

Many Chinese firms that list on U.S. stock exchanges and operate offshore use complex structures that may obscure risks, state ties—including to the Communist Party of China (CPC), the government, and the military—and other corporate details, complicating the effectiveness of U.S. government oversight and U.S. investors' legal recourse. In many instances, the stocks and core assets of parent Chinese firms are not listed on U.S. exchanges. Like other foreign companies, some Chinese firms use American Depositary Receipts (ADRs), a structure that allows a secondary U.S. exchange listing of a foreign company.[28] The overseas parent firm's stocks are listed in the United States through a contractual arrangement that bundles the company's stock certificates. Most listings of China's large state-owned enterprises (SOEs) are ADRs. These ADRs typically include a small portion of the shares that SOEs list in China. The original China-listed shares represent a small portion of the overall firm. This structure potentially shields the parent and its assets from the exercise of shareholder rights and financial or litigation risk. The U.S. legal entity for China's SOEs may be a shell company with few assets of its own.[29]

The opacity of China's system can make it hard to secure evidence. It also can prolong litigation and impose significant costs on U.S. investors in asserting their rights. The PRC government's backing and support for Chinese firms in U.S. courts could create potential asymmetric advantages in their resources over U.S. counterparts. Even when a Chinese SOE parent company directs and controls a U.S. entity, it has proven difficult (but not impossible) to establish the relationship in legal proceedings. Since 2014, the Aviation Industry Corporation of China (AVIC), for example, has tried to deny direct ties to its U.S. affiliates and assert immunity under the Foreign Sovereign Immunities Act (P.L. 94-583) to thwart U.S.

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[24] James McGregor, "China's Drive for 'Indigenous Innovation': A Web of Industrial Policies," U.S. Chamber of Commerce and APCO Worldwide, July 2010.

[25] Jeremie Waterman and Tami Overby, "China's Approval Process for Inbound Foreign Direct Investment: Impact on Market Access, National Treatment and Transparency," U.S. Chamber of Commerce, November 11, 2012.

[26] Pittman P. Potter, "The Chinese Legal System: Continuing Commitment to the Primacy of State Power," *The China Quarterly*, February 12, 2009; Jamie P. Horsley, "Party Leadership and Rule of Law in the Xi Jinping Era: What Does an Ascendant Chinese Communist Party Mean for China's Legal Development?," The Brookings Institution, September 2019; Moritz Rudolf, "Xi Jinping Thought on the Rule of Law: New Substance in the Conflict of Systems with China," Stiftung Wissenschaft und Politik, SWP Comment, April 2021.

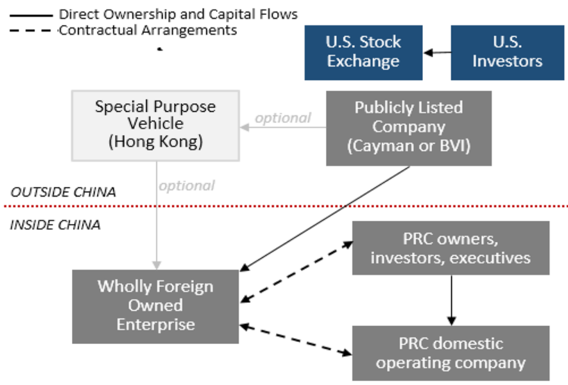
[27] See CRS In Focus IF11803, *U.S. Capital Markets and China: Issues for Congress*, by Michael D. Sutherland and Karen M. Sutter Jamie P. Horsley, "Party Leadership and Rule of Law in the Xi Jinping Era: What Does an Ascendant Chinese Communist Party Mean for China's Legal Development?," Global China Report, The Brookings Institution, September 2019.

[28] United States Securities and Exchange Commission, "Investor Bulletin: American Depository Receipts," August 2012, https://www.sec.gov/investor/alerts/adr-bulletin.pdf.

[29] Shen Hong and Yvonne Lee, "China Sees Citic Listing as Model for State-Firm Overhauls," *The Wall Street Journal*, June 2, 2014.

litigation, despite China having committed when it joined the World Trade Organization (WTO) that its state firms would operate on a commercial basis.[30]

Figure 1. Outline of the VIE Structure



Source: CRS, with information from multiple sources. Note: Example of a typical variable interest entity (VIE) structure. The specific potential flows between the U.S. Stock Exchange and U.S investors, and the VIE structure, are not shown.

CRS estimates that two-thirds of all PRC firms listed in the United States—including Alibaba, Baidu, and Tencent—use a variable interest entity (VIE) structure. While not unique to Chinese firms, many Chinese companies use a VIE structure to work around Chinese government restrictions on direct or active foreign investment in certain sectors. The structure has also been used by firms to participate and compete in otherwise restricted market segments in China.[31] A VIE structure involves the owners of a Chinese firm creating an offshore holding company in which foreign investors can purchase an equity claim. The holding company is tied to the "parent" through a series of contracts and revenue sharing agreements that mimic ownership arrangements but do not provide the same rights typically afforded to investors in U.S.-listed firms.[32] The contracts underpinning the VIE allow the PRC owner(s) to move funds across the

[30] Patrick Jenevein, testimony before the U.S. – China Economic and Security Review Commission on *Chinese Investment in the United States: Impacts and Issues for Policymakers*, January 26, 2017; "Chinese state entities argue they have 'sovereign immunity' in U.S. courts," *Reuters*, May 11, 2016, https://www.reuters.com/article/us-china-usa-companies-lawsuits-idUSKCN0Y2131.

[31] See CRS In Focus IF11803, *U.S. Capital Markets and China: Issues for Congress*, by Michael D. Sutherland and Karen M. Sutter. The term "variable interest entity" originates from the U.S. Financial Accounting Standards Board FIN46(R), which stipulates the conditions for consolidating VIEs in corporate financial statements. For more, see Financial Accounting Standards Board, "FASB Interpretation No. 46 (revised December 2003): Consolidation of Variable Interest Entities," https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true.

[32] Chinese variable interest entity (VIE) structures typically depend on five types of legal agreements: 1) a loan agreement that capitalizes the VIE; 2) an equity pledge made by the VIE owners as collateral; 3) a call option agreement allowing the WFOE to purchase the VIE at a set price; 4) a power of attorney agreement that assigns to the WFOE normal shareholder rights; and 5) a series of technical service agreements or asset licensing agreements that allow the WFOE to extract all of the residual profits of the VIE. See Paul L. Gillis, "Accounting Matters: Variable Interest Entities in China," *Forensic Asia*, September 18, 2012, https://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf.

business, while creating a firewall between the listed entity and the core assets and licenses held by the PRC owner (**Figure 1**).[33]

VIE arrangements appear to have no definitive legal standing in China, which may leave U.S. investors without recourse in China. U.S. Securities and Exchange Commission (SEC) Form 20-F disclosures by some firms acknowledge the risks of VIEs because they are incorporated offshore, conduct most operations in China, and have executives who reside outside the United States.[34] Some Chinese VIEs have reduced U.S. shareholder value, including for large corporate investors, by shifting business licenses and issuing off-the-books bonds. In 2010, for example, Alibaba reportedly failed to inform Yahoo (a 43% stake investor) about its spinoff of the online payment firm Alipay to a separate VIE, controlled by its chairman Jack Ma. Some analysts assess that the terms of the subsequent settlement were unfair to Yahoo.[35] In February 2021, global investors reportedly also had no alternative exit strategy or legal rights for an estimated $10 billion invested in an offshore shell company after the PRC government suspended Ant Financial's $34.5 billion IPO in Shanghai and Hong Kong.[36] In 2021, the PRC government enhanced controls over technology firms, including new restrictions on Alibaba, shareholding and a board seat in ByteDance, and new data security reviews for firms listing offshore.[37]

Disclosure and Accounting Issues

While most Chinese firms are required to file an SEC 20-F annual report for foreign issuers, there are exemptions on specific disclosure requirements, particularly for ADRs. The SEC relies on China's reporting and disclosure rules, which are less extensive than U.S. requirements.[38] Disclosure of shareholders and operations may present a conflict of interest for Chinese firms with government ties. China's government prohibits the Public Company Accounting Oversight Board (PCAOB)—a nonprofit entity created by Congress to oversee audits of U.S.-listed firms—from inspecting the work of auditors based in China and Hong Kong.[39] Chinese law restricts the auditors' documentation of work performed in the country from being transferred out of China. The PRC government has sometimes invoked state secrets and national security provisions to limit the ability of U.S. regulators to review financial reporting

[33] Brandon Whitehill, "Buyer Beware: Chinese Companies and the VIE Structure," *Council of Institutional Investors*, December 2017; Paul L. Gillis and Fredrik Oqvist, "Variable Interest Entities in China," *GMT Research*, March 13, 2019, https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf; Justin Hopkins, Mark Lang, and Jianxin Zhao, "The Rise of US-Listed VIEs from China: Balancing State Control and Access to Foreign Capital," *Kenan Institute of Private Enterprise Research Paper No. 19* (February 2018); and Jamie Powell, "VIEs: China's nuclear option," *The Financial Times*, October 9, 2019,

[34] See, for example, Baidu Inc., 2018 Annual Report, p. 25, http://ir.baidu.com/static-files/b22e554d-d929-4c21-92a4-d3e1fbc4da0b.

[35] Liana B. Baker, "Yahoo Gets Short End of Stick in Alibaba Deal," *Reuters*, July 29, 2011.

[36] Jing Yang and Julie Steinberg, "How a 'Surefire' Bet on Ant Group Has Trapped Global Investors," *The Wall Street Journal*, February 9, 2021.

[37] Keigh Zhang and Jing Yang, "China Targets Firms Listed Overseas After Launching Didi Probe," *The Wall Street Journal*, July 6, 2021.

[38] Securities Exchange Act of 1934, §240.12g3-2, https://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=ac604a56b88470087f66b127d7c029f0&mc=true&n=pt17.4.240&r=PART&ty=HTML#se17.4.240_112g3_62.

[39] U.S. Securities and Exchange Commission, "Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China," December 7, 2018, https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other.

of U.S.-listed, China-based companies.[40] PCAOB's inability to confirm the financial health of U.S.-listed Chinese firms may expose U.S. investors in these firms to greater risk.

In June 2020, NASDAQ delisted Chinese firm Luckin Coffee after it was found to have fabricated sales.[41] The Holding Foreign Companies Accountable Act (P.L. 116-222) requires firms to disclose state and military ties and mandates a delisting from U.S. exchanges if the PCAOB cannot inspect a firm's auditors for three consecutive years. In July 2020, the SEC issued an alert about U.S. exposure to China's financial markets.[42] In November 2020, the SEC announced disclosure considerations for China-based issuers.[43] In July 2021, the SEC enhanced scrutiny of Chinese firms, particularly VIEs, after China's restrictions on U.S.-listed firms wiped out an estimated $400 billion in value and China's ride-hailing firm DiDi Global Inc. failed to fully disclose regulatory risks before listing on the New York Stock Exchange.[44]

The ongoing financial troubles of Evergrande Group, China's second-largest property developer, have highlighted several accounting and investment practices that affect the firm's financial position and that are not necessarily unique to Evergrande.[45] U.S. auditors and underwriters have signed off on the firm's investment and accounting practices for years.[46] These practices include:

- **Counting unbuilt and unsold properties and interest payments as assets.** About 60% of the firm's assets are unbuilt and unsold properties, and the firm counts loan interest payments as assets. This inflates the firm's position and increases risks if property values fall.[47]
- **Using previously-financed deals as collateral for new loans.** This practice allowed the firm to accumulate debt and become leveraged.[48] The People's High Court of Hainan Province determined that another state-tied firm undergoing government restructuring due to debt issues, HNA Group, had affiliates that provided mutual guarantees for repayments.[49] The Swiss government in 2019 determined that HNA used similar practices to leverage and finance its global acquisitions and operations.[50]
- **Investing in unrelated sectors beyond the core business.** Some Chinese firms use insurance, trust, and wealth management businesses to earn higher returns and invest offshore. The Shenzhen government is investigating Evergrande's insurance business.[51]

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[40] Karen Yeung, "Trade war may scuttle China's interest to share 'state secret' company audit reports with U.S." *South China Morning Post*, July 5, 2019, https://www.scmp.com/economy/china-economy/article/3017457/trade-war-may-scuttle-chinas-interest-share-state-secret. For an overview of the U.S. accounting and auditing regulatory structures involved, see CRS Report R44894, *Accounting and Auditing Regulatory Structure: U.S. and International*, by Raj Gnanarajah.

[41] "Luckin Coffee Receives Delisting Notice from Nasdaq for Failure to File its Annual Report," Company Press Release, June 23, 2020.

[42] "U.S. Investors' Exposure to Domestic Chinese Issuers," Risk Spotlight, Division of Economic and Risk Analysis, Securities and Exchange Commission, July 6, 2020.

[43] "Disclosure Considerations for China-Based Issuers," CF Disclosure Guidance: Topic No. 10, Division of Corporation Finance, Securities and Exchange Commission, November 23, 2020.

[44] "Statement on Investor Protection Related to Recent Developments in China," Public Statement, SEC Chair Gary Gensler, July 30, 2021.

[45] See CRS In Focus IF11953, *Evergrande Group and China's Debt Challenges*, by Karen M. Sutter and Michael D. Sutherland.

[46] Tabby Kinder, "Evergrande Crisis Puts PwC Role in Spotlight," *Financial Times*, October 11, 2021.

[47] China Evergrande Group, Annual Report 2020.

[48] Ibid.

[49] Kenji Kawase, "Chinese Court Says Troubled HNA Group's Businesses Highly Chaotic," *Nikkei Asia*, March 16, 2021.

[50] "HNA Group Commits Serious Breach of Disclosure Obligations," Swiss Financial Market Supervisory Authority (FINMA), September 25, 2019.

[51] "China Evergrande's Wealth Management Arm Faces Local Government Inquiry," *Reuters*, September 27, 2021.

- **Use of complex offshore structures tied to the CEO**. Evergrande uses overlapping contracts and shareholding to facilitate financial flows that make it difficult to assess liabilities. The CEO and his family reportedly hold a large share of the firm's offshore debt.[52] In March 2021, a Hainan court ruled that HNA's 320 affiliates should be merged because: (1) relationships and shareholding were too confusing to disaggregate; (2) internal controls were fictitious; (3) internal credit and debit dealings were impossible to align; and (4) shell companies were used extensively.[53]

Economic Factors

U.S. concerns about China's high debt levels have intensified since September 2021, when Evergrande Group failed to repay its debt obligations.[54] Evergrande's situation highlights potential broader and longer-term risks in China's economy that Congress may consider as U.S. financial investors seek to expand investments in China. It also raises questions about the role of U.S. and other underwriters and auditors of Chinese firms and whether they sufficiently assess and disclose risks to U.S. investors.[55]

China's government appears to be seeking to reduce debt and curtail market risks among firms like Evergrande, but defaults and a decline in property values could have broader effects. The property market accounts for almost 30% of China's GDP, a higher percentage than in most countries, and thus has complicated China's efforts to reduce debt.[56] Property is a main source of local government revenue and a key factor in corporate valuations and household net worth. This constrains policy options, despite China's leader Xi Jinping's statements that support reducing debt and inequality. Declining land revenue could affect local governments' ability to repay loans and special bonds, which Nomura Holdings estimates reached almost $7 trillion in 2020 (44% of China's GDP).[57] China relies on debt-financed fixed asset investment (including property) and exports for growth, and is facing supply disruptions; energy and commodity shortages; and industrial and property overcapacity, potentially exacerbating economic risks.[58]

Evergrande owes about $305 billion in debt (2% of China's GDP). The firm is obligated to repay $124 billion this year—including $19.3 billion in bonds—but may only have 10% of this amount in cash on hand.[59] The firm is said to owe money to 171 domestic banks and 121 financial firms.[60] Off-book liabilities have not been disclosed. As China's largest issuer of high-yield dollar denominated debt, Evergrande was an attractive investment, despite known risks, because it paid coupons of 7.5% to 14 %.[61]

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[52] "In Depth: How Evergrande's Founder Played the Capital Markets," *Caixin*, September 28, 2021.

[53] Kenji Kawase, "Chinese Court Says Troubled HNA Group's Businesses Highly Chaotic," *Nikkei Asia*, March 16, 2021.

[54] Narayanan Somasundaram, "Evergrande Favors Domestic Investors as Default Looms," *Nikkei Asia*, October 19, 2021.

[55] Han Wei, "Hong Kong Regulator Probes PwC on Evergrande Audit," *Caixin*, October 19, 2021.

[56] Greg Ip, "China's Necessary but Risky Pivot from Debt," *The Wall Street Journal*, September 23, 2021.

[57] Amanda Lee, "China Debt Concerns Mounting as Beijing Shifts Attention to Hidden Local Government Financing," *South China Morning Post*, September 20, 2021.

[58] Michael Pettis, "What Does Evergrande Meltdown Mean for China?," China Financial Markets, Carnegie Endowment for International Peace, September 20, 2021.

[59] On October 21, 2021, Evergrande reportedly transferred $83.5 million to Citibank in its role as a trustee to repay investors for a September 23, 2021 coupon payment that had been due on September 23, 2021. Thomas Hale and Hudson Lockett, "Evergrande Pays Missed Dollar Bond Coupon, says Chinese State Media," *Financial Times*, October 22, 2021.

[60] "China: What is Evergrande and is it too Big to Fail," BBC News, September 29, 2021.

[61] Brian Spegele, Julie Steinberg, and Elaine Yu, "How Evergrande Grew and Grew, Despite Years of Red Flags," *The Wall Street Journal*, October 8, 2021.

China's total debt—household, corporate, and government—is estimated to have reached 290% of GDP in 2020, with the majority of debt held by companies.[62]

The PRC government so far is using a traditional toolkit to rein in risky activity, while trying to avoid market contagion and moral hazard, a tendency toward riskier behavior when someone else bears the risks. The government benefits from a closed capital account, but the size of Evergrande's exposure (including secondary exposure), could complicate this approach, weaken confidence, and raise debt levels.

- **Commercial bankruptcy is a policy choice that appears to be prompted by Chinese government actions.** Evergrande's debt crisis was triggered by government restrictions on its ability to raise new funds to pay its debt obligations, exposing its highly leveraged position. Tightened housing policies have further softened the market and weakened the position of Evergrande and other Chinese property firms.[63]
- **Restructuring assets and shareholding aims to stabilize operations and avoid a direct bailout.** The PRC government is a shareholder in Evergrande and many other firms it investigates or restructures.[64] The government typically directs state investors to acquire assets and shareholding positions to cover liabilities and reposition troubled firms, at times realigning winners and losers within China's system.[65] In 1999 and 2003, the government created large asset management companies to offload pervasive non-performing loans in the state banking sector. In 2012, the government directed firms to prop up the Shanghai Stock Exchange. The Shenzhen government has intervened to support Evergrande in the past. State investors are now investing in the firm and its subsidiaries, and are assuming some of its liabilities.[66]
- **Creditors may not be repaid equally.** It is uncertain to what extent China will allow losses on Evergrande's creditors and whether it might offer preferential repayment terms for domestic creditors.[67] Some analysts expect the PRC government to prioritize domestic retail investors, suppliers, contractors, and banks.[68] With the collapse of the Guangdong Investment Trust Corporation in 1999, the government prioritized domestic creditors.[69] Internal transactions among business units and executives, as well as unregistered

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[62] CRS review of data from the Bank of International Settlements.

[63] "Economic Watch: China's First-tier Cities Tighten Real Estate Policies," *Xinhua*, March 27, 2021.

[64] The Shenzhen government is a large shareholder in Evergrande. In 2017, Evergrande moved its real estate assets into the Hengda Real Estate firm, with plans (later deferred) to list Hengda on the Shenzhen Stock Exchange through a reverse takeover of Shenzhen Real Estate, a Shenzhen government firm. Hengda sold 25 percent of its shares to the Shenzhen government and other state investors. Evergrande is also tied to the central government. The Ministry of Finance's CITIC Group is a shareholder. In 2018, Evergrande signed a $16 billion agreement with the central government's China Academy of Science to invest in priority emerging technologies on its behalf. Evergrande has acquired electrical vehicle firms in the United States, the UK, and Sweden, and has invested in biotechnology research at Harvard University.

[65] Thomas Hale, Edward White, and Sun Yu, "Evergrande: What would China's biggest debt restructuring look like?," *Financial Times*, September 22, 2021; Yu Ning, Wang Juanjuan, and Denise Jia, "HNA Group's Final Crisis," *Caixin*, February 22, 2021.

[66] Matthew Loh, "Beijing is Working Behind the Scenes to Pull Evergrande out of Danger, Urging State-Owned Firms to Buy the Property Developer's Assets," *Business Insider*, September 29, 2021.

[67] Narayanan Somasundaram, "Evergrande Favors Domestic Investors as Default Looms," Nikkei Asia, October 19, 2021.

[68] Michael Pettis, "What Does Evergrande Meltdown Mean for China?," China Financial Markets, Carnegie Endowment for International Peace, September 20, 2021.

[69] T.K. Chang, "Ten Lessons of the GITIC Bankruptcy," *The Wall Street Journal*, January 12, 2021; Wu Jiesi, *Chinese Phoenix: The Debt Restructuring of the Guangdong Enterprises Group*, ISI Publications, 2001.

investments, may not be repaid. In the Chinese government's restructuring of HNA Group, the company is proposing to only repay $25 billion of $60 billion in obligations.[70]

Political Factors

The national security assessments of both the Trump and Biden Administrations have warned about China's trajectory and have prioritized concerns about China as a strategic competitor.[71] There is ongoing concern among some in the executive branch and Congress about the ways in which U.S. commercial and investment ties may be supporting China's industrial policies of concern and funding the development of technological capabilities of concern that also may support China's military. Concerns about the risks that China's statist economic and technology practices and the related asymmetric structure of commercial ties may pose to U.S. national interests have been building for over 15 years in the executive branch, Congress, and the U.S. business community. Moreover, passive financial investments may indirectly support China's policies to restrict its strategic and technology sectors to foreign competition because China can access U.S. capital through financial markets instead, without having to worry about U.S. control or competition. This lack of reciprocity in investment terms and China's market barriers appears to disadvantage the United States.

The U.S. government has taken some actions to restrict U.S. investments in certain firms identified as being tied to China's military, but the ecosystem of relevant activity tied to China's dual-use industrial policies is arguably broader.[72] In June 2021, the Biden Administration issued Executive Order (E.O.) 14032—which supersedes the Trump Administration's E.O. 13959. It restricts U.S. capital market investments in certain named PRC companies identified as being tied to China's military. The E.O. omitted some military-tied firms that had been previously identified by the Department of Defense and included in the November 2020 Trump Administration Executive Order.[73] Some in the U.S. financial sector had challenged the scope of E.O. 13959, including corporate nomenclature and whether listed firms are tied to their China parent.[74] Some Chinese firms challenged the earlier E.O. on due process and evidence issues and said they would launch parallel indices to retain stocks in question.[75] As of June 2020, the U.S. Department of Defense (DOD) identified 44 PRC military firms operating in the United States under reporting requirements in the FY1999 National Defense Authorization Act (NDAA) (P.L. 105-261). The new executive order and the June 2021 DOD list do not include previously-listed firms, such as China National Chemical Corporation, Xiaomi, Inc., and Advanced Micro Fabrication Equipment. DOD's list is not exhaustive and some experts view it as only a first step in identifying Chinese firms of concern.

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[70] Wang Juanjuan and Manyun Zou, "HNA Seeks to Repay Less Than Half of Debt Claims Sought Against Airline Unit," *Caixin*, September 28, 2021.

[71] "Interim National Security Strategic Guidance," Office of the White House, March 3, 2021; "National Security Strategy of the United States of America," Office of the White House, December 18, 2017.

[72] See CRS In Focus IF10964, *"Made in China 2025" Industrial Policies: Issues for Congress*, by Karen M. Sutter; CRS In Focus IF11684, *China's 14th Five-Year Plan: A First Look*, by Karen M. Sutter and Michael D. Sutherland; CRS Report R46767, *China's New Semiconductor Policies: Issues for Congress*, by Karen M. Sutter; and CRS Report R46581, *Semiconductors: U.S. Industry, Global Competition, and Federal Policy*, by Michaela D. Platzer, John F. Sargent Jr., and Karen M. Sutter.

[73] "Executive Order on Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," June 3, 2021.

[74] Seleha Mohsin and Jennifer Jacobs, "Biden Team Likely to Proceed With Trump China Investment Ban," *Bloomberg*, May 6, 2021.

[75] "Granting Plaintiffs' Motion for Preliminary Injunction; Granting Plaintiffs' Motion for Leave to File Supplemental Declaration," Xiaomi Corporation vs. Department of Defense, United States District Court for the District of Columbia, March, 12, 2021, https://www.courtlistener.com/recap/gov.uscourts.dcd.226816/gov.uscourts.dcd.226816.21.0_1.pdf.

These concerns are exacerbated by developments in China to tighten control in the name of national economic security interests. Since 2014, China's government has adopted a set of interrelated laws and measures that seek to enhance the government's control over a wide range of commercial activity, within and outside of China. These measures signal the government's growing assertiveness in advancing and aligning China's national policy tools to seek global economic, technology, and military leadership. The measures include extraterritorial reach and aim to counter policy tools and actions that the United States and other governments have applied toward China. The policies pressure U.S. and other firms to abide by China's policies and laws in ways that contravene U.S. authorities. Some of China's actions appear to be aimed at pressuring U.S. and foreign firms to work around U.S. and foreign government authorities and potentially violate U.S. and foreign laws by penalizing firms that contravene China's measures. Some provisions provide for retaliation in what appears to be an effort to codify and legitimize the PRC government's apparent propensity to use economic coercive measures to advance its economic and political objectives, often arguably in violation of global trade rules and norms.[76]

China's efforts to promote data sovereignty appear to be central to advancing its broader economic security policies. China has expanded data localization requirements and placed data under new trade authorities, such as export controls and security review requirements for Chinese firms listing or operating overseas. China's new measures enhance the government's control over foreign data (e.g., personal identifying and health information), intellectual property (IP), technology, and research that is transferred to or developed in China and may increase the potential risks to the United States of U.S. government, commercial, and academic activities in these areas. In 2021, China has passed laws on data security and personal data that appear aimed at strengthening PRC government control and curtailing U.S. extraterritorial reach over data subject to China's control. [77]

These new requirements could further limit the ability of the U.S. government to implement measures, such as SEC requirements that PRC-listed firms disclose details about their owners and subsidiaries. In July 2021, for example, China's Cybersecurity Administration reportedly undertook a security review of the China's ridesharing service Didi Chuxing Technology Co., arguably due in part to concerns that its overseas listing on the New York Stock Exchange could prompt greater public disclosure and release of the company's data as part of U.S. listing requirements [78] Some Members of Congress have asked the SEC to investigate and respond to these measures and related PRC government actions regarding particular companies listed on U.S. exchanges.[79] In July 2021, the SEC announced it would require additional disclosure by and scrutiny of PRC firms listed on U.S. exchanges, and particularly those using a VIE structure.[80]

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[76] See CRS Report R46915, *China's Recent Trade Measures and Countermeasures: Issues for Congress*, by Karen M. Sutter.

[77] Mary Lam, "PRC Legal Update: Key Takeaways from China's Two Sessions 2021," Bryan Cave Leighton Paisner, March 16, 2021; Jihong Chen, Peng Cai, Jiawei Wu, Yating Jiao, and Jiabin Sun, "New Legislative Trend of Tightening ICV Data Regulation in China," Zhong Lun Law Firm, June 1, 2021.

[78] Lingling Wei and Keith Zhai, "Chinese Regulators Suggested Didi Delay Its U.S. IPO," *The Wall Street Journal*, July 5, 2021.

[79] Kiran Stacey and James Politi, "Senators Call on U.S. Securities Regulator to Investigate Didi IPO," *The Financial Times*, July 8, 2021.

[80] "Statement on Investor Protection Related to Recent Developments in China," Public Statement by SEC Chair Gary Gensler, July 30, 2021, https://www.sec.gov/news/public-statement/gensler-2021-07-30. CRS estimates that two-thirds of all Chinese firms listed in the United States use a VIE structure. A VIE structure involves the owners of a Chinese firm creating an offshore holding company to which foreign investors can purchase an equity claim. The holding company is tied to the "parent" through a series of contracts and revenue sharing agreements that mimic ownership arrangements but do not provide the same rights typically afforded to investors in U.S.-listed firms. See CRS In Focus IF11803, *U.S. Capital Markets and China: Issues for Congress*, by Michael D. Sutherland and Karen M. Sutter.

Considerations for Congress

Many Members of Congress have raised concerns about market transparency and U.S. investor protections, and in 2020, Congress passed the Holding Foreign Companies Accountable Act (P.L. 116-222) to address its concerns about the lack of compliance by Chinese firms with the SEC's statutory audit requirements. Congress also has focused on potential risks arising from areas in which the U.S. government may lack visibility and understanding of aggregate PRC financial holdings in the United States and U.S. holdings in China. In the 116th Congress, some Members introduced legislation that would have required the Secretary of the Treasury to submit to Congress a report on the exposure of the United States to China's financial sector (S. 4629). In addition, the National Defense Authorization Act for FY 2021 (P.L. 116-283) requires the Secretary of the Treasury to conduct a study about the extent to which China's increasing global trade and investment exposes the international financial system to increased risk relating to illicit finance. Some in Congress have raised concerns that U.S. investors may be funding PRC state and military-tied firms, and broader industrial policies and activities of concern.[81] In May 2020, the U.S. government's Thrift Savings Plan board deferred implementing a decision to tie its international fund to an index that includes Chinese firms. The deferral was in response to pressure from Congress and the Trump Administration.[82] In the 2021 NDAA, Congress reauthorized and bolstered requirements for DOD to report on PRC military firms operating in the United States.

Congress also might consider the potential costs and benefits of the following options:

- Expanding U.S. government identification of Chinese firms with state and military ties and potentially expanding related restrictions.
- Examining China's role beyond U.S. stock exchange listings—such as private equity, debt financing, and private placements—to assess the costs and benefits of U.S. exposure and strategic implications. As the U.S. government increases oversight and scrutiny over Chinese firms listed on U.S. exchanges, other investment options may emerge.
- Considering due diligence and liability requirements for U.S. actors that represent Chinese firms; potentially urging the SEC to further investigate and verify the accuracy and completeness of the information provided and to issue regular alerts on China investments.
- Strengthening disclosure requirements—including for investment risk and beneficial ownership—to account for state ties, opacity in China's system, complex corporate structures, and limited legal recourse. Consider requiring that all firms, including ADRs, (1) file a 10K equivalent with full details about ownership, shareholding, and corporate ties; (2) issue quarterly reports and timely updates on major changes; and (3) provide separate unconsolidated financial statements for VIE contracts and controllers.
- Potentially requiring Chinese firms to: (1) establish a U.S. legal presence directly tied to its China parent; (2) hold ultimate beneficiaries in China legally accountable for listed firms; and (3) place a significant deposit with U.S. regulators in the event of litigation.
- Examining how Chinese firms are operating, investing, and raising funds in U.S. markets or with U.S. capital in strategic and emerging technology sectors, with a focus on those

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[81] In March 2021, Senators Marco Rubio, Mike Braun, Tom Cotton, Ben Sasse, John Kennedy, and Rick Scott introduced the American Financial Markets Integrity and Security Act. The legislation would prohibit Chinese companies that are listed on the U.S. Department of Commerce Entity List or the U.S. Department of Defense list of Communist Chinese military companies from accessing U.S. capital markets. Representative Mike Gallagher introduced companion legislation in the House of Representatives.

[82] Ana Swanson, "Federal Retirement Fund Halts Planned China Investment Under Pressure," *The New York Times*, May 13, 2020.

- that remain closed or restricted to U.S. competitors in China. Determining if there is sufficient visibility and oversight of China's activity. Working with the executive branch to set reciprocity terms and seek similar provisions with other countries to align approaches.

Congress also may consider:

- How common are Evergrande's accounting and investment practices among Chinese firms? What is the full scope of Evergrande's liabilities and potential direct and indirect exposure for U.S. and other firms?
- What do PRC government efforts to restructure Chinese firms show about the role of the state in China's companies? Are there risks of PRC government overreach or miscalculation?
- How open, transparent, and accountable are China's financial markets to U.S. investors? Do U.S. investors have the same rights in China that PRC investors have in the United States?
- What international rules may exist and how should they be reformed, strengthened, or leveraged to ensure more reciprocity, transparency and accountability in financial services?

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America's Voice for Main Street's Investors

October 26, 2021

The Honorable Brad Sherman
Chairman
Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets
U.S. House of Representatives
Washington, DC 20515

The Honorable Bill Huizenga
Ranking Member
Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets
U.S. House of Representatives
Washington, DC 20515

Re: October 26th Subcommittee Hearing Entitled "Taking Stock of China, Inc.: Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets

Dear Chairman Sherman and Ranking Member Huizenga:

For years, the American Securities Association (ASA)[1] has been advocating to remove fraudulent Chinese companies from our capital markets because of the harm they have caused America's retail investors and working families. That's why we grateful to provide this statement for the October 26th Subcommittee hearing regarding the risks U.S. investors face from Chinese companies listed in the United States.

We appreciate Congress' continued bipartisan approach to address the biggest threat facing American investors today, and we applaud the Subcommittee for holding this hearing today.

Recent Action.

The ASA is proud to have partnered with numerous members on both sides of the aisle on the *Holding Foreign Companies Accountable Act*, (HFCAA) a bill which was recently enacted into law after passing both chambers of Congress unanimously. We are eager to continue working with policymakers in a bi-partisan manner to protect the interests of American investors and the U.S. capital markets.

We welcome the recent statements and actions taken by the Securities and Exchange Commission (SEC) to halt new listings of Chinese companies in U.S. markets. These companies continue to fail to comply with our laws and fail to provide even a baseline level of disclosure regarding their risks and true ownership structure. As SEC Chairman Gary Gensler noted recently, "Whether in California, the Cayman Islands or China, all companies that seek to raise

[1] The ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This mission advances financial independence, stimulates job creation, and increases prosperity. The ASA has a geographically diverse membership of almost one hundred members that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.

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money in the deep and liquid U.S. capital markets should play by America's rules."[2] We could not agree more, and we appreciate Chairman Gensler's leadership on this critical issue.

Next Steps.

While Congress has already made great progress by passing the HFCAA, the recent losses of billions of American investor dollars in July create an urgency that requires further Congressional action.[3] We believe the current interpretation of the HFCAA will allow fraudulent Chinese companies to list on U.S. exchanges for an unacceptably long period of time and harm American investors in the process.

The ASA is also concerned about the attention – or lack thereof – that U.S. exchanges have given this issue and their apparent willingness to continue to allow Chinese companies to list in the U.S. The exchanges are self-regulatory organizations governed by the SEC with an obligation to protect the American public. Preserving a business relationship with a foreign government does not supersede that obligation.

This Committee can continue to protect investors as well as the economic and national security interests of the United States by passing Chairman Sherman's *Accelerating Holding Foreign Companies Accountable Act*. This bill, also introduced by Senator Kennedy, passed the Senate unanimously and would remove non-compliant Chinese companies from U.S. exchanges starting in 2022. In the interim period, the SEC could also recommend that U.S. stock exchanges delist every Chinese company and any index fund that includes such companies until those companies comply with U.S. financial, accounting, disclosure, and governance laws.

Additional Information.

The ASA is also pleased to provide the materials below to the Subcommittee regarding the pervasiveness of the Chinese fraud perpetrated upon our markets and potential solutions for policymakers. These materials include:

- October 2019 ASA Op Ed "Why are American Investors Funding Chinese Fraud?"[5]
- June 2020 ASA Op Ed: "Washington Must End China's Fraud on our Markets";[6]
- July 2020 ASA letter to the SEC regarding the SEC's roundtable on emerging market investment risk;[7]

[2] SEC Chair: Chinese Firms Need to Open Their Books – Wall Street Journal (opinion by Chair Gensler) September 13, 2021.
[3] https://www.wsj.com/articles/investors-rethink-china-bets-after-beijing-crackdown-triggers-stock-market-rout-11627669954
[5] https://www.americansecurities.org/post/why-are-american-investors-funding-chinese-fraud
[6] https://www.americansecurities.org/post/asa-opinion-washington-must-end-china-s-fraud-on-our-markets
[7] https://www.americansecurities.org/post/asa-sends-letter-to-sec-highlighting-risks-to-investors-from-chinese-companies

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- March 2021 testimony before the U.S.-China Economic and Security Review Commission for its hearing entitled "U.S. Investment in China's Capital Markets and Military Industrial Complex";[8] and
- May 2021 ASA comment letter to the SEC regarding implementation of the Holding Foreign Companies Accountable Act.[9]

Conclusion.

As one author put it "many in government and the private sector see political warfare waged by hostile countries against the United States as important, but not my job," we don't believe that applies to this Committee and how it has approached the China issue.[10]

We thank the members for their ongoing attention and action in this area and we stand ready to assist you in any way we can to protect America's retail investors and the integrity of our capital markets.

Sincerely,

Christopher A. Iacovella

Christopher A. Iacovella
Chief Executive Officer
American Securities Association

[8] https://www.americansecurities.org/post/asa-submits-testimony-to-u-s-china-commission
[9] https://www.americansecurities.org/post/sec-must-swiftly-implement-holding-foreign-companies-accountable-act
[10] Political Warfare : Strategies for Combating China's Plan to "win without fighting", Kerry K. Gershaneck, Marine Corps University Press, 2020. https://www.usmcu.edu/Outreach/Marine-Corps-University-Press/Expeditions-with-MCUP-digital-journal/To-Win-without-Fighting/

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TAKING STOCK OF "CHINA, INC.": EXAMINING RISKS TO INVESTORS AND THE U.S. POSED BY FOREIGN ISSUERS IN U.S. MARKETS

Before the House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets on October 26, 2021

WRITTEN TESTIMONY

BY ROBBY STEPHANY SMITH, NATIONAL SECURITY ADVISOR | SUBMITTED November 1, 2021

Coalition for a Prosperous America (CPA) thanks the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee for holding this hearing exploring the risks to American investors posed by non-vetted Chinese companies' exploitation of our free and open capital markets. CPA is a nonprofit, bipartisan organization representing the interests of 4.1 million households across the country who are engaged in domestic production through our agricultural, manufacturing and labor members.

Risks to Investors Posed by China's Manipulative Behavior, Fundraising Schemes, Lack of Disclosure and Accountability, and Gaps in U.S. Law

Variable Interest Entities (VIEs)
Unlike in the United States, the government of the People's Republic of China (PRC) restricts foreign ownership in Chinese companies in a wide array of what it deems to be "strategic" sectors. These sectors notably include many of China's most profitable technology firms and internet companies. In order to list overseas and access foreign capital, Chinese firms often use the Variable Interest Entity (VIE) structure to subvert Beijing's foreign ownership limits. While there is dissent in China regarding whether or not U.S. dollars or the Chinese renminbi are better for these sensitive industries, as of now, the dollar prevails as the currency of choice.

To raise capital, Chinese parent companies set up a shell company outside of China (often incorporated in the Cayman Islands), which mirror the value of the parent via a contract, and list on an American exchange. Unbeknownst to the vast majority of American investors, rather than owning shares of a Chinese company (Alibaba Group, for instance), they are in fact invested in a Cayman-based company with no assets or operations. Further, the legal validity of a VIE contract has not been explicitly confirmed by the Chinese government. This leaves American investors entirely devoid of legal recourse to recuperate their losses in the event of delisting or fraud and no minority shareholder rights. These shell companies in the Caymans, and other offshore locations, enjoy foreign issuer status and yet are not subject to the U.S. securities laws that would provide material risk information and protection to American investors.

Recently, Securities and Exchange (SEC) Chairman Gary Gensler discussed this issue and outlined steps the SEC is taking to protect American investors. These steps include pausing IPO approvals for Chinese companies; asking SEC staff to enforce higher disclosure standards for listed Chinese companies (only) to make information more readily available to American

investors, including political and regulatory risk posed by the CCP and warnings on what the government of China could do to significantly change the rules in the middle of the game.

Americans must not be complicit in funding Chinese companies engaged in industries or activities that undermine American values, economic, and national security interests. Congress should take action to protect American investors from the risks associated with scandalously deceptive VIEs and their questionable legal status, beginning with informing American investors of whether their money is, in fact, invested in Chinese shell corporations domiciled in the Cayman Islands with no real equity ownership rights or investor protections whatsoever. This dubious financial structure should be terminated, as it is "unreformable".

A-shares, Indices, and ETFs

Over the last nearly two decades, basic investor protection measures required by law in the U.S. for inspecting the audits of public companies have been evaded by U.S.-listed and traded Chinese companies. The Chinese government is the only foreign government which does not comply with the required third-party financial audits of companies listed in the United States and has sought special waivers for non-compliance with U.S. law.

Last year, the *Holding Foreign Companies Accountable Act* (HFCAA) was signed into law, and the SEC is now working with the Public Company Accounting Oversight Board (PCAOB) to implement the law to bring Chinese companies into compliance with U.S. securities laws. This is welcome progress, but the new law only covers Chinese companies listed on a U.S. exchange, or N-shares.

The HFCAA neglects to address A-shares (securities listed on mainland Chinese exchanges and only accessible to American and foreign investors via inclusion in indices and associated index funds) and H-shares (Hong-Kong listed shares). For example, there are over 4,200 such A-share companies in American passive investment products that have basically never seen the regulatory light of day and little, if any, diligence. The vast majority of American investors are unaware that their Exchange-Traded Funds or mutual fund portfolios includes exposure to China A-share companies that are not compliant with U.S. securities laws and, in some cases, have been sanctioned by the U.S. for egregious human rights and national security abuses.

The scope of the HFCAA is limited to approximately 260 U.S. -listed N-shares, and approximately 900 securities traded on the over the counter (OTC) market but neglects to include the A-shares present in indices and Exchange-Traded Funds (ETFs) tracking them, which, as mentioned earlier, leaves over 4,200 Chinese companies not covered by the same laws that protect American investors and are required of U.S. companies. Put another way, HFCAA only covers about 22 percent of the problem, if we consider the problem to be Chinese companies not covered by American securities law, leaving 78 percent of the problem yet unresolved. Exposure to these indices through ETFs amounts to hundreds of billions of dollars or more in U.S. investment.

Congress must therefore pass a similar act like HFCAA to address the glaring problem facing U.S. investors.

Risks to Investors Posed by Lack of Disclosure and Accountability of Chinese Companies

Disclosures

Many criteria are considered to be required material information to investors, but often this information neglects to include important and financially significant information on key risk factors such as political or national security risk posed by the location or type of investment being made. In order to protect American investors from unknowingly investing in Chinese corporate bad actors – including enablers of genocide and other gross human rights violations, the Chinese Communist Party (CCP), Chinese military companies, the Chinese civilian-military fusion operations, the Chinese surveillance technology regime, and the list goes on.

The Committee should work closely with the SEC to promulgate rules that require greater disclosures of national security, human rights and political information that is material to investor protection, as well as reassess the definitional standard of a foreign issuer to ensure that the highest degree of scrutiny and protection is brought to bear against companies that pose a heightened risk to American investors.

ESG Standards

As the SEC pursues implementation of new rules and definitions regarding environmental, social, and governance (ESG) standards, it is paramount that an approach be taken to include national security, human rights and political factors into the analysis of both social and governance factors when providing information to American investors and investment managers.

This would include such information as a company's status as being a sanctioned entity by the U.S., ties or connectivity to forced labor, linkages to state-owned enterprises and dubious foreign governments, genocide or other gross human rights violations, support for foreign militaries or the military industrial / civilian-military fusion operation of a foreign government (notably those considered to be an adversary of or non-allied with the U.S.), and connection to surveillance technology companies and those in the technology sector that have linkages to international espionage or the construction of a" surveillance state".

Chinese solar companies are an excellent example whereby a company could have a false positive rating under ESG for its efforts on renewables. But the company in question has direct links to forced labor and using dirty-coal fire power plants to manufacture its product. This real-world example should serve as a template for how companies should receive a negative rating in ESG. ESG must be inclusive of forced labor, and related U.S. government sanctionable activities.

It is highly troubling that of the at least 440 Chinese companies on the Commerce Department's Entity List, only 4 of them –less than 1% - are on the Treasury Department's Office of Foreign Assets Control (OFAC) list of sanctioned companies, thereby imposing an investment ban via capital markets sanctions per Executive Order 14032 and the establishment of the Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List). This means that companies that are sanctioned by our government and denied access to U.S. technology, components, equipment, and other services are still allowed to raise large sums of capital from unsuspecting American retail investors and enjoy all of the global prestige of being listed or

traded on the world's deepest and most voluminous markets. This is a scandalous double-standard that must be reconciled immediately. Simple improvements to ESG standards and sharing information with investors such as U.S. sanctions status would greatly enhance investor protection and improve the efficacy and quality of what is ESG.

Risks to Investors Posed by the Gaps and Inconsistencies in Imposition of U.S. Sanctions

The Global Magnitsky Human Rights Accountability Act

The U.S. has a robust sanctions arsenal, including the individual and targeted sanctions of the *Global Magnitsky Human Rights Accountability Act* that freeze assets or block property, eliminate access to visas, and imposes other punitive measures for criminal activity. However, this law has untapped potential when it comes to punishing bad actor companies and protecting American investors. While companies affiliated with sanctioned individuals have been listed in previous executive orders implementing the *Global Magnitsky Human Rights Accountability Act* sanctions (the first in 2017), companies are not formally targeted by this law. And until the capital markets sanctions imposed by Executive Orders 13959, 13974, and now 14032, U.S. sanctions did not focus on purely financial and capital markets activities of bad actor corporations – instead, they primarily targeted the individual. While targeting individuals is meritorious, there is room for greater Congressional and Executive action to enhance the *Global Magnitsky Human Rights Accountability Act,* or establish new laws covering corporate bad actors and capital markets activities. Congress must clarify its intentions, or pass new laws, that create a requirement that the State Department, in consultation with Treasury, report semi-annually on the presence of PRC-incorporated companies in U.S. capital markets (including in passive investment funds and products), and their ties to activities that violates internationally recognized human rights or represent a national security risk to the U.S. The resulting list of companies must then be placed on the capital markets sanctions NS-CMIC List. Chinese corporate human rights abusers, for example, or companies engaged in militarizing illegal man-made islands in the South China Sea, should not be permitted to attract funds, often in the billions of dollars, from unwitting American retail investors. It is that simple.

Capital Markets Sanctions and the Office of Foreign Assets Control

Since June 3, 2021 — the date that President Biden issued Executive Order (EO) 14032 — not one Chinese company has been added to the OFAC Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List). There are hundreds of companies, some of which are already sanctioned in some fashion by the U.S., that are well past due in being added to this list. It should be obvious by now that American retail investors, numbering over 100 million, should not be – and generally do not wish to be – holding in their Exchange-Traded Funds (ETFs) and other passive investment products, the equities and debt of Chinese companies that can be proved to be associated with, or tied to, the genocide underway against the Uyghurs and other religious minorities in Xinjiang; trafficking in slave labor; equipping concentration camps; manufacturing advanced Chinese weapons systems designed for use against American forces; and several other malevolent activities which undermine America's national security and fundamental values.

If Treasury will not take immediate action on its own, then this Committee must put forward legislation to adequately protect American investors and, for example, prohibit investment in

companies on the Commerce Department's Entity List. Moreover, according to EO 14032, Chinese surveillance technology "used to facilitate repression" is deemed a "national emergency," while Chinese corporate use of forced labor gets a free pass in our capital markets? A case in point are the Chinese solar companies which are raising large-scale funds from unsuspecting American retail investors to be used to further savage our domestic renewable energy industry. Congress must pass legislation to permanently establish the use of capital markets sanctions and broaden the language of EO 14032 to include forced labor and other Chinese corporate human rights abuses and harmonize the Commerce Department's Entity List and the OFAC NS-CMIC List in such a way that all companies sanctioned on one list are covered by the other.

Congress has made clear in an overwhelming bipartisan fashion that it believes China must be held accountable for its genocide and other egregious human rights abuses as well as corporate national security threats. One step in that process includes protecting retail American investors, including state public employee retirement systems, from investing in companies that undermine our security and values. Moreover, publicly traded subsidiaries of companies already on the NS-CMIC List that serve as the parent companies' funding vehicles on U.S. exchanges should have been added to the NS-CMIC List months ago. One example of this includes Aviation Industry Corporation of China (AVIC) that is listed as a Chinese Military-Industrial Company (CMIC) per the Treasury Department but has several publicly traded subsidiaries, including for instance AviChina Industry & Technology (2357.HK), which continues to attract American investment in the MSCI ACWI and Emerging Markets indexes, and is held by the New York State Teacher's Retirement System (NYSTRS) as of September 30, 2021. Congress must bolster the list and require the inclusion of subsidiaries and parent companies where clear financial linkages and ownership stakes exist.

Lastly, Chinese enterprises that are reported by our Department of Defense to be Chinese Military Companies (CMCs) must also be subject to capital markets sanctions and placed on the OFAC NS-CMIC List immediately. Specifically, legislation should be introduced to strengthen action already taken in last year's National Defense Authorization Act (NDAA) to place all companies listed on the DOD 1260H Chinese Military Companies Report list on the NS-CMIC List administered by the Treasury Department.

Appendix A:
Letter to Secretary of the Treasury Janet Yellen, October 19, 2021:

October 19, 2021

The Honorable Janet L. Yellen
Secretary of the Treasury
1500 Pennsylvania Ave. NW
Washington, DC 20220

Dear Secretary Yellen,

We are writing to bring to your and your Deputy's attention the very troubling fact that since June 3, 2021 — the date that President Biden issued Executive Order (EO) 14032 — not one Chinese company has been added to the OFAC Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List).

This is nothing short of astounding, as there have been many Chinese companies – a number of them already sanctioned by the U.S. via being placed on the Commerce Department's Entity List or other designations – which have committed, or enabled, egregious human rights and national security abuses and urgently warrant being added to the NS-CMIC List.

It should be obvious by now that American retail investors, numbering over 100 million, should not be – and generally do not wish to be – holding in their Exchange-Traded Funds (ETFs) and other passive investment products, the equities and debt of Chinese companies that can be proved to be associated with, or tied to, the genocide underway against the Uyghurs and other religious minorities in Xinjiang; internationally-recognized human rights violations throughout China; trafficking in slave labor; equipping concentration camps; manufacturing advanced Chinese weapons systems designed for use against American forces; militarizing illegally-claimed islands in the South China Sea; and several other malevolent activities which undermine America's national security and fundamental values.

Take the case of the five Chinese polysilicon companies that were added to the Entity List on June 24, 2021, for engaging in forced labor against Muslims in Xinjiang. Two of the five – Hoshine Silicon Industry (Shanshan) Co., Ltd. (SHA:603260) and Xinjiang Daqo New Energy Co., Ltd. (SHA:688203 – are traded on U.S. exchanges via passive investment products. In the case of the latter, its parent company, Daqo New Energy Corp. (NYSE:DQ), is listed directly on the New York Stock Exchange. A third, Xinjiang GCL New Energy Material Technology Co., Ltd., is a subsidiary of publicly traded GCL Energy Technology Co., Ltd.

These Chinese companies were placed on the Entity List for trafficking in slave labor, and hence are, in effect, denied access to American equipment, technology, components and services. How can it then be judged as acceptable by the Treasury Department to have these same companies funded by unwitting American investors and imbued with the marketable prestige of being traded in the world's deepest and most voluminous capital markets?

Moreover, why is it that, according to EO 14032, Chinese surveillance technology "used to facilitate repression" is deemed a "national emergency," while Chinese corporate use of forced labor gets a free pass in our capital markets? This is even more troubling in the case of Chinese solar companies which are raising large-scale funds from unwitting American retail investors to be used to further savage our domestic renewable energy industry.

Indeed, of the 440 Chinese companies (including those Hong Kong-based) on the Entity List, only 4 also appear on the NS-CMIC List. That represents less than 1%. This is simply unconscionable. If the reasons for this scandalous disparity include such excuses as "forced labor" not being covered by EO 14032, then this Executive Order needs to be broadened forthwith to include it and other Chinese corporate human rights abusers.

Congress has made clear in overwhelming bipartisan fashion that it believes China must be held accountable for its genocide, egregious human rights abuses, and use of forced labor. Democrats and Republicans alike will surely be concerned and demand corrective action by the Treasury Department once these and other facts are placed before them — as they surely will be — not to mention retail American investors, including state public employee retirement systems. After all, it is *their money* that is being subject to epic fiduciary malfeasance.

Moreover, verifiable subsidiaries of companies already on the NS-CMIC List that serve as the parent companies' funding vehicles on U.S. exchanges should have been added to the NS-CMIC List months ago. The Administration has claimed that the NS-CMIC List is dynamic and designed to "live and breathe." If so, the Administration needs to change course and strengthen the List's vital signs that are rapidly fading.

With regard to capital markets sanctions, we urge you to implement the following measures:

- Place all companies listed on the DOD 1260H Chinese Military Companies Report list on the NS-CMIC List.
- Place all companies on the Department of Commerce's Entity List onto the NS-CMIC List, and vice versa.
- Add more companies to the NS-CMIC List pursuant to the surveillance technology and broader human rights requirements, including forced labor.
- Expand and clarify the language of the EO to include covering subsidiaries of parent companies which are raising funds for the parent company and/or participating in the odious activities that justified the parent company being sanctioned.

In addition to numerous new Chinese military and surveillance companies being placed on the NS-CMIC list, as well as the inclusion of Entity List companies, we urge that you also

coordinate with the SEC immediately with the intention of: 1) instituting new disclosure requirements for the thousands of Chinese A-share companies (a significant number of which are U.S.-sanctioned), drawn directly from Chinese domestic exchanges and placed into American passive investment products (notably ETFs), that are held by scores of millions of unknowing U.S. investors; 2) demanding similar disclosure requirements for the hundreds of Chinese companies traded on the Over-the-Counter market; and 3) eliminating altogether the unreformable, scandalously deceptive Variable Interest Entities served up to American investors by Chinese shell corporations domiciled in the Cayman Islands and perhaps elsewhere, with no real equity ownership rights or investor protections whatsoever.

Madame Secretary, the protection of American retail investors, our national security, and the fundamental values of our nation are all at stake here. We understand the pressures you and your team face from Wall Street. However, the Treasury Department cannot put the profits and well-being of Wall Street and the Chinese Communist Party above America's national security and economic interests. Capital markets sanctions are arguably the most fearsome and effective non-military deterrent and penalty vis a vis the Chinese Communist Party ever devised by our country.

We can no longer watch in good conscience as this exceptionally powerful policy tool languishes under your stewardship. The hard-earned retirement and investment dollars of a large percentage of the American people are unwittingly underwriting genocide-enablers and other Chinese corporate human rights and national security abusers aiding the Chinese Communist Party. This is an empirically provable fact happening on your watch. You must take action to put an end to this now.

Please let us know your thoughts and action plan concerning these urgent matters at your earliest convenience.

Sincerely,

Coalition for a Prosperous America
Fight for Freedom. Stand with Hong Kong.
Hong Kong Watch
Victims of Communism Memorial Foundation

Cc: The Honorable Antony Blinken, Secretary of State
The Honorable Lloyd Austin, Secretary of Defense
The Honorable Gina Raimondo, Secretary of Commerce
The Honorable Marty Walsh, Secretary of Labor
The Honorable Katherine Tai, U.S. Trade Representative
The Honorable Avril Haines, Director of National Intelligence
The Honorable Jake Sullivan, National Security Advisor
The Honorable Brian Deese, Director of the National Economic Council The Honorable Jerome Powell, Chairman of the Federal Reserve
The Honorable Gary Gensler, Chairman of the Securities and Exchange Commission

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Statement for the Record

ON: "Taking Stock of China, Inc.: Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets"

TO: U.S. House of Representatives Committee on Financial Services

BY:

Tom Quaadman

Executive Vice President

Center for Capital Markets Competitiveness (CCMC)

U.S. Chamber of Commerce

DATE: November 2, 2021

Importance of Transparency to U.S. Capital Markets

The U.S. Chamber of Commerce is committed to maintaining the U.S. capital markets' reputation as the deepest, most competitive, and most transparent in the world. Investors that deploy their capital in the U.S. equity markets know they can rely on the financial statements and disclosures demanded by our regulatory system to make informed investment decisions.

Investors' experience with the U.S. capital markets demonstrates how strong institutions, the rule of law, and transparency can transform economies and help create opportunities and sustainable wealth for households. This contrasts with the market systems of other countries – including China – that lack these characteristics. Given the ever-increasing competition for global capital, the U.S. must not deviate from the open and transparent system that has long made it the most attractive market for investors. For instance, the United States has actively engaged with international bodies, such as the Financial Stability Board (FSB) and International Organization of Securities Commissions (IOSCO) to promote capital markets systems based upon transparency and the rule of law – an approach that has not been embraced by all major markets.

In the past, when the regulatory system has needed to be enhanced, Congress has established new laws and tools for regulators to restore confidence in the reliability of financial disclosures and other disclosures. The enactment of the 2002 Sarbanes-Oxley Act mandated minimum standards for public company internal financial controls and created the Public Company Accounting Oversight Board ("PCAOB") to inspect the accounting firms that audit public companies. Enactment of the Sarbanes-Oxley Act was a national response to the high-profile accounting scandals of the 21st Century that shook investor confidence in our capital markets.

The Chamber has long believed that strong internal controls are essential for a business to grow from small to large, and that external audits are critical for both investor protection and capital formation. Since 2002, U.S. public companies and auditors have had to comply with provisions of the Sarbanes-Oxley Act, which is now recognized as a core characteristic of U.S. capital markets; so much so that Sarbanes-Oxley has since become a model for reforms in other countries around the world.

The independent PCAOB plays a crucial function in protecting investors in the U.S. marketplace, and the participation of U.S.-listed firms has helped to mitigate risk for investors. Relatedly, companies that have refused to allow the PCAOB to inspect the audit work related to U.S.-listed firms have generated a string of high-profile accounting scandals and have created enormous risks for U.S.-based investors.

As a result, Congress enacted reasonable and necessary legislation, the Holding Foreign Companies Accountable Act (HFCAA), on an overwhelmingly bipartisan basis. The HFCAA is an important initiative to protect investors and maintain confidence in the U.S. capital markets. We applaud Congress for taking this action and for establishing a pragmatic timeline for de-listing companies who do not comply with PCAOB inspections. We also appreciate recent actions by the Securities and Exchange Commission (SEC) to pause new offerings from Chinese

companies in the U.S. until these companies provide sufficient disclosures as to their risk and corporate structure.

We encourage companies who wish to trade in U.S. capital markets to abide by U.S. law; Congress must maintain its position that companies which refuse to abide by U.S. law should not be listed on U.S. equity exchanges. Further, the SEC should continue to alert and educate investors as to the unique risks posed by U.S.-listed Chinese companies and to update Congress regarding implementation of the HFCAA and any de-listings of Chinese or other foreign-based issuers.

In addition, the integrity, capability, and credibility of the PCAOB are integral to audit quality and investor confidence in financial disclosures and the U.S. capital markets. For this very purpose, the SEC and Congress must avoid weakening or politicizing the PCAOB's mission. It is critical that the PCAOB have both the capability and credibility in the eyes of the public to help address the China audit issue and maintain investor confidence in our markets and in the financial statements provided by listed companies. The Chamber is alarmed by recent developments that have undermined SEC oversight of the PCAOB and impaired the PCAOB's ability to carry out its mission. We are also concerned by attempts to politicize the PCAOB and involve the board in hot-button social and political issues that are currently being debated in Congress.

We echo the concerns raised by SEC Commissioners Elad Roisman and Hester Peirce who stated that in removing all five PCAOB board members, the Commission "proceeded in an unprecedented manner that is unmoored from any practical standard that could be meaningfully applied in the future…These actions set a troubling precedent for the Commission's ongoing oversight of the PCAOB and for the appointment process, including with respect to attracting well-qualified people who want to serve. A future in which PCAOB members are replaced with every change in administration would run counter to the Sarbanes Oxley Act's establishment of staggered terms for Board members, inject instability at the PCAOB, and undermine the PCAOB's important mission by suggesting that it is subject to the vicissitudes of politics."[1]

Congress and the SEC should reject these efforts and instead ensure entities such as the PCAOB and FASB are focused on carrying out their mission and are not influenced by partisan politics. The HFCAA is a great opportunity for the United States to show China and the world that the regulation of our capital markets is always guided by the rule of law and what is in the best interests of investors. Subjecting the PCAOB or other regulatory bodies to the daily whims of politics and the demands of a vocal minority of activists undermines these efforts and will cause damage to investor confidence in our markets.

Finally, while the Chamber strongly condemns human rights abuses, including the persecution and detention of the Uyghur ethnic minority in China, we have concerns about using U.S. securities laws to achieve these ends. We urge Congress and the Administration to deploy targeted foreign policy tools and to work with the business community to combat human rights abuses. For this reason, the Chamber believes that H.R. 2072, the Uyghur Forced Labor

[1] Statement on the Commission's Actions Regarding the PCAOB (June 4, 2021)

Disclosure Act, would, as currently conceived, prove ineffective and may hinder efforts to prevent human rights abuses.

Past attempts to utilize domestic U.S. securities law to combat human rights abuses provide a cautionary tale. For example, a well-intentioned effort to resolve abuses related to the mining of conflict minerals in the Democratic Republic of Congo (DRC) in many cases worsened the situation on the ground in that country.[2,3] In that instance, Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required public companies to disclose: whether any of their products used a defined list of minerals; whether the minerals were mined in the DRC; and if the products were conflict mineral-free. The absence of a qualitied inspection and audit systems made it nearly impossible for companies to ensure accurate disclosures. This, in turn, caused many companies to implement a de facto embargo against material sourced in the region, which then hurt legitimate miners. At the same time, the original targets of the provision simply shifted their activities to avoid being impacted. In addition to the measure's unintended consequences, aspects of the conflict minerals disclosure were ultimately struck down by the courts. The Chamber looks forward to working with Congress and the administration to ensure that workable, appropriate actions and initiatives are implemented to aid the Uyghurs.

We thank you for holding this hearing. We look forward to continuing our discussion on these important issues.

Sincerely,

Tom Quaadman

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[2] David Aronson, How Congress Devastated Congo, The New York Times (Aug. 7, 2011), http://www.nytimes.com/2011/08/08/opinion/how-congress-devastated-congo.html

[3] Sudarsan Raghavan, How a well-intentioned U.S. law left Congolese miners jobless, Washington Post (Nov. 30, 2014), https://www.washingtonpost.com/world/africa/how-a-well-intentioned-us-law-left-congolese-miners-jobless/2014/11/30/14b5924e-69d3-11e4-9fb4-a622dae742a2_story.html

COMMITTEE ON CAPITAL MARKETS REGULATION

ASSESSING THE FUTURE OF U.S. LISTINGS BY CHINESE COMPANIES: A CALL FOR STRUCTURED DIALOGUE

OCTOBER 2021

COMMITTEE ON CAPITAL MARKETS REGULATION

The Committee on Capital Markets Regulation (the "Committee") is an independent 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations. The Committee's membership includes thirty-eight leaders drawn from the finance, business, law, accounting, and academic communities. The Committee Co-Chairs are R. Glenn Hubbard, Dean Emeritus of Columbia Business School, and John L. Thornton, Former Chairman of the Brookings Institution. The Committee's President is Hal S. Scott, Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems. Founded in 2006, the Committee undertook its first major report at the request of the incoming U.S. Secretary of the Treasury, Henry M. Paulson. Over ten years later, the Committee's research continues to provide policymakers with an empirical and non-partisan foundation for public policy. The Committee thanks its research staff, including John Gulliver, Executive Director, Jonathan Ondrejko, Senior Research Fellow, and Sam Holt, Financial Data Analyst, for their role in the preparation of this report.

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Assessing the Future of U.S. Listings by Chinese Companies

Call for a Structured U.S.-China Dialogue

COMMITTEE ON CAPITAL MARKETS REGULATION

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Executive Summary

The Committee on Capital Markets Regulation (the "**Committee**") is concerned with the potential impact on U.S. capital markets from recent policy developments in China and the United States indicating that Chinese companies may halt future listings on U.S. stock exchanges and that Chinese companies presently listed on U.S. stock exchanges may be delisted or will voluntarily delist in the near future.

The withdrawal of Chinese companies from U.S. stock exchanges would be a significant blow to the United States as an international financial center and could threaten the U.S. stock market's role as the world's deepest and most attractive capital market. The purpose of this report is to provide an overview of recent policy developments affecting U.S.-listed Chinese companies and call for a structured dialogue between U.S. and Chinese policymakers with the goal of avoiding a costly decoupling of Chinese companies from U.S. capital markets.

In **Part I** of this report, we describe the role of Chinese companies in U.S. capital markets. As of October 15, 2021, there were 247 Chinese companies listed in the United States with a total market capitalization of $1.6 trillion spanning a diverse range of business sectors. We then describe the unique legal structure—the variable interest entity ("**VIE**")—employed by the majority of Chinese companies listed in the United States.

In **Part II**, we review the four policy issues that threaten Chinese companies' ability to list or remain listed in the United States. First, we describe the Holding Foreign Companies Accountable Act (the "**HFCAA**") that requires the Securities and Exchange Commission (the "**SEC**") to delist Chinese companies from U.S. exchanges as soon as 2024 if Chinese officials continue to prevent U.S. regulators from reviewing the audits of U.S.-listed Chinese companies. Second, we describe U.S. Executive Orders issued by President Trump in 2020 and President Biden in 2021 banning trading by U.S. investors in firms with links to the Chinese military, including four large companies that have subsequently delisted from U.S. exchanges. And third, we review actions by Chinese regulators requiring that the Cyberspace Administration of China pre-approve foreign listings for certain Chinese companies. Finally, we examine recent indications that U.S. and Chinese regulators could restrict the ongoing use of the VIE structure.

In **Part III**, we briefly consider the market reaction to these policy developments. We find that the market valuation of U.S.-listed Chinese companies has fallen sharply suggesting that recent policy developments are materially harming U.S.-listed Chinese companies and their investors. We also note that the majority of Chinese companies listed in the United States by market capitalization have recently cross-listed in other jurisdictions to preserve their access to global pools of investment capital outside of China.

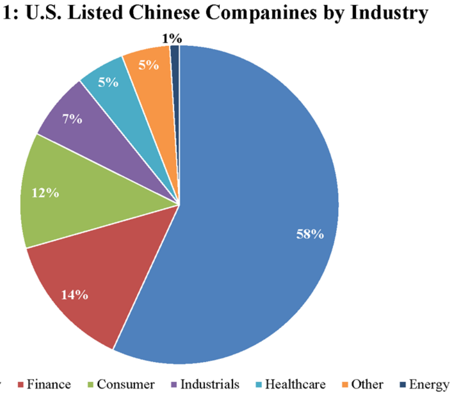
We recommend that U.S. and Chinese authorities form a high-level working group with participants from both sides, including the SEC and China Securities Regulatory Commission ("**CSRC**"), to systematically evaluate the full range of issues together and make joint recommendations for resolution. The goal should be to avoid a large-scale delisting of Chinese companies from U.S. stock exchanges that could lead to further restrictions on cross-border investment that would harm issuers and investors in both countries.

Part I. U.S. Listings by Chinese Companies

U.S. listings by Chinese companies are a relatively recent phenomenon: website operator China.com Corp began the trend when it went public on the Nasdaq in 1999 during the dotcom bubble, raising $84 million.[1] Since then, U.S. listings by Chinese companies have increased steadily over time. Over the past ten years, public offerings in the United States by Chinese companies raised $78 billion,[2] representing 8.4% of the capital raised by U.S. IPOs.[3]

As of October 15, 2021, there were 247 Chinese companies listed on U.S. stock exchanges with a total market capitalization of $1.6 trillion, representing approximately 4% of all U.S.-listed equities.[4] Chinese companies listed on U.S. exchanges include private-sector companies and state-owned enterprises ("**SOEs**") and represent a diverse range of sectors, including: technology, finance, consumer services, industrials and health care, among others. However, as demonstrated by **Figure 1**, technology companies such as Alibaba and JD.com constitute 58% of U.S.-listings by Chinese companies based on market capitalization.

Figure 1: U.S. Listed Chinese Companines by Industry



Source: Capital IQ data as of June 2021.

[1] Richard Frost and Sophia Horta e Costa, *China Signals End to $2 Trillion U.S. Listings Juggernaut*, BLOOMBERG (Jul. 19, 2021), https://www.bloomberg.com/news/articles/2021-07-18/china-signals-end-to-2-trillion-u-s-stock-listing-juggernaut. *See also* LOS ANGELES TIMES, *Price Raised for China.com IPO* (July 13, 1999), https://www.latimes.com/archives/la-xpm-1999-jul-13-fi-55411-story.html.

[2] Bloomberg data accessed July 20, 2021. Data restricted to IPOs (including SPACs) priced between January 1, 2011 and July 19, 2021 on U.S. exchanges that issued: ADRs; common stock; class A, B, or C shares; or units.

[3] *Ibid.*

[4] Bloomberg data accessed on October 18, 2021. "U.S.-listed Chinese company" is defined as a company domiciled in China listed on the NASDAQ, New York Stock Exchange, or NYSE American. *See also* U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION, *Research*: *Chinese Companies Listed on Major U.S. Stock Exchanges* (May 13, 2021), https://www.uscc.gov/research/chinese-companies-listed-major-us-stock-exchanges. Figures include: i) companies identified as based in China, ii) companies listing a Chinese address as their principal executive offices in SEC filings, and iii) companies with the majority of operations in China, including those structured offshore.

Variable Interest Entity Structure

More than 80% of Chinese companies listed on U.S. stock exchanges use a variable interest entity ("**VIE**") structure.[5] The VIE structure emerged in response to Chinese government restrictions on the foreign ownership of businesses that operate in certain sectors,[6] such as the internet and education sectors.[7] Major exceptions to the VIE structure include the eight SOEs listed on U.S. exchanges, including PetroChina and China Life Insurance Company.[8] The SOEs listed on U.S. exchanges were more readily able to obtain the regulatory and government permissions for raising foreign capital and therefore were not required to adopt a VIE structure. Instead, these large SOEs are listed in the United States in the same manner as other non-U.S. non-Chinese firms. They issued shares in their home stock market to a U.S. depositary institution, which in turn issued American Depository Receipts ("**ADRs**") on U.S. stock exchanges that are available to U.S. investors.[9]

As demonstrated on the next page by **Figure 2**, under the VIE structure, a Chinese business is separated into two parts: the parts of the business that are open to non-Chinese ownership (e.g., U.S. investors) are put into a foreign owned enterprise ("**FOE**") which is owned by an overseas parent entity ("**ParentCo**"). The ParentCo is usually incorporated in a tax-efficient jurisdiction like the Cayman Islands or the British Virgin Islands, and it lists in the United States using the ADR structure whereby U.S. depositary institutions purchase shares in the ParentCo and issue ADRs representing these shares to U.S. investors that are available to trade on U.S. exchanges. The parts of the business that are *not* available to foreign ownership (i.e., only available to Chinese investors) are in a separate Chinese company—the "**VIE**"—which enters into an equity-collateralized debt relationship with the FOE in order to transfer profits to the FOE. The obligation for the transfer is usually provided by a services agreement which establishes the FOE as the

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[5] Jing Yang, *U.S. and Chinese Regulators Are in a Bind Over a Three-Letter Acronym*, WALL STREET JOURNAL (Sept. 30, 2021), https://www.wsj.com/articles/u-s-and-chinese-regulators-are-in-a-bind-over-a-three-letter-acronym-11632999033?st=bklnjwbs6qmpi9h&reflink=article_email_share.

[6] Paul Gillis, *Variable Interest Entities in China*, GMT RESEARCH, 1-2 (Mar.13, 2019), https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf; Brandon Whitehill, *Buyer Beware: Chines Companies and the VIE Structure*, COUNCIL OF INSTITUTIONAL INVESTORS (Dec. 2017), https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf. *See also* JONES DAY, *China Further Opens its Market with New "Foreign Investment Law"* (Feb. 2020), https://www.jonesday.com/en/insights/2020/02/chinas-new-foreign-investment-law.

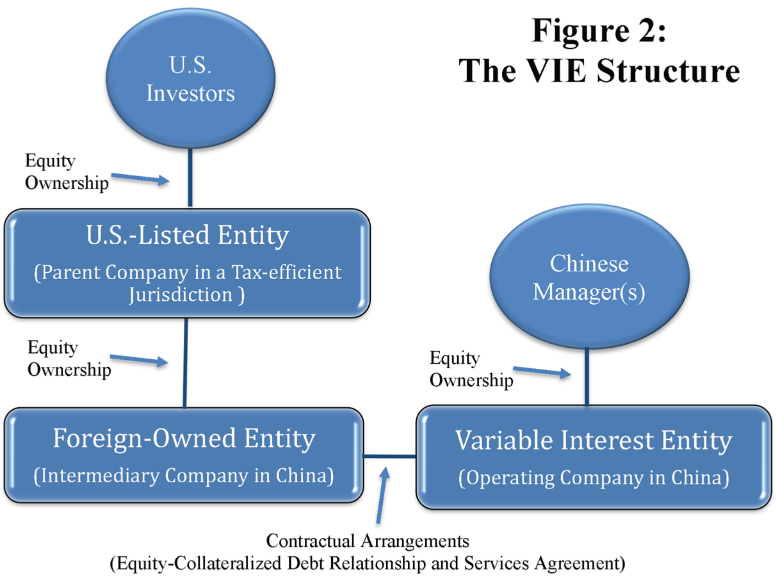
[7] DEAN, SHIRA & ASSOCIATES, *The Special Administrative Measures on Access to Foreign Investment (2020 ed.)* (July 2020), https://www.dezshira.com/library/legal/special-administrative-measures-access-foreign-investment-2020-edition-national-negative-list.html?1593598930#.

[8] PetroChina was established as a joint stock company under Chinese law on Nov. 5, 1999. The American Depositary Shares (ADS) and H shares of PetroChina were listed on the NYSE on Apr. 6, 2000 (stock code: PTR) and the Stock Exchange of Hong Kong Limited on April 7, 2000 (stock code: 857), respectively. It was listed on the Shanghai Stock Exchange on Nov. 5, 2007 (stock code: 601857). *See* http://www.petrochina.com.cn/ptr/gsjj/gsjs_common.shtml. China Life was established under Chinese law on Jun. 30, 2003. It was listed on the NYSE, the Hong Kong Stock Exchange and Shanghai Stock Exchange on Dec. 17 and 18, 2003, and Jan. 9, 2007, respectively. See https://www.e-chinalife.com/xxpl/gywm/gsjs/.

[9] *See, e.g.*, PETROCHINA COMPANY LIMITED, *Annual Report on Form 20-F for the fiscal year ended December 31, 2020* (April 29, 2021), https://www.sec.gov/Archives/edgar/data/0001108329/000119312521140226/d77520d20f.htm. *See* FIDELITY, *Understanding American Depositary Receipts* (2017), https://www.fidelity.com/learning-center/investment-products/stocks/understanding-american-depositary-receipts.

exclusive supplier of technical or consultancy services to the VIE.[10] The relationship between the FOE and the VIE is designed to establish the mutual interdependence of the two entities and thus the presumption that both their accounts should be consolidated into the accounts of the ParentCo.[11]

Figure 2: The VIE Structure



Risks for U.S. Investors from the VIE Structure

The VIE structure poses certain risks for U.S. investors. First, VIEs may not pay their earnings to the FOE and U.S. investors. According to a 2017 analysis by the Council of Institutional Investors ("**CII**"), "less than one fifth of U.S.-listed Chinese VIEs currently pay or intend to pay dividends to shareholders."[12] Similarly, according to a February 2021 report, a dozen U.S.-listed Chinese internet companies have not been remitting profits to their ParentCo as

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[10] Paul Gillis, *Variable Interest Entities in China*, GMT RESEARCH (Mar.13, 2019), https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf

[11] *Ibid.*

[12] Brandon Whitehill, *Buyer Beware: Chines Companies and the VIE Structure*, COUNCIL OF INSTITUTIONAL INVESTORS (Dec. 2017), https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf.

contemplated by the VIE structure.[13] According to the CII, "this arrangement potentially leaves investors to rely solely on the appreciation of the company's stock price for a return on their investment."[14]

Second, the VIE structure provides U.S. and other non-Chinese investors with limited ability to change or influence the operating company's management, because U.S. and other non-Chinese investors typically lack voting rights in the VIE. One high-profile dispute between Alibaba and Yahoo illustrates the risks associated with this absence of such rights.[15] In 2005, Yahoo invested in Alibaba by way of a VIE structure. Alibaba later successfully developed Alipay—a mobile and online payment platform—as a wholly-owned subsidiary.[16] However, in 2011, when Alibaba elected to spin out Alipay into a separate entity owned by Alibaba's Chinese founders, Yahoo was unable to prevent the transfer; and when the parties ultimately settled a dispute over the spinoff, Alibaba (and therefore its investors, including Yahoo) became entitled to a reduced share of Alipay's pre-tax income compared to the status quo ante, when Alipay was a wholly-owned subsidiary.[17]

Third, and perhaps most importantly, the various agreements binding the VIE to the FOE (and supporting the VIE's consolidation onto the ParentCo's balance sheet) have never been officially approved by a Chinese regulatory body,[18] and in the event of a dispute over the terms and validity of these agreements, there is no guarantee that a Chinese court would enforce them. If the underlying contracts binding the FOE and VIE were declared invalid by Chinese authorities, then investors would have no interest in the Chinese operating company in which they intended to invest.[19]

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[13] Jing Yang, *U.S. and Chinese Regulators Are in a Bind Over a Three-Letter Acronym*, WALL STREET JOURNAL (Sept. 30, 2021), https://www.wsj.com/articles/u-s-and-chinese-regulators-are-in-a-bind-over-a-three-letter-acronym-11632999033?st=bklnjwbs6qmpi9h&reflink=article_email_share.

[14] *Supra* at 13.

[15] *See* Kaitlyn Johnson, *Variable Interest Entities: Alibaba's Regulatory Work-Around to China's Foreign Investment Restrictions*, 12 LOY. U. CHI. INT'L L. REV. 249, 255-256 (2015), https://lawecommons.luc.edu/cgi/viewcontent.cgi?article=1181&context=lucilr.

[16] *See id.* at 255-256.

[17] *See* Kathrin Hille and Joseph Menn, *Alibaba settles Alipay dispute with Yahoo*, FINANCIAL TIMES (July 29, 2011), https://www.ft.com/content/40a66dd2-b9ec-11e0-8171-00144feabdc0. See also Stephen Foley and Nicole Bullock, *Alibaba defends payments unit split-off*, FINANCIAL TIMES (Sept. 11, 2014), https://www.ft.com/content/dba294ac-39cb-11e4-8aa2-00144feabdc0.

[18] Paul Gillis, *Variable Interest Entities in China*, GMT RESEARCH, 7 (Mar.13, 2019), https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf.

[19] *See, e.g.*, Gregory J. Millman, *Alibaba's IPO Puts VIE Structure in the Spotlight*, THE WALL STREET JOURNAL (Sept. 22, 2014), https://www.wsj.com/articles/BL-252B-5198. *See also*, ALIBABA GROUP HOLDING LIMITED, *Registration Statement on Form F-1*, 40-43 (May 6, 2014), https://www.sec.gov/Archives/edgar/data/1577552/000119312514184994/d709111df1.htm; USCC, *Chinese Companies Listed on Major U.S. Stock Exchanges,* 2 (May 5, 2021), https://www.uscc.gov/sites/default/files/2021-05/Chinese_Companies_on_US_Stock_Exchanges_5-2021.pdf.

Part II. Policy Issues Affecting Chinese Companies Listed in the United States

Several policy issues are threatening Chinese companies' ability to list or remain listed in the United States. These include longstanding issues with the ability of U.S. regulators to review the audits of U.S.-listed Chinese companies as well as more recent developments, including U.S. executive orders targeting firms with links to the Chinese military; Chinese authorities' enhanced scrutiny of strategic sectors such as technology; and potential regulatory challenges to the VIE structure. This section will address each issue in turn.

A. U.S. Regulators Lack Access to Audits of U.S.-Listed Chinese Companies

i. Background on Audit Requirements of U.S.-Listed Companies

The SEC requires U.S.-listed issuers to provide audited financial statements to investors.[20] In 2002, Congress passed the Sarbanes-Oxley Act ("**SOX**") strengthening these requirements in response to corporate and accounting scandals that shook confidence in U.S. capital markets.[21] Under SOX, accounting firms (whether located in the United States or abroad) that prepare or issue an audit opinion with respect to any U.S.-listed issuers are required to register with the Public Company Accounting Oversight Board (the "**PCAOB**"), submit to PCAOB inspection, and produce audit work papers upon request.[22] When the PCAOB inspects an accounting firm, it reviews specific audits that the firm has performed, which affords the PCAOB access to the underlying records about the accounting firm's issuer-clients. [23]

However, when the PCAOB inspects non-U.S.-based accounting firms and their audit work papers, foreign laws concerning data protection, privacy, confidentiality, bank secrecy, state secrecy, or national security can restrict access to the information reasonably necessary for the PCAOB to perform inspections.[24] For this reason, the SEC and PCAOB have entered into cooperative agreements with foreign regulators to facilitate the timely exchange of information related to audit inspections.[25] When negotiating agreements with foreign regulators, the PCAOB

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[20] U.S. TREASURY DEPT., *President's Working Group on Financial Markets: Report on Protecting United States Investors from Significant Risks from Chinese Companies*, 5 (July 24, 2020), https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf ["**PWG Report (2020)**"].
[21] CORPORATE FINANCE INSTITUTE, *What is the Sarbanes-Oxley Act?* (2021), https://corporatefinanceinstitute.com/resources/knowledge/other/sarbanes-oxley-act/.
[22] PWG Report (2020), supra note 20, at 2-3
[23] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, *PCAOB Inspection Procedures: What Does the PCAOB Inspect and How Are Inspections Conducted?* (last accessed Feb. 5, 2021), https://pcaobus.org/oversight/inspections/inspection-procedures.
[24] Chairman Jay Clayton, Chief Accountant Wes Bricker, and PCAOB Chairman William D. Duhnke III, *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China*, U.S. Sec. & Exch. Comm'n (Dec. 7, 2018) https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other ["**SEC Statement (2018)**"].
[25] SEC Statement (2018), supra note 24. *See also* U.S. SEC. & EXCH. COMM'N, *International Enforcement Assistance* (May 31, 2021), https://www.sec.gov/about/offices/oia/oia_crossborder.shtml; PCAOB, *PCAOB Cooperative Arrangements with Non-U.S. Regulators* (last accessed April 1, 2021), https://pcaobus.org/oversight/international/regulatorycooperation.

prioritizes three principles of access: (i) the ability to conduct inspections and investigations consistent with its mandate; (ii) the ability to select the audit work and potential violations to be examined; and (iii) access to firm personnel, audit workpapers, and other information or documents deemed relevant by its team.[26]

ii. Lack of PCAOB Access to Audits of U.S.-Listed Chinese Companies & Past Initiatives Aimed at Resolution

Chinese accounting firms, including the Chinese affiliates of the four largest U.S. accounting firms that audit the overwhelming majority of U.S.-listed Chinese issuers,[27] are registered with the PCAOB. However, as of 2007, Chinese authorities have prevented Chinese accounting firms from sharing key records and information with the PCAOB, citing concerns about national security, state secrets, and sovereignty.[28] Therefore, for the past fourteen years, the PCAOB has been generally unable to inspect to its satisfaction the audit work papers and practices of PCAOB-registered accounting firms in China (including Hong Kong) with respect to their audit work for U.S.-listed Chinese companies.[29] The lack of audit inspection access raises concerns for the SEC and PCAOB as to the quality of financial statements by Chinese issuers listed in the United States.

U.S. and Chinese authorities have undertaken a number of initiatives to attempt to resolve the PCAOB's audit access concerns.[30] In August 2011, U.S. and Chinese securities regulators

[26] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, *Letter to the U.S. Department of the Treasury, U.S. Securities and Exchange Commission, Board of Governors of the Federal Reserve System, and U.S. Commodity Futures Trading Commission*, 20 (July 10, 2020), https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf ["**PCAOB Letter (2020)**"]
[27] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, *Data About our China-Related Access Challenges* (June 30, 2021), https://pcaobus.org/oversight/international/china-related-access-challenges/data-about-our-china-related-access-challenges.
[28] SEC Statement (2018), supra note 24; PWG Report (2020), supra note 1, at 6-7; PCAOB Letter (2020), supra note 26, at 5; BLOOMBERG TAX AND ACCOUNTING, *Podcast: China Refuses US Audit Inspections. Why It Matters.* (last accessed Feb. 2, 2020), https://pro.bloombergtax.com/podcast-china-refuses-us-audit-inspections-why-it-matters/. See also Dawn Lim and Jing Yang, *Countdown Starts on Chinese Company Delistings After Long U.S.-China Audit Fight*, WALL STREET JOURNAL (Oct. 2, 2021), https://www.wsj.com/articles/countdown-starts-on-chinese-company-delistings-after-long-u-s-china-audit-fight-11633172403?st=4kzb3xo6v4pkajo&reflink=article_email_share.
[29] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, *Letter to the U.S. Department of the Treasury, U.S. Securities and Exchange Commission, Board of Governors of the Federal Reserve System, and U.S. Commodity Futures Trading Commission*, 3 (July 10, 2020), https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf ("China's refusal to cooperate meaningfully with the PCAOB is not new. It dates back to 2007 when Chinese and Hong Kong audit firms first invoked Chinese restrictions to refuse us access to conduct inspections of audit work performed in China. Since that initial refusal in 2007, the PCAOB has engaged in numerous attempts to obtain access to conduct inspections and enforcement activities in China on terms consistent with the remainder of the world.").
[30] See, e.g., PCAOB Letter (2020), supra note 26, at 21; PCAOB, *Joint Press Release Chinese and U.S. Regulators Held Meeting in Beijing on Audit Oversight Cooperation* (Aug. 8, 2011), https://pcaobus.org/news-events/news-releases/news-release-detail/joint-press-release-chinese-and-u-s-regulators-held-meeting-in-beijing-on-audit-oversight-cooperation_346; CHINA SECURITIES REGULATORY COMMISSION, *Officials from relevant departments of the CSRC answered reporter questions* (April 27, 2020),

attended a "Sino-U.S. Symposium on Audit Oversight" where respective authorities briefed each other on their audit oversight processes in order to deepen mutual understanding and facilitate future cooperation on audit issues.[31] They also held recurring discussions on audit inspection issues at the U.S.-China Strategic and Economic Dialogue.[32] In 2013, the China Securities Regulatory Commission (the "**CSRC**") and PCAOB signed a non-binding memorandum of understanding on enforcement cooperation under which Chinese auditors shared with the PCAOB the working papers for the audits of four different Chinese companies listed in the U.S. that were under investigation by U.S. authorities.[33] Following this agreement, in 2015, U.S. and Chinese officials entered into discussions to establish a broader set of inspection protocols, but these talks failed to result in an agreement.[34] From 2016 to 2017, the PCAOB and CSRC conducted a pilot inspection of one PCAOB-registered Chinese accounting firm where, according to the CSRC, "the Chinese side facilitated PCAOB's inspection of the quality control system of the firm and the examination by PCAOB staff of audit working papers of three engagements by the firm."[35] More recently, in early 2020, the CSRC proposed a joint inspection framework whereby U.S. officials would conduct inspections under the supervision of Chinese officials,[36] but the PCAOB again reiterated its position that the Chinese proposal imposed "critical limitations" on its ability to conduct inspections, including the PCAOB's ability to select the target and scope of its inspections.[37]

While these efforts were ongoing, in 2012, the SEC brought an administrative proceeding against the China-based affiliates of Deloitte, Ernst & Young, KPMG, and PwC for refusing to produce audit work papers relating to Chinese companies listed in the United States under SEC

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http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/202004/t20200427_374553.html; REUTERS, *Timeline: U.S., HK regulators struggle to get China audit papers* (Dec. 20, 2017), https://www.reuters.com/article/china-audit-timeline/timeline-u-s-hk-regulators-struggle-to-get-china-audit-papers-idUSKBN1EE0HT; PCAOB, *PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators* (May 24, 2013), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-enters-into-enforcement-cooperation-agreement-with-chinese-regulators_430; CHINA SECURITIES REGULATORY COMMISSION, *Officials from relevant departments of the CSRC answered reporter questions* (April 27, 2020), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/202004/t20200427_374553.html.

[31] PCAOB, *Joint Press Release Chinese and U.S. Regulators Held Meeting in Beijing on Audit Oversight Cooperation* (Aug. 8, 2011), https://pcaobus.org/news-events/news-releases/news-release-detail/joint-press-release-chinese-and-u-s-regulators-held-meeting-in-beijing-on-audit-oversight-cooperation_346.

[32] PCAOB Letter (2020), supra note 26, at 21.

[33] CHINA SECURITIES REGULATORY COMMISSION, *Officials from relevant departments of the CSRC answered reporter questions* (April 27, 2020), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/202004/t20200427_374553.html; REUTERS, *Timeline: U.S., HK regulators struggle to get China audit papers* (Dec. 20, 2017), https://www.reuters.com/article/china-audit-timeline/timeline-u-s-hk-regulators-struggle-to-get-china-audit-papers-idUSKBN1EE0HT; PCAOB, *PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators* (May 24, 2013), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-enters-into-enforcement-cooperation-agreement-with-chinese-regulators_430.

[34] Dawn Lim and Jing Yang, *Countdown Starts on Chinese Company Delistings After Long U.S.-China Audit Fight*, WALL STREET JOURNAL (Oct. 2, 2021), https://www.wsj.com/articles/countdown-starts-on-chinese-company-delistings-after-long-u-s-china-audit-fight-11633172403?st=4kzb3xo6v4pkajo&reflink=article_email_share.

[35] CHINA SECURITIES REGULATORY COMMISSION, *Officials from relevant departments of the CSRC answered reporter questions* (April 27, 2020), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/202004/t20200427_374553.html.

[36] Dawn Lim and Jing Yang, *Countdown Starts on Chinese Company Delistings After Long U.S.-China Audit Fight*, WALL STREET JOURNAL (Oct. 2, 2021), https://www.wsj.com/articles/countdown-starts-on-chinese-company-delistings-after-long-u-s-china-audit-fight-11633172403?st=4kzb3xo6v4pkajo&reflink=article_email_share.

[37] PCAOB Letter (2020), supra note 26, at 21-24.

investigation.[38] The firms argued that Chinese law prevented them from fulfilling these requests, and the SEC responded that this did not relieve them of their obligations under U.S. law.[39] In 2015, the SEC issued an order settling the proceedings that required each firm to pay $500,000 and perform specified steps to satisfy SEC requests for similar materials over the following four years.[40] Under the settlement order, the SEC agreed to coordinate its requests for information through the CSRC; the audit firms agreed to provide responsive information to the CSRC; and the SEC and CSRC would exchange documents and information directly.[41] The audit firms also agreed to produce a "withholding log" including all information withheld from the PCAOB due to Chinese legal restrictions.[42] If the audit firms failed to follow the terms of the order, then they would face an automatic six-month suspension from auditing U.S.-listed companies.[43] Although the order did not result in PCAOB access to the audits of U.S.-listed Chinese issuers, the settlement facilitated direct communications between the SEC and CSRC before it expired in February 2019.[44]

Notwithstanding all of these efforts, in 2020, the PCAOB asserted that "the Chinese side has never agreed to provide access consistent with PCAOB core principles,"[45] because Chinese authorities have imposed critical limitations on the PCAOB's ability to select the specific engagements, define the scope of its inspections, access documents, and investigate potential violations.[46]

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[38] U.S. SEC. & EXCH. COMM'N, *Press Release: SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents* (Dec. 3, 2012), https://www.sec.gov/news/press-release/2012-2012-249htm; SIMPSON THATCHER, *Global Accounting Firms Caught in the Crossfire as SEC Fails to Reach Agreement with Chinese Regulators on Document Sharing* (Dec. 10, 2012), https://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub1551.pdf.

[39] U.S. SEC. & EXCH. COMM'N, *Corrected Order on the Basis of Offers of Settlement of Certain Respondents Implementing Settlement*, File Nos. 3-14872, 3-15116, 6 (Feb. 6, 2015), https://www.sec.gov/litigation/admin/2015/34-74217.pdf.

[40] U.S. SEC. & EXCH. COMM'N, *Press Release: SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents* (Feb. 6, 2015), https://www.sec.gov/news/pressrelease/2015-25.html. *See also* Gina Chon, *China auditors settle with SEC for $2m*, FINANCIAL TIMES (Feb. 6, 2015), https://www.ft.com/content/e1d13df2-ae1e-11e4-8d51-00144feab7de; Sarah N. Lynch, *'Big Four' auditors' Chinese units settle with U.S. SEC over document dispute*, REUTERS (Feb. 6, 2015), https://www.reuters.com/article/us-sec-china-bigfour/big-four-auditors-chinese-units-settle-with-u-s-sec-over-document-dispute-idUSKBN0LA1QD20150206.

[41] U.S. SEC. & EXCH. COMM'N, *Corrected Order on the Basis of Offers of Settlement of Certain Respondents Implementing Settlement*, File Nos. 3-14872, 3-15116, 21-23 (Feb. 6, 2015), https://www.sec.gov/litigation/admin/2015/34-74217.pdf.

[42] *See id.* at 22.

[43] *See id.* at 24.

[44] *See id.* at 28.

[45] PCAOB Letter (2020), supra note 26, at 21. *See also* WEAVER, *PCAOB Says Its Rules Override Chinese Regulations* (Feb. 27, 2017), https://weaver.com/blog/pcaob-says-its-rules-override-chinese-regulations.

[46] PWG Report (2020), supra note 1, at 22-23.

iii. The Holding Foreign Companies Accountable Act of 2020

In response to the longstanding U.S.-China audit inspection issue, Congress passed the Holding Foreign Companies Accountable Act (the "**HFCAA**") in December 2020.[47] The HFCAA introduces documentation and disclosure requirements as well as trading restrictions for certain public companies that have had a "non-inspection year." Under the HFCAA, a "non-inspection year" is a year for which the SEC determines that the PCAOB has been unable to carry out audit inspections or investigations adequately "because of a position taken by an authority in the foreign jurisdiction."[48]

According to the HFCAA, if an issuer has had a non-inspection year, then the SEC must require the issuer to submit documentation to the SEC establishing that the issuer is not "owned or controlled" by a governmental entity in the foreign jurisdiction.[49] A foreign issuer that has had a non-inspection year must also disclose in its annual report: (i) that, during the period covered by the relevant annual report, the auditor that prepared the audit report was not subject to PCAOB inspection; (ii) the percentage of shares owned by government entities; (iii) whether government entities have a controlling financial interest; (iv) whether the issuer's articles of incorporation contain any charter of the Chinese Communist Party; and (v) information related to board members who are also Chinese Communist Party members.[50] As with other disclosure requirements, the SEC has the authority to bring enforcement actions against issuers that fail to comply,[51] which can result in trading suspensions and delisting, among other sanctions.[52]

Critically, if the SEC determines that an issuer has experienced three consecutive non-inspection years, then the SEC must prohibit the issuer's securities from trading in the United States on national exchanges or through other methods within the SEC's jurisdiction (such as over-the-counter trading).[53] This requirement would effectively mandate the delisting of firms whose auditors are not subject to PCAOB inspection or investigation for three consecutive non-inspection years.

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[47] Pub. L. 116-222, *Holding Foreign Companies Accountable Act* (Dec. 18, 2020), https://www.congress.gov/bill/116th-congress/senate-bill/945 [the "**HFCAA**"]. *See also* Andrew Olmem, Christina Thomas, and Jason Elder of Mayer Brown LLP, *Congress Passes the "Holding Foreign Companies Accountable Act,"* HARVARD LAW SCHOOL (Jan. 10, 2021), https://corpgov.law.harvard.edu/2021/01/10/congress-passes-the-holding-foreign-companies-accountable-act/; SKADDEN, *Holding Foreign Companies Accountable Act Poised To Be Signed Into Law* (Dec. 3, 2020), https://www.skadden.com/insights/publications/2020/12/holding-foreign-companies-accountable.

[48] HFCAA §2(i)(1)(b).

[49] HFCAA §2.

[50] HFCAA §3; U.S. SEC. & EXCH. COMM'N, *SEC Issues Amendments, Seeks Public Comment on Holding Foreign Companies Accountable Act* (March 24, 2021), https://www.sec.gov/news/press-release/2021-53.

[51] *See, e.g.*, U.S. SEC. & EXCH. COMM'N, *Selected Provision from the U.S. Securities Exchange Act of 1934 Relating to the Authority and Discretion of the U.S. SEC to Investigate and Seek Sanctions Relating to Violations of the Securities Laws* (last accessed Sept. 2021), https://www.sec.gov/about/offices/oia/oia_enforce/selpro.pdf.

[52] *See, e.g.*, U.S. SEC. & EXCH. COMM'N, *Selected Division of Enforcement Accomplishments: December 2016 – December 2020* (Dec. 30, 2020), https://www.sec.gov/enforce/selected-division-enforcement-accomplishments-december-2016-december-2020; U.S. SEC. & EXCH. COMM'N, *Investor Bulletin: Trading Suspensions* (May 2012), https://www.sec.gov/files/tradingsuspensions.pdf; U.S. SEC. & EXCH. COMM'N – DIVISION OF ENFORCEMENT, *2020 Annual Report*, 10 (Nov. 2, 2020), https://www.sec.gov/files/enforcement-annual-report-2020.pdf.

[53] HFCAA §2(i)(3).

iv. Timing of Regulatory Implementation of the HFCAA

The HFCAA's requirements do not come into effect until the SEC and PCAOB finalize their rules for determining non-inspection years and identify firms as having non-inspection years.[54]

On March 24, 2021, the SEC adopted an interim final rule[55] addressing disclosure and submission requirements established by the HFCAA. The interim final rule indicated that the PCAOB was considering its process for determining whether it can sufficiently inspect or investigate an accounting firm for audits of U.S.-listed foreign companies due to positions taken by an authority in a foreign jurisdiction.[56] Following the PCAOB's establishment of this process, the SEC stated that it would use the PCAOB determination and information from issuers' annual reports to compile a list of issuers with non-inspection years.[57]

On May 13, the PCAOB proposed a rule that would establish a framework for making non-inspection determinations, including the factors that it will consider when assessing whether a determination is warranted.[58] These factors include: (i) the PCAOB's ability to select engagements, audit areas, and potential violations to be reviewed; (ii) the PCAOB's access to any documents, interviews, testimony, or information in the accounting firm's possession that the PCAOB considers relevant to its inspection; and (iii) the PCAOB's ability to conduct inspections and investigations in a manner consistent with applicable laws and regulations, as interpreted and applied by the PCAOB.[59] The PCAOB adopted the final rule on September 22, 2021 and filed it with the SEC for approval.[60] The SEC comment period remains open.[61]

Although no PCAOB determinations have been made, in September 2021, SEC Chairman Gary Gensler stated that he expects that the SEC will begin identifying non-compliant issuers in

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54 HFCAA §2(i)(1)(b).

55 U.S. SEC. & EXCH. COMM'N, *Holding Foreign Companies Accountable Act Disclosure*, Release No. 34-91364; IC-34227, 3-4 (March 24, 2021), https://www.sec.gov/rules/interim/2021/34-91364.pdf.

56 U.S. SEC. & EXCH. COMM'N, *Holding Foreign Companies Accountable Act Disclosure*, Release No. 34-91364; IC-34227, 3-4 (March 24, 2021), https://www.sec.gov/rules/interim/2021/34-91364.pdf; Pub. L. 116-222, *Holding Foreign Companies Accountable Act*, § 2(i)(2)(B) (Dec. 18, 2020), https://www.congress.gov/bill/116th-congress/senate-bill/945.

57 U.S. SEC. & EXCH. COMM'N, *Holding Foreign Companies Accountable Act Disclosure*, Release No. 34-91364; IC-34227, 5-6 (March 24, 2021), https://www.sec.gov/rules/interim/2021/34-91364.pdf.

58 See *Public Company Accounting Oversight Board, News Release: PCAOB Proposes Rule to Create Framework for HFCAA Determinations* (May 13, 2021), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-proposes-rule-to-create-framework-for-hfcaa-determinations.

59 PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, *Fact Sheet: Proposing Release for PCAOB Rule to Establish HFCAA Framework* (May 13, 2021), https://pcaobus.org/news-events/news-releases/fact-sheet-proposing-release-for-pcaob-rule-to-establish-hfcaa-framework.

60 PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, *PCAOB Adopts Rule to Create Framework for HFCAA Determinations* (Sept. 22, 2021), https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-adopts-rule-to-create-framework-for-hfcaa-determinations

61 U.S. SEC. & EXCH. COMM'N, *Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Board Determinations Under the Holding Foreign Companies Accountable Act,* 86 FED. REG. 53699 (Sept. 28, 2021), https://www.federalregister.gov/documents/2021/09/28/2021-21056/public-company-accounting-oversight-board-notice-of-filing-of-proposed-rule-on-board-determinations.

early 2022, and that in 2024, the SEC will prohibit trading in the shares of companies that have been non-compliant for three years.[62]

[62] Gary Gensler, *SEC Chair: Chinese Firms Need to Open Their Books*, THE WALL STREET JOURNAL (Sept. 13, 2021), https://www.wsj.com/articles/china-accounting-standards-shell-company-vie-investment-sarbanes-oxley-sec-gensler-11631563524?st=hzlp98t37mtgxaw&reflink=article_email_share. *See also* Dawn Lim and Jing Yang, *Countdown Starts on Chinese Company Delistings After Long U.S.-China Audit Fight*, WALL STREET JOURNAL (Oct. 2, 2021), https://www.wsj.com/articles/countdown-starts-on-chinese-company-delistings-after-long-u-s-china-audit-fight-11633172403?st=4kzb3xo6v4pkajo&reflink=article_email_share.

B. U.S. Executive Orders Affecting Companies with Links to Chinese Military

Two Executive Orders—one signed by President Trump in November and one signed by President Biden in June—are also driving forward the process of decoupling between Chinese companies and U.S. capital markets by prohibiting the sale or purchase of certain publicly-traded Chinese securities by U.S. persons.

On November 12, 2020, President Trump issued Executive Order 13959 barring U.S. investors from investing in Chinese companies which, the Administration said, supply and/or support China's military, intelligence and security services—a company-specific determination.[63] The legal basis for the order was the International Emergency Economic Powers Act ("**IEEPA**"), which authorizes the President to regulate foreign economic transactions in order to deal with any unusual or extraordinary foreign threat to the national security or economy of the United States if the President declares a national emergency with respect to that threat,[64] and Section 1237 of the National Defense Authorization Act for Fiscal Year 1999, which broadens the President's authority under the IEEPA with respect to "Communist Chinese Military Companies" ("**CCMCs**") designated by the Secretary of Defense.[65] Executive Order 13959 was designed to prevent U.S. capital markets from financing Chinese military-industrial activities that threaten "the national security, foreign policy, and economy of the United States."[66]

The companies covered by Executive Order 13959 were initially identified by the Defense Department as CCMCs in June and August 2020[67] (the Defense Department then identified additional companies in December 2020 and January 2021).[68] Covered companies included, among others: China Mobile Communications Group, China Telecommunications Corp., and China United Network Communications Group Co Ltd. As a result, the NYSE began delisting proceedings against three listed affiliates before the end of 2020 and called a halt to trading of the securities on January 11, 2021. A subsequent appeal by the companies against the decision was

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[63] Executive Order 13959 of November 12, 2020 *Addressing the Threat From Securities Investments That Finance Communist Chinese Military Companies*, https://home.treasury.gov/system/files/126/13959.pdf. Later, amended by Executive Order 13974 of January 13, 2021, https://home.treasury.gov/system/files/126/13974.pdf.

[64] *International Emergency Economic Powers Act*, PUBLIC LAW NO: 95-223 (Dec. 28, 1977), https://www.congress.gov/bill/95th-congress/house-bill/7738.

[65] *Strom Thurmond National Defense Authorization Act for Fiscal Year 1999*, PUBLIC LAW NO: 105-261, §1237 (Oct. 17, 1998), https://www.congress.gov/bill/105th-congress/house-bill/3616?r=6. *See also* COVINGTON, *New Executive Order Revises Prohibition on Transactions Involving Publicly Traded Securities of Certain Chinese Companies* (June 7, 2021), https://www.cov.com/en/news-and-insights/insights/2021/06/new-executive-order-revises-prohibition-on-transactions-involving-publicly-traded-securities-of-certain-chinese-companies.

[66] Executive Order 13959 of November 12, 2020 *Addressing the Threat From Securities Investments That Finance Communist Chinese Military Companies*, https://home.treasury.gov/system/files/126/13959.pdf.

[67] See Gordon Lubold and Dawn Lim, *Trump Bars Americans From Investing in Firms That Help China's Military*, WALL STREET JOURNAL (Nov. 12, 2020), https://www.wsj.com/articles/trump-bars-americans-from-investing-in-firms-that-help-chinas-military-11605209431?mod=article_inline.

[68] U.S. DEFENSE DEPT., *DOD Releases List of Additional Companies, In Accordance With Section 1237 of FY99 NDAA* (DEC. 3, 2020), https://www.defense.gov/News/Releases/Release/Article/2434513/dod-releases-list-of-additional-companies-in-accordance-with-section-1237-of-fy/; U.S. DEFENSE DEPT., *DOD Releases List of Additional Companies, In Accordance with Section 1237 of FY99 NDAA* (Jan. 14, 2021), https://www.defense.gov/News/Releases/Release/Article/2472464/dod-releases-list-of-additional-companies-in-accordance-with-section-1237-of-fy/.

rejected in May 2021.[69] In addition, after CNOOC Limited was added to the list of CCMCs in January 2021, NYSE delisted the company in March,[70] but its appeal of the delisting decision remains pending.[71]

On June 3, 2021, President Biden issued Executive Order 14032 amending Executive Order 13959.[72] Like its predecessor, Executive Order 14032 prohibits U.S. persons from engaging in the purchase or sale of any publicly-traded securities of certain designated companies, referred to in implementing guidance as Chinese Military-Industrial Complex Companies ("**CMICs**").[73] Executive Order 14032 also tasks the Secretary of the Treasury, in consultation with the Secretary of State and, if deemed appropriate, the Secretary of Defense, with the responsibility of identifying future additions to the list.[74]

Under the terms of Executive Order 14032 and its predecessor, the clear intention is to prohibit the sale and purchase by U.S. persons of *any* securities issued by CMICs, whether domestic or foreign, and *any* financial instruments that offer synthetic exposure to such securities, whether traded on-exchange or over-the-counter. In that respect, the Executive Orders go beyond the HFCAA for the firms included in the list, because while the HFCAA would prohibit trading

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[69] *See* Chong Koh Ping, *Chinese Telecom Carriers Ask NYSE to Make Another U-Turn on Delisting*, WALL STREET JOURNAL (Jan. 21, 2021), https://www.wsj.com/articles/chinese-telecom-carriers-ask-nyse-to-make-another-u-turn-on-delisting-11611223140?mod=article_inline; Chong Koh Ping and Alexander Osipovich, *NYSE to Delist Chinese Telecom Carriers After Rejecting Appeals*, WALL STREET JOURNAL (May 7, 2021), https://www.wsj.com/articles/nyse-to-delist-chinese-telecoms-carriers-after-rejecting-appeals-11620394719.

[70] INTERCONTINENTAL EXCHANGE, *NYSE to Commence Delisting Proceedings Against CNOOC Limited (CEO) to Comply with Executive Order 13959* (Feb. 26, 2021), https://ir.theice.com/press/news-details/2021/NYSE-to-Commence-Delisting-Proceedings-Against-CNOOC-Limited-CEO-to-Comply-with-Executive-Order-13959/default.aspx. *See also* Alexander Osipovich, *NYSE Moves to Delist Chinese Oil Company*, WALL STREET JOURNAL (Feb. 26, 2021), https://www.wsj.com/articles/nyse-moves-to-delist-chinese-oil-company-11614383331.

[71] P.R. Venkat and Quentin Webb, *China's Cnooc Plans Big Share Sale at Home as U.S. Delisting Looms*, WALL STREET JOURNAL (Sept. 27, 2021), https://www.wsj.com/articles/chinas-cnooc-plans-big-share-sale-at-home-as-u-s-delisting-looms-11632722451.

[72] Executive Order 14032 *Addressing the Threat From Securities Investments That Finance Certain Companies of the People's Republic of China*. See the text here: https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/ *See also* JD SUPRA, *Biden Revises Ban on U.S. Investors Buying Certain Chinese Securities* (June 8, 2021), https://www.jdsupra.com/legalnews/biden-revises-ban-on-u-s-investors-9368419/.

[73] *See* U.S. DEPT. OF TREASURY, *Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List)* (last Updated: June 16, 2021), https://home.treasury.gov/policy-issues/financial-sanctions/consolidated-sanctions-list/ns-cmic-list; Kim Caine, Katie McDougall, and Jeffrey W. Cottle, *US expands sanctions targeting investments in securities of Chinese military companies*, NORTON ROSE FULBRIGHT (June 17, 2021), https://www.nortonrosefulbright.com/en-us/knowledge/publications/2d19bb99/us-expands-sanctions-targeting-investments-in-securities-of-chinese-military-companies.

[74] *Ibid*. and see The White House, *Fact Sheet: Executive Order Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China* BRIEFING ROOM (Jun. 3, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/; SKADDEN, *US Amends Sanctions Targeting Investments in Securities of Chinese Companies* (June 11, 2021), https://www.skadden.com/insights/publications/2021/06/us-amends-sanctions; Demetri Sevastopulo, *Washington to bar US investors from 59 Chinese companies*, FINANCIAL TIMES (June 4, 2021), https://www.ft.com/content/91e6fb2a-6385-49b3-83aa-8044374805c4.

through methods within the SEC's jurisdiction, the Executive Orders prohibit U.S. investors from trading *any* securities denominated in *any* currency that trade in *any* jurisdiction.[75]

In theory, so long as the President declares a "national emergency" and characterizes the "unusual and extraordinary threat… to the national security, foreign policy, or economy of the United States" in a manner that passes muster under the IEEPA, then the President could extend these trading prohibitions to any Chinese issuer.[76] However, there are no indications that any such policy is under consideration.

[75] SKADDEN, *US Amends Sanctions Targeting Investments in Securities of Chinese Companies* (June 11, 2021), https://www.skadden.com/insights/publications/2021/06/us-amends-sanctions.

[76] *International Emergency Economic Powers Act*, PUBLIC LAW NO: 95-223, § 202 (Dec. 28, 1977), https://www.congress.gov/bill/95th-congress/house-bill/7738.

C. Enhanced Chinese Regulatory Oversight of Key Sectors

Chinese authorities have recently announced new regulatory policies that apply to key sectors of the economy with a focus on technology firms. It is important to note that, although these initiatives have important implications for Chinese firms that are listed in the United States (including Alibaba and JD.com), they may not be specifically targeted at Chinese companies listed in the United States.[77]

The first major development was in November 2020, when Chinese regulators suspended Ant Group's dual-listing in Hong Kong and Shanghai,[78] later ordering the firm to separate its lending and payments businesses on antitrust grounds.[79] Then, in April 2021, Chinese market and internet regulators directed China's thirty-four leading tech companies, including Alibaba and Tencent, to curb "monopolistic practices" that prevent customers from freely migrating between platforms.[80] Next, in August, market regulators released new rules banning certain anticompetitive practices, such as exploiting user data to learn how customers behave and influencing them to avoid competitors' products.[81]

i. Didi Global's U.S. Listing

Chinese policies began to more directly affect U.S.-listings by Chinese issuers in July 2021, when Chinese authorities launched an investigation of Didi Global Inc. a few days after its U.S. IPO.[82] Didi had filed with the SEC in April 2021 for a listing on the NYSE and on Wednesday, June 30th it launched its IPO as planned, although at the time, there were reports that Didi was under investigation by Chinese authorities for antitrust concerns.[83] At first, the offering looked as though it had been successful, raising $4.4 billion, but a few days later, on Sunday, July 4th, the Cyberspace Administration of China ("**CAC**") announced a cybersecurity review of Didi's data

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[77] Christian Shepherd, Ryan McMorrow, Hudson Lockett, and Edward White, *China unveils five-year plan to strengthen control of economy*, FINANCIAL TIMES (Aug. 12, 2021), https://www.ft.com/content/bdcbbdf3-24dd-436d-9e0f-36db2348eadd?shareType=nongift. *See also*
Brooke Masters, *Investors in China should beware Beijing's unpredictability*, FINANCIAL TIMES (Aug. 11, 2021), https://www.ft.com/content/32b8a1c7-cd06-4628-b608-a29bd2de1eab?shareType=nongift.

[78] Ryan McMorrow and Hudson Lockett, *China halts $37bn Ant Group IPO, citing 'major issues'*, FINANCIAL TIMES (Nov. 3, 2020), https://www.ft.com/content/c1ee03d4-f22e-4514-af46-2f8423a6842e.

[79] Yuan Yang and Sun Yu, *Ant ordered to restructure by Chinese regulators*, FINANCIAL TIMES (April 12, 2021), https://www.ft.com/content/5c14c1d1-bd9e-4654-9a12-93c4ac46792d.

[80] Ryan McMorrow, *China tech groups given a month to fix antitrust practices*, FINANCIAL TIMES (April 13, 2021), https://www.ft.com/content/c26eaf88-f0c7-4e8a-9dca-d5669166226f. *See also* REUTERS, *China market regulator fines 12 firms for violating anti-monopoly law* (March 12, 2021), https://www.reuters.com/world/china/china-market-regulator-fines-12-firms-violating-anti-monopoly-law-2021-03-12/.

[81] Christian Shepherd, *China to tighten competition rules for internet groups*, FINANCIAL TIMES (Aug. 17, 2021), https://www.ft.com/content/7ccf409d-489b-411a-8b4f-4b5d8b8ed0b1?shareType=nongift.

[82] Yuan Yang, *China cracks down on Didi days after New York IPO*, FINANCIAL TIMES (July 4, 2021), https://www.ft.com/content/809b31e2-6b1e-42b6-8009-3ea78969d870.

[83] Michelle Toh, *Didi launches blockbuster U.S. IPO in quest to go 'truly global'*, CNN (Jul. 1, 2021), https://edition.cnn.com/2021/06/30/investing/didi-china-us-ipo-intl-hnk/index.html. See also Clay Chandler, Grady McGregor and Eamon Barrett, *How Didi's data debacle doomed China's love affair with Wall Street*, FORTUNE (Jul. 10, 2021), https://fortune.com/2021/07/09/didi-ipo-stock-data-crackdown-china-wall-street-investors/.

practices and banned Didi's app from app stores in China.[84] The announcement was made as part of an effort by Chinese authorities to more closely scrutinize the data security implications of domestic firms listing abroad.[85] This was followed by a brief announcement on July 16th that "seven departments, including the National Internet Information Office," had established a presence within Didi Chuxing to conduct cybersecurity reviews.[86] Didi lost over $17 billion of its market value in the week following its listing, including about $15 billion on July 6th alone, and the share price quickly fell to half of the offering price.[87] As of close on October 15, 2021, Didi was trading at $8.26, still nearly 50% below its initial trading price.[88]

ii. Cyberspace Administration of China Review Process for Foreign Listings

The following week, on July 10th, the CAC proposed new rules requiring "critical information infrastructure operators" and "data processors" holding the personal information of more than one million users to "report to the Cyber Security Review Office for a cyber security review" if applying to list outside of China.[89] Although the proposal appears to target Chinese tech companies, it could require the majority of Chinese companies that list overseas to undergo review, according to market reports.[90]

The CAC review will focus on protecting sensitive data and addressing the national security risks arising from foreign IPOs.[91] According to the CAC, the review "should generally be completed within three months" but can be extended where "the situation is complicated."[92] The cost, delay, and uncertainty created by this new review process is likely to discourage foreign IPOs by Chinese tech companies. Moreover, companies may interpret the new policy, together with the creation of a new Beijing Stock Exchange for technology-oriented small and medium-sized

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[84] *China Weighs Unprecedented Penalty for Didi After U.S., IPO* BLOOMBERG (Jul. 22, 2021), https://www.bloomberg.com/news/articles/2021-07-22/china-is-said-to-weigh-unprecedented-penalty-for-didi-after-ipo; Yuan Yang and Hudson Lockett, *Didi shares fall 20% as China tightens overseas listings rules*, FINANCIAL TIMES (July 6, 2021), https://www.ft.com/content/095eb7ac-09ea-4a5c-8253-d8ca2d945614; Yuan Yang, *China cracks down on Didi days after New York IPO*, FINANCIAL TIMES (July 4, 2021), https://www.ft.com/content/809b31e2-6b1e-42b6-8009-3ea78969d870.

[85] FINANCIAL TIMES, *Didi caught as China and US battle over data* (July 6, 2021), https://www.ft.com/content/00403ae5-7565-413e-907d-ad46549375ba.

[86] Cybersecurity Administration of China, *Notice: Seven departments including the National Internet Information Office stationed in Didi Chuxing Technology Co., Ltd. to conduct cybersecurity reviews* (Jul. 16, 2021), http://www.cac.gov.cn/2021-07/16/c_1628023601191804.htm.

[87] Filipe Pacheco and Matt Turner, *Didi Extends Drop to Fresh Lows as China Weighs Rule Changes*, BLOOMBERG (Jul. 7, 2021), https://www.bloomberg.com/news/articles/2021-07-07/didi-extends-drop-after-sliding-below-ipo-price-on-crackdown.

[88] Bloomberg data accessed on October 18, 2021.

[89] Cybersecurity Administration of China, *Notice: Public Consultation on the "Cyber Security Review Measures (Revised Draft for Solicitation of Comments)"* (Jul. 10, 2021). See draft article 6, http://www.cac.gov.cn/2021-07/10/c_1627503724456684.htm.

[90] BLOOMBERG, in THE ECONOMIC TIMES, *China tightens rules on foreign IPOs in new blow to tech firms* (July 10, 2021), https://economictimes.indiatimes.com/news/international/business/china-tightens-rules-on-foreign-ipos-in-new-blow-to-tech-firms/articleshow/84301041.cms.

[91] Cybersecurity Administration of China, *Notice: Public Consultation on the "Cyber Security Review Measures (Revised Draft for Solicitation of Comments)"*, Article 10 (Jul. 10, 2021). See draft article 6, http://www.cac.gov.cn/2021-07/10/c_1627503724456684.htm.

[92] *Ibid*, draft article 14.

enterprises,[93] as signals that Chinese authorities are discouraging going public in foreign markets. Indeed, following the announcement of the Didi probe and cybersecurity review process, there have been no U.S. IPOs by Chinese companies and several Chinese companies' have decided to defer or cancel their plans to go public in the United States, including: Daojia Ltd., a Chinese home service platform, and Xiaohongshu (Little Red Book), a social media and e-commerce platform.[94]

Reports have recently emerged that Chinese authorities intend to enact additional protections for consumer data. In August 2021, the Wall Street Journal reported that Chinese regulators plan to propose additional rules that would prevent *any* internet firms holding large amounts of sensitive consumer data from going public in the United States.[95]

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[93] James T. Areddy, *China to Launch Beijing Stock Exchange to Steer Investment Into Innovation*, WALL STREET JOURNAL (Sept. 2, 2021), https://www.wsj.com/articles/china-to-launch-beijing-stock-exchange-to-steer-investment-into-innovation-11630622825.

[94] *Daojia Joins Little Red Book in Pausing USU.S. IPO Plans* BLOOMBERG (Jul. 19, 2021), https://www.bloomberg.com/news/articles/2021-07-19/daojia-is-said-to-join-little-red-book-in-pausing-u-s-ipo-plans.

[95] Keith Zhai, *China Plans to Ban U.S. IPOs for Data-Heavy Tech Firms*, THE WALL STREET JOURNAL (Aug. 27, 2021), https://www.wsj.com/articles/china-plans-to-ban-u-s-ipos-for-data-heavy-tech-firms-11630045061?mod=hp_lead_pos1.

D. Potential U.S. and Chinese Reforms to the VIE Structure

In recent months, U.S. and Chinese policymakers have enhanced scrutiny of the VIE structure used by most U.S.-listed Chinese firms. The SEC has imposed additional risk disclosure requirements and Chinese regulators have also enacted new restrictions on the use of VIEs.

i. U.S. Securities and Exchange Commission Review of VIE Structure

On July 30, the SEC published a *Statement on Investor Protection Related to Recent Developments in China* by Chair Gary Gensler expressing concern that, for VIE structures, "average investors may not realize that they hold stock in a shell company rather than a China-based operating company," and announcing new risk disclosure requirements for VIE structures.[96] These disclosures include: (i) that investors are buying shares in a shell company issuer that maintains service agreements with the China-based operating company, clearly distinguishing between the two entities and their activities; (ii) that the company faces uncertainty about future action by the Chinese government that could significantly impact financial performance and the enforceability of contractual arrangements; and (iii) detailed financial information, including quantitative metrics, necessary to understand the relationship between the VIE and the issuer.[97] Additionally, all China-based operating companies seeking to register securities with the SEC, whether directly or through a VIE structure, will be required to disclose: (i) whether the issuer and associated operating company received permission from Chinese authorities to list on U.S. exchanges, and the risks that such permission may be denied or rescinded; and (ii) that the HFCAA may result in the issuer being delisted in the future.[98]

By August, Chinese issuers seeking to list in the United States began receiving more detailed instructions from the SEC staff with respect to these disclosure requirements as part of the registration statement review process.[99] These instructions included, among other things, that issuers "refrain from using terms such as 'we' or 'our' when describing activities or functions of a VIE,"[100] presumably in order to reduce the risk that shareholders mistakenly assume that the issuer and the VIE are the same legal entity. Moreover, in a September interview with the *Financial Times*, SEC Chair Gensler raised concerns about whether "any real money" was flowing from VIEs to their affiliates with U.S. investors, suggesting that the SEC may consider additional regulatory actions with respect to VIEs in the future.[101]

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[96] See U.S. SEC. & EXCH. COMM'N, *Statement on Investor Protection Related to Recent Developments in China* (Jul. 30, 2021), https://www.sec.gov/news/public-statement/gensler-2021-07-30.
[97] *Ibid.*
[98] *Ibid.*
[99] Echo Wang, *Exclusive: SEC gives Chinese companies new requirements for U.S. IPO disclosures*, REUTERS (Aug. 23, 2021), https://www.reuters.com/business/finance/exclusive-sec-gives-chinese-companies-new-requirements-us-ipo-disclosures-2021-08-23/.
[100] Echo Wang, *Exclusive: SEC gives Chinese companies new requirements for U.S. IPO disclosures*, REUTERS (Aug. 23, 2021), https://www.reuters.com/business/finance/exclusive-sec-gives-chinese-companies-new-requirements-us-ipo-disclosures-2021-08-23/.
[101] Gary Silverman and Kiran Stacey, *Crypto platforms need regulation to survive, says SEC boss*, FINANCIAL TIMES (Sept. 1, 2021), https://www.ft.com/content/fb126d79-2e60-4002-8aba-b08887fca609?shareType=nongift.

In response to the SEC's July statement, the CSRC has sought further talks, calling for mutual respect and collaboration on the issue.[102] According to the CSRC, "the CSRC has always been open to companies' choices to list their securities on international or domestic markets in compliance with relevant laws and regulations."[103]

ii. Potential Restrictions on VIE Structures by Chinese Regulators

In early July, when the CAC announced its new cybersecurity review for companies raising capital overseas, reports emerged that the CAC was working with other Chinese authorities to revise the regulation of VIEs.[104] Then, on July 24, the Central Committee of the Communist Party of China and the State Council issued joint *Opinions on Further Reducing the Burden of Compulsory Education Students' Homework and Off-campus Training*, which contemplated stronger regulation of "off-campus training institutions" and which provided, in respect of tutoring institutions, that "foreign capital shall not control or hold shares [these] institutions through mergers and acquisitions …*[or] use variable interest entities to hold or participate in [these] institutions*" (emphasis added).[105] The announcement heightened concerns that VIE structures were potentially vulnerable to regulatory curbs.[106]

Chinese authorities have also begun curtailing use of the VIE structure in other ways.[107] For example, when Chinese issuers establish a VIE structure for listing overseas, they commonly inject capital into the overseas ParentCo so that it can pay its listing and other expenses; and in order to make these capital injections overseas, Chinese issuers under the jurisdiction of the National Development and Reform Commission ("**NDRC**") must obtain its permission to do so. However, by September 2021, firms that approached the NDRC for permission had been advised

[102] Edward White, *China calls for closer communication with U.S. over stock market controls*, FINANCIAL TIMES (Aug. 1, 2021), https://on.ft.com/2ViRSky; and see *China Seeks More Communication With U.S. on Overseas IPOs*, BLOOMBERG (Aug. 1, 2021), https://www.bloomberg.com/news/articles/2021-08-01/china-calls-for-more-communication-with-u-s-on-overseas-ipos.

[103] *Ibid*.

[104] Lingling Wei, *China's Cyber Watchdog to Police Chinese Overseas Listings*, WALL STREET JOURNAL (July 8, 2021), https://www.wsj.com/articles/chinas-cyber-watchdog-to-police-chinese-overseas-listings-11625742254; Hudson Lockett and Tabby Kinder, *China's crackdown on US listings threatens $2tn market*, FINANCIAL TIMES (July 7, 2021), https://www.ft.com/content/299ba00b-dfef-4c53-88a2-e6725d14025d.

[105] Ministry of Education of the People's Republic of China, *News Item: The General Office of the Central Committee of the Communist Party of China and the General Office of the State Council issued the "Opinions on Further Reducing the Work Burden of Students in Compulsory Education and the Burden of Off-campus Training"* (Jul. 24, 2021), http://www.moe.gov.cn/jyb_xwfb/gzdt_gzdt/s5987/202107/t20210724_546566.html. The text of the opinion is available at: http://www.moe.gov.cn/jyb_xxgk/moe_1777/moe_1778/202107/t20210724_546576.html. See also *China issues guidelines to ease burden of young students*, PEOPLE'S DAILY (Jul. 25, 2021), http://en.people.cn/n3/2021/0725/c90000-9876270.html; *China Considers Turning Tutoring Companies Into Non-Profits*, BLOOMBERG (Jul. 23, 2021), https://www.bloomberg.com/news/articles/2021-07-23/china-is-said-to-mull-turning-tutoring-firms-into-non-profits.

[106] Tabby Kinder, Hudson Lockett, Ryan McMorrow, Michael Mackenzie and Harriet Agnew, *Beijing's threat to VIEs triggers Wall Street angst over China stocks*, FINANCIAL TIMES (Jul. 28, 2021), https://on.ft.com/3iWxQ7G.

[107] *See* BLOOMBERG, *Shanghai Suspends Key Approval on Route to Offshore Listings* (Sept. 3, 2021), https://www.bloomberg.com/news/articles/2021-09-03/shanghai-suspends-key-approval-on-route-to-offshore-listings.

that "the process for outbound investment into VIE structures is being halted."[108] At the same time, the NDRC has also claimed that "it has not rejected requests for outbound direct investment by companies *because of their use of VIEs*" (emphasis added), leaving unclear the basis for the policy change.[109]

Reports have also recently emerged that Chinese authorities are planning to propose rules that would require companies to obtain formal approval from a cross-ministry committee in order to list overseas using a VIE structure.[110] However, it remains unclear when the new rules would come into effect and whether the new rules would affect companies that have already used the VIE structure to list in foreign markets.

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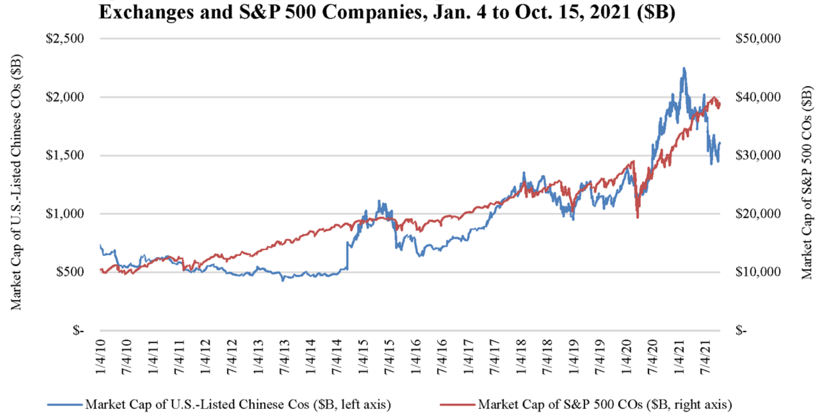
[108] *See* BLOOMBERG, *Shanghai Suspends Key Approval on Route to Offshore Listings* (Sept. 3, 2021), https://www.bloomberg.com/news/articles/2021-09-03/shanghai-suspends-key-approval-on-route-to-offshore-listings.
[109] *Id.*
[110] Keith Zhai, *China Plans to Ban U.S. IPOs for Data-Heavy Tech Firms*, THE WALL STREET JOURNAL (Aug. 27, 2021), https://www.wsj.com/articles/china-plans-to-ban-u-s-ipos-for-data-heavy-tech-firms-11630045061?mod=hp_lead_pos1.

Part III. Market Reaction to Regulatory Developments

Figure 3 displays the market capitalization of both Chinese companies listed on major U.S. exchanges (left axis) and the market capitalization of S&P 500 companies (right axis) from January 4, 2010 to October 15, 2021. Changes in the market capitalization of U.S.-listed Chinese companies largely mirrored the changes of S&P 500 companies prior to 2021. However, during Summer 2021, when several new regulatory initiatives were announced by U.S. and Chinese authorities, the two diverged. In the month of July alone, U.S.-listed Chinese companies lost approximately 20% of their value while S&P 500 companies gained 2%. Since the Shanghai Composite Index fell by a much more modest 5% over the same period, the sharper decline for U.S.-listed Chinese issuers suggests that this was not solely caused by a broader downturn in the Chinese economy.

U.S. listings by Chinese companies also rapidly dried up over the same period. Although 34 Chinese companies raised a record $12.4 billion from U.S. listings in the first half of 2021, an additional 50 Chinese companies that filed to list in the United States are now in "limbo," and there have been zero U.S. listings by Chinese companies since July.[111]

Figure 3: Market Cap of Chinese Companies Listed on Major U.S. Exchanges and S&P 500 Companies, Jan. 4 to Oct. 15, 2021 ($B)



Data note: "U.S.-listed Chinese company" is defiend as a company domiciled in China that has issued common stock or ADRs on the NASDAQ, New York Stock Exchange, or NYSE American exchanges.
Source: Bloomberg data accessed October, 18, 2021.

[111] Bloomberg data, accessed October 18, 2021; and Tabby Kinder and Hudson Lockett, *Chinese start-ups caught in US listings limbo*, FINANCIAL TIMES (Aug. 17, 2021), https://www.ft.com/content/56a7dff0-cc63-40b0-ad96-7ce82780cce2?shareType=nongift.

Cross-Listings by U.S.-Listed Chinese Companies

Several Chinese companies that are listed in the United States have recently established cross-listings on other exchanges, with Hong Kong as the preferred venue.[112] Alibaba began the trend by listing in Hong Kong in November 2019. Since then, many other major Chinese technology companies including Baidu, JD.com, Bilibili, and NetEase have followed suit. By August 2021, of the 251 Chinese companies listed in the United States, 24 were cross-listed in Hong Kong, and these cross-listed firms represented 71% of the $1.8 trillion market capitalization of U.S.-listed Chinese companies.[113]

Cross-listing means that U.S. investors should be able to continue to obtain exposure to delisted Chinese companies by holding stocks directly on the foreign exchange or by investing indirectly via global investment funds (barring any applicable U.S. sanctions).[114] From the perspective of issuers, cross-listing enables Chinese companies that could be delisted in the United States to continue to access global pools of investment capital outside of China.

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[112] Rachael Johnson, U.S.-*listed Chinese companies gravitate to secondary listings in Hong Kong*, INTERNATIONAL BAR ASSOCIATION (2020), https://www.ibanet.org/article/fcf04a93-cff7-44ca-98c1-bcd5cb1a1d6c.

[113] Bloomberg data accessed on August 13, 2021. “U.S.-listed Chinese company” is defined as a company domiciled in China listed on the NASDAQ, New York Stock Exchange, or NYSE American.

[114] If stocks are delisted from U.S. exchanges for regulatory non-compliance in the ordinary course of market business they can still be advertised on the “Pink Sheets” (also known as “OTC Pink”), a service offered by OTC Markets Group. Since all dealers that trade on OTC Pink must be registered with the SEC, however, and trading is therefore within its regulatory reach, it seems virtually certain that the SEC will act, in due course, to prohibit the trading of securities issued by any issuers determined to have been Commission-identified issuers for three consecutive years in order to implement the terms of section 3 of the HFCAA.

Conclusion

Four key issues threaten the continued ability of Chinese companies to list or remain listed in the United States. First, U.S. and Chinese authorities have yet to resolve long-standing issues over U.S. regulators' access to audits of Chinese companies listed in the United States; second, Presidential Executive Orders have recently limited U.S. investor access to Chinese firms perceived as posing national security risks to the United States; third, in response to cybersecurity concerns, Chinese authorities have recently imposed a new regulatory review process for firms in key sectors (such as technology) seeking to list overseas; and fourth, regulators in the United States and China are directing greater scrutiny at the VIE structure that many Chinese firms use to list in the United States.

Taken together, these issues threaten to cause the large-scale delisting of Chinese issuers in the United States, which would potentially undermine the United States' role as the world's largest capital market. It could also cause U.S. investors to access these investments in overseas markets where they enjoy fewer protections than at home (assuming applicable sanctions do not prevent them from doing so). In addition, these issues increase the risk that the United States and China engage in tit-for-tat escalation by, for example, further restricting investment in each other's companies, which would segment global capital markets, undermine the efficient allocation of capital, and harm both sides. For instance, if policy disputes affecting U.S.-listed Chinese issuers remain unresolved, China may respond by reorienting its market opening away from U.S. issuers and investors and towards institutions from Europe and Japan.

The Committee recognizes that there are many social, geopolitical, and economic dimensions to the U.S.-China relationship. However, the Biden Administration has stressed "the responsibility of both nations to ensure competition does not veer into conflict,"[115] and authorities should keep in mind that decoupling U.S. and Chinese capital markets can have broader negative consequences for the bilateral relationship beyond business.

In our view, the audit, national security, cybersecurity, and exchange listing structure issues between U.S. and Chinese policymakers are likely too complex and intertwined to be effectively considered and resolved in isolation from one another. Consequently, the Committee recommends that U.S. and Chinese authorities form a high-level working group with participants from both sides, including the SEC and CSRC, to systematically evaluate the full range of issues together, consider potential solutions, and make recommendations. This working group should have a clear mandate setting forth the concerns it is expected to resolve, and it should be staffed by professionals from both sides that are familiar with the relevant issues.

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[115] THE U.S. WHITE HOUSE, *Readout of President Joseph R. Biden Jr. Call with President Xi Jinping of the People's Republic of China* (Sept. 9, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/09/09/readout-of-president-joseph-r-biden-jr-call-with-president-xi-jinping-of-the-peoples-republic-of-china/;

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October 26th Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing

Taking Stock of China, Inc.: Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets

Congressman Gregory Meeks' Questions for the Record
Witness: Eric Lorber and Karen Sutter

- **Mr. Eric Lorber,** when many Chinese companies delisted around a decade ago, some just went dark and stopped reporting altogether to the American regulators, instead of relisting in another jurisdiction. Investors lost billions of dollars, and it is extremely difficult and burdensome, if not impossible, for American investors to recover these losses from Chinese courts. A complete delisting of China would be significantly more catastrophic for investors. But of course, there is also a need to protect the American investors and the American capital markets. What do you think the effect will be on the American investor if there is a complete delisting of Chinese companies? What can be done to counteract any negative impacts on investors?

Response: A complete delisting of Chinese companies on U.S. exchanges would likely have a significant impact on U.S. investors for the reasons noted. In particular, blanket delisting could lead to substantial losses for U.S. investors and recouping such losses could be challenging. A more tailored approach, to include only considering delisting those companies who do not abide by U.S. reporting requirements and therefore pose a substantial risk to U.S. investors – as well as those who threaten U.S. national security – could help limit the negative impacts on U.S. investors. It would also ensure that the United States would still be able to target those companies it considers national security threats.

- **Ms. Karen Sutter,** Chinese companies that choose to list in NYC instead of Hong Kong, Shanghai, and London is proof of New York's undisputed capital markets leadership. This leadership brings talent, money, and jobs to our country. My comprehensive Eagle Act legislation on China, that has passed through the House Foreign Affairs Committee, calls out and addresses China's human rights record, their bullying foreign policy, and their concerning record on climate. It is important that we are tough on China when appropriate. But in the capital markets part of my bill, I make sure we are balancing the costs of decoupling against the benefits of addressing China's behavior. How do we weigh these real tradeoffs going forward?

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MEMORANDUM November 18, 2021

To:	House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Attention: Terrie Allison
From:	Karen M. Sutter, Specialist in Asian Trade and Finance, ksutter@crs.loc.gov, 7-8638
Subject:	**Question for the Record for the October 26, 2021, Hearing, *Taking Stock of 'China, Inc.': Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets***

This memorandum provides my response to the question for the record (QFR) that the subcommittee sent to me following my testimony at the October 26, 2021, hearing, *Taking Stock of 'China, Inc.': Examining Risks to Investors and the U.S. Posed by Foreign Issuers in U.S. Markets.* Thank you for the opportunity to testify at the hearing, and for the chance to respond to this QFR. Please contact me if I can be of further assistance.

QFR submitted by Representative Gregory Meeks

Question: Chinese companies that choose to list in NYC instead of Hong Kong, Shanghai, and London is proof of New York's undisputed capital markets leadership. This leadership brings talent, money, and jobs to our country. My comprehensive Eagle Act legislation on China, that has passed through the House Foreign Affairs Committee, calls out and addresses China's human rights record, their bullying foreign policy, and their concerning record on climate. It is important that we are tough on China when appropriate. But in the capital markets part of my bill, I make sure we are balancing the costs of decoupling against the benefits of addressing China's behavior. How do we weigh these real tradeoffs going forward?

Response: A move to require that People's Republic of China (PRC) firms listed on U.S. exchanges adhere to current U.S. requirements, as well as those recently proposed by Congress, may not necessarily deter PRC corporate interest in listing on U.S. exchanges and seeking U.S. investment. At the same time, these requirements may help to protect U.S. investors and provide greater transparency about investments in companies of potential concern to Congress. U.S. exchanges could remain attractive for some PRC firms, particularly if the U.S. government were to ensure the global playing field is level by standardizing its approaches for alternative investment pathways. For example, the U.S. government might negotiate similar requirements among like-minded countries' exchanges. It also could require that U.S. investment in PRC firms through other means—including venture capital, private equity, private placements, and funds tied to overseas listings—adhere to similar requirements. The enactment of the Holding Foreign Companies Accountable Act (P.L. 116-222) appears to have strengthened U.S. leverage vis-à-vis the Chinese government by signaling U.S. resolve in imposing consequences for PRC firms' failure to

comply with U.S. listing requirements. Chinese officials have proposed certain limited concessions in response—even if they likely do not go far enough to address requirements—suggesting they realize the prospects for the suspension of trading of PRC stocks and subsequent delisting of PRC firms are real.[1] Furthermore, Chinese firms constitute a relatively small percentage of the overall market capitalization of U.S. exchanges (see below), indicating that U.S. investors in any delisted PRC firms would still have a wide range of investment options on U.S. exchanges.

U.S. stock exchanges offer China's firms access to deep capital markets and paths to earn hard currency, build brand recognition, and expand overseas. Initial public offerings (IPOs) in the United States have been particularly popular with Chinese firms in emerging industries. Chinese firms raised an estimated $15 billion in U.S. IPOs in 2020.[2] As of May 2021, 248 Chinese firms were listed on the three major U.S. stock exchanges—up from 217 in December 2020—with a combined market capitalization of $2.1 trillion, according to the U.S.-China Economic and Security Review Commission.[3] China's Alibaba Group constitutes over 20 percent of this combined market capitalization value for Chinese firms listed on U.S. exchanges. This combined market capitalization for Chinese firms, including Alibaba, represents approximately 4.7% of the total market capitalization of the three U.S. exchanges.[4] When Alibaba is not included, China's combined listings represent a market capitalization of approximately $1.6 trillion, or an estimated 3.8% of the total market cap of the three U.S. exchanges.

U.S. Requirements and Concerns

Requirements for firms that list on U.S. exchanges aim to protect the interests and rights of U.S. investors and the U.S. market more generally. The market disclosure and accounting requirements that Congress and the Securities and Exchange Commission (SEC) are applying to PRC firms that list on U.S. exchanges in many instances involve longstanding obligations that they have required of all listed firms, such as the ability to inspect auditors of listed firms.[5] The PRC government has prevented the Public Company Accounting Oversight Board (PCAOB) from auditing the auditors of PRC firms listed on U.S. exchanges for over 10 years.[6] By not enforcing these U.S. requirements for PRC firms to date, the U.S. government has not held PRC firms and their auditors to the same level of scrutiny as U.S. companies and firms from other countries.

The U.S. government is also increasingly concerned about the potential risks associated with the corporate structures that PRC firms are using to expand overseas and invest in U.S. capital markets—such as the variable interest entity (VIE) structure.[7] These structures are complex and arguably make it difficult for U.S. investors to assess potential risks. While U.S. underwriters, accountants, or legal counsel may have insights into these risks, they may not share this knowledge fully with U.S. investors who ultimately bear the costs of these risks. These complex corporate structures separate the underlying company (and its operations and assets) from U.S. investors. In many instances, the stocks and core assets of parent

[1] "China Makes Proposal to U.S. in Concession to Solve Accounting Dispute," *Reuters*, August 26, 2020.

[2] Julia Fioretti and John Cheng, "Chinese Firms Are Listing in the U.S. at a Record-Breaking Pace," *Bloomberg*, April 24, 2021.

[3] "Chinese Companies Listed on Major U.S. Stock Exchanges," U.S.-China Economic and Security Review Commission, May 5, 2021.

[4] Estimates calculated by the author based on public information reported by the three U.S. exchanges.

[5] See CRS In Focus IF11714, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by Gary Shorter.

[6] See CRS Report R44894, *Accounting and Auditing Regulatory Structure: U.S. and International*, by Raj Gnanarajah.

[7] In July 2021, the SEC enhanced scrutiny of Chinese firms, particularly VIEs, after China's restrictions on U.S.-listed firms wiped out an estimated $400 billion in value and China's ride-hailing firm DiDi Global Inc. failed to fully disclose regulatory risks before listing on the New York Stock Exchange. See "Statement on Investor Protection Related to Recent Developments in China," Public Statement, SEC Chair Gary Gensler, July 30, 2021.

Chinese firms are not listed on U.S. exchanges. This shields the PRC parent and its assets from the exercise of U.S. shareholder rights including legal recourse if necessary. [8]

Most listings of China's large state-owned enterprises (SOEs) on U.S. stock exchanges use American Depositary Receipts (ADRs), a structure that allows a secondary U.S. exchange listing of a foreign company.[9] The overseas parent firm's stocks are listed in the United States through a contractual arrangement that bundles the company's stock certificates as ADRs. These ADRs typically include a small portion of the shares that SOEs list in China. The original China-listed shares represent a small portion of the firm.[10] CRS estimates that two-thirds of all PRC firms listed in the United States—including large technology firms such as Alibaba, Baidu, and Tencent—use a VIE structure to work around Chinese government restrictions on direct or active foreign investment in certain sectors.[11] A VIE structure involves the owners of a Chinese firm creating an offshore holding company in which foreign investors can purchase an equity claim. The holding company is tied to the "parent" through a series of contracts and revenue sharing agreements that mimic ownership arrangements but do not provide the same rights typically afforded to investors in U.S.-listed firms.[12] The contracts underpinning the VIE allow the PRC owner(s) to move funds across the business, while creating a firewall between the listed entity and the core assets and licenses held by the PRC owner.[13] VIE arrangements appear to have no definitive legal standing in China. Some Chinese VIEs have reduced U.S. shareholder value by shifting business licenses, issuing off-the-books bonds, and failing to disclose regulatory risks they face in China as they arise.[14]

Potential Short-Term Costs

A delisting of certain PRC stocks would have some potential short-term costs for U.S. investors. U.S. financial firms earn revenue on PRC firms' listings, but they may also be exposed to a suspension of trading and delisting if they are also invested in any of these firms. Some American Depositary Receipts

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8 See CRS In Focus IF11803, *U.S. Capital Markets and China: Issues for Congress*, by Michael D. Sutherland and Karen M. Sutter.

9 United States Securities and Exchange Commission, "Investor Bulletin: American Depository Receipts," August 2012, https://www.sec.gov/investor/alerts/adr-bulletin.pdf.

10 Shen Hong and Yvonne Lee, "China Sees Citic Listing as Model for State-Firm Overhauls," *The Wall Street Journal*, June 2, 2014.

11 See CRS In Focus IF11803, *U.S. Capital Markets and China: Issues for Congress*, by Michael D. Sutherland and Karen M. Sutter. The term "variable interest entity" originates from the U.S. Financial Accounting Standards Board FIN46(R), which stipulates the conditions for consolidating VIEs in corporate financial statements. For more, see Financial Accounting Standards Board, "FASB Interpretation No. 46 (revised December 2003): Consolidation of Variable Interest Entities," at https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true.

12 Chinese variable interest entity (VIE) structures typically depend on five types of legal agreements: 1) a loan agreement that capitalizes the VIE; 2) an equity pledge made by the VIE owners as collateral; 3) a call option agreement allowing the wholly foreign owned enterprise (WFOE) to purchase the VIE at a set price; 4) a power of attorney agreement that assigns to the WFOE normal shareholder rights; and 5) a series of technical service agreements or asset licensing agreements that allow the WFOE to extract all of the residual profits of the VIE. See Paul L. Gillis, "Accounting Matters: Variable Interest Entities in China," *Forensic Asia*, September 18, 2012, at https://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf.

13 Brandon Whitehill, "Buyer Beware: Chinese Companies and the VIE Structure," *Council of Institutional Investors*, December 2017; Paul L. Gillis and Fredrik Oqvist, "Variable Interest Entities in China," *GMT Research*, March 13, 2019, at https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf; Justin Hopkins, Mark Lang, and Jianxin Zhao, "The Rise of US-Listed VIEs from China: Balancing State Control and Access to Foreign Capital," *Kenan Institute of Private Enterprise Research Paper No. 19* (February 2018); and Jamie Powell, "VIEs: China's nuclear option," *The Financial Times*, October 9, 2019.

14 Liana B. Baker, "Yahoo Gets Short End of Stick in Alibaba Deal," *Reuters*, July 29, 2011; Keigh Zhang and Jing Yang, "China Targets Firms Listed Overseas After Launching Didi Probe," *The Wall Street Journal*, July 6, 2021.

(ADRs) or other PRC stocks might be moved to a foreign exchange in which U.S. ownership rights are maintained. In the event that ADRs or other stocks do not transfer to a foreign exchange, there are potential risks to U.S. investors. For example, if the trading of stocks were suspended and the firms were eventually delisted, the stock could see a decline in price in the run up to the trading suspension and stock delisting, potentially affecting U.S. investors in the short term. There are also potential transaction costs for investors who hold these stocks. Should U.S. investors choose to invest in these delisted PRC companies on a foreign exchange, they would be subject to those countries' rules and regulations.

Some degree of U.S. capital outflow could occur if investors in these PRC stocks choose to transfer funds to an overseas account to maintain their investments. This outflow could be small given the current percentage share of U.S. holdings in these stocks compared to the total valuation of the U.S. stock market. Delisting could also strengthen China's exchange, particularly if well-known firms that list in the United States as ADRs remain attractive to U.S. and foreign investors and are only traded in China. Delisting could support alternative exchanges if firms transfer their listings to these exchanges. The Hong Kong Stock Exchange may be one potential alternative for PRC technology firms, including any that might be delisted from U.S. exchanges.[15] Congress might consider whether global rules and standards are adequate. If not, Congress might request that U.S. officials more actively engage counterparts in other countries where U.S. concerns may be shared, such as Europe and Japan, to encourage their exchanges to adopt similar standards.

PRC Government Pressures

U.S. actions may not necessarily be the strongest driver in PRC firms' decisions about where they list. Separate from recent U.S. actions, the Chinese government has been encouraging, and in some cases pressuring, PRC firms to list on China's domestic exchanges in an apparent effort to develop China's capital markets. The government opened the Shanghai Stock Exchange Science and Technology Innovation (STAR) Board in Shanghai in 2019 and a new exchange in Beijing this year to support smaller companies, including technology firms.[16] China's new cybersecurity and data policies are also affecting the ability of PRC firms to list in the United States. In July 2021, for example, the Cybersecurity Administration of China (CAC) reportedly undertook a cybersecurity review of China's ridesharing service Didi Chuxing Technology Co., reportedly due in part to concerns that its overseas listing on the New York Stock Exchange could prompt greater public disclosure and release of the company's data as part of U.S. listing requirements.[17]

Alternative Investment Pathways and Considerations

U.S. stock exchanges are an important but not the only avenue for Chinese firms to secure U.S. investment. Efforts by the U.S. government to enforce existing rules or address new concerns with regard to China might consider addressing the full range of pathways through which Chinese firms receive U.S. investment—including venture capital, private equity, private placements, and funds tied to overseas listings—so that U.S. requirements and congressional concerns are fully addressed, and to prevent potential market workarounds. Congress might seek to review the ways in which U.S. funds and investment firms are facilitating the flow of U.S. investments to PRC firms through private investments and indices that link to PRC firms listed in China, Hong Kong, and other global exchanges. Congress

[15] Yvonne Lau, "China's Crackdown on U.S. IPOs is a Windfall for Hong Kong—So Long As It Can Handle the Influx of Listings," *Fortune*, July 18, 2021.

[16] Jiang Yaling, "Why is China Setting Up a Third Major Stock Exchange in Beijing?," *Sixth Tone*, September 7, 2021; "China Turns to New Stock Exchanges to Channel Finance to Innovative Firms," *The Economist*, September 11, 2021.

[17] Lingling Wei and Keith Zhai, "Chinese Regulators Suggested Didi Delay Its U.S. IPO," *The Wall Street Journal*, July 5, 2021.

might consider whether, and if so, how these investments should be regulated or required to adhere to certain requirements.

U.S. investors invest in PRC firms that are listed on China's exchanges, including through investment funds and dual listings on both U.S. and PRC exchanges. Five major index fund managers include Chinese bonds and A-shares of firms listed on China's exchanges in their funds; three major funds include central and local government debt.[18] U.S. pension funds are exposed to China's economy through these indices and direct holdings in PRC firms. U.S. investors have shown increased interest in China's market since the PRC government recently approved a few U.S. financial firms, including Goldman Sachs, JP Morgan, and BlackRock, to increase their equity stakes in financial services joint ventures with Chinese firms and to operate wholly-owned funds.[19] These firms generally do not publicly disclose their China assets.[20]

Available data also likely understate U.S.-China bilateral financial flows, which appear to be expanding.[21] There is a lack of transparency on deals and an absence of publicly-available data on the main and growing pathways for two-way investment, which include private equity, venture capital, and private placements. Financial flows through these pathways are not captured in most data sets and there is limited transparency as to specific transactions. U.S. and Chinese monies appear to be increasingly comingled through the use of funds that operate in both the United States and China. Without further transparency, it is difficult to assess how some financial deals may also support related agreements that are strategic and involve the transfer of technology or know-how. Transparency gaps also potentially affect the ability of the U.S. government to assess aggregate U.S. financial and economic exposure to China and potential risks.[22]

The PRC government's use of a private equity model to channel state funds into domestic and foreign companies, projects, and investments through its use of Government Guidance Funds (GGFs) creates an additional layer of complexity in understanding and assessing potential state and military ties to PRC firms. In this model, China's Ministry of Finance is channeling state funds to GGFs and sub-funds. State money is also routed through SOEs, pensions, state banks, and venture capital firms.[23] China's use of complex structures also can obscure state ties—including to the Communist Party of China (CPC), the government, and the military—and other corporate details, complicating the effectiveness of U.S. government oversight and U.S. investors' legal recourse.

In this regard, Congress might consider additional disclosure requirements for PRC firms that list in the United States or receive U.S. investment through other pathways. Congress might consider establishing new due diligence and liability requirements for U.S. actors that represent Chinese firms and facilitate these investments.

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[18] A-shares represent publicly-listed PRC companies that trade on China's stock exchanges in China's currency, the renminbi.

[19] "JPMorgan Gets Beijing's Approval for First Fully Foreign-owned Brokerage," Reuters, August 6, 2021; "Goldman Sachs Moves to Full Ownership of China securities JV," *Reuters*, October 17, 2021.

[20] Dawn Lim, "BlackRock Closes In on the Once Unthinkable, $10 Trillion in Assets," *The Wall Street Journal*, July 14, 2021.

[21] Nicholas Lardy and Tianlei Huang, "Despite the Rhetoric, US-China Financial Decoupling is not Happening," *IR Magazine*, July 20, 2020.

[22] Sean O'Connor, "How Chinese Companies Facilitate Technology Transfer from the United States," Staff Research Report, U.S.-China Economic and Security Review Commission, May 6, 2019.

[23] Tianlei Huang, "Government-Guided Funds in China: Financing Vehicles for State Industrial Policy," PIIE, June 17, 2019; U.S. Chamber of Commerce, "Made in China 2025: Global Ambitions Build on Local Protections, "2017; "Four Things to Know about Chinas $670 billion Government Guidance Funds," *Caixin*, February 25, 2020.