CHINA'S PRESENCE IN THE GLOBAL CAPITAL MARKETS

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

APRIL 16, 2004

Printed for the use of the
U.S.-China Economic and Security Review Commission
Available via the World Wide Web: http://www.uscc.gov

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ROGER W. ROBINSON, Jr., *Chairman*
C. RICHARD D'AMATO, *Vice Chairman*

CAROLYN BARTHOLOMEW, Commissioner
GEORGE BECKER, Commissioner
STEPHEN D. BRYEN, Commissioner
JUNE TEUFEL DREYER, Commissioner
ROBERT F. ELLSWORTH, Commissioner
PATRICK A. MULLOY, Commissioner
WILLIAM A. REINSCH, Commissioner
MICHAEL R. WESSEL, Commissioner
LARRY M. WORTZEL, Commissioner

DAVID J. OHRENSTEIN, *Executive Director*
KATHLEEN J. MICHELS, *Associate Director*

The Commission was created in October 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 sec. 1238, Public Law 106–398, 114 STAT. 1654A–334 (2000) (codified at 22 U.S.C. sec. 7002 (2001)), as amended, and the "Consolidated Appropriations Resolution of 2003," Public Law 108–7, dated February 20, 2003. Public Law 108–7 changed the Commission's title to U.S.-China Economic and Security Review Commission.

The Commission's full charter is available via the World Wide Web: http://www.uscc.gov.

The Commission's Statutory Mandate begins on page 79.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

MAY 21, 2004

The Honorable TED STEVENS,
President Pro Tempore of the U.S. Senate, Washington, D.C. 20510
The Honorable J. DENNIS HASTERT,
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the record of our April 16, 2004 hearing on "***China's Presence in the Global Capital Markets***."

This hearing addresses the charge in our mandate to examine "Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests." This is a cutting-edge element of our broader look at the U.S.-China economic relationship.

At this hearing the Commission heard testimony from two panels of witnesses on the goals, methods and implications of Chinese firms' use of global debt and equity markets to raise capital. Witnesses expressed particular concern about the governance and transparency of Chinese enterprises listing on U.S. exchanges. Recently, these listings have come under increased scrutiny in light of the Securities and Exchange Commission's investigation into China Life's accounting irregularities and a trade secret theft and patent infringement suit brought in U.S. courts against Semiconductor Manufacturing International Corporation, two Chinese firms listed on the New York Stock Exchange. However, despite mounting investor apprehension, China's outreach to international capital markets continues to grow in size and frequency, with some analysts forecasting the volume of Chinese company initial public offerings (IPOs) in the global markets to be as high as $23 billion for 2004.

Accessing international capital markets is an important component of China's economic development strategy. Notably, despite the fact that Chinese private firms account for roughly 60 percent of the country's GDP, the Chinese government has permitted state-owned enterprises (SOEs) to launch the overwhelming majority of IPOs in global capital markets. Chinese SOEs listing on global capital markets generally remain under the control of the Chinese government whose corporate governance and disclosure practices differ significantly from U.S. norms. With billions of dollars in U.S. investor funds being attracted by these firms, it is vital to understand whether U.S. investors are being provided adequate information about these firms' governance and financial performance, and whether U.S. regulatory requirements are sufficient to capture this concern.

The Commission also heard testimony about potential linkages between listed Chinese firms and China's defense-industrial complex and weapons proliferation activities. Such security-sensitive activities could constitute a material risk to investors because of the possible negative impact on the share value and reputations of these enterprises. More fundamentally, the Commission is concerned about whether the U.S. Government is sufficiently monitoring this nexus and focused on the potential security implications.

The Commission will provide a comprehensive analysis of this issue, along with recommendations for Congressional action, as part of its upcoming report to the Congress.

Sincerely,



Roger W. Robinson, Jr.
Chairman



C. Richard D'Amato
Vice Chairman

CONTENTS

Page

FRIDAY, APRIL 16, 2004

CHINA'S PRESENCE IN THE GLOBAL CAPITAL MARKETS

Opening remarks of Chairman Roger W. Robinson, Jr. 1
Prepared statement 3
Opening remarks of Vice Chairman C. Richard D'Amato 7
Prepared statement 8
Opening remarks of Commissioner Michael R. Wessel, Hearing Co-Chair 32

PANEL I: TRENDS AND KEY IPOS

Statement of Pieter Bottelier, Adjunct Professor, Johns Hopkins University (SAIS) and Georgetown University 9
Prepared statement 12
Statement of William Gamble, Founder and President, Emerging Market Strategies Company 17
Prepared statement 19
Statement of Timothy P. Halter, Managing Director, USX China Index 24
Prepared statement 27
Statement of Amit Tandon, Managing Director, New York Global Securities, Inc. 28
Prepared statement 30
Panel I Discussion, Questions and Answers 32

PANEL II: CORPORATE GOVERNANCE AND INVESTOR CONCERNS

Statement of Nell Minow, Founder and Editor, The Corporate Library 48
Statement of Norman A. Bailey, Senior Fellow, Potomac Foundation, former Special Assistant to the President and Senior Director of International Economic Affairs at the National Security Council 51
Prepared statement 54
Statement of Thomas J. Byrne, Vice President and Senior Credit Officer, Financial Institutions and Sovereign Risk Group, Moody's Investors Service 55
Prepared statement 58
Statement of Jeffrey L. Fiedler, President, Food and Allied Service Trades Department, AFL–CIO (FAST) 61
Prepared statement 63
Panel II Discussion, Questions and Answers 66

CHINA'S PRESENCE IN THE GLOBAL CAPITAL MARKETS

FRIDAY, APRIL 16, 2004

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION,
Washington, D.C.

The Commission met in Room SD–138, Dirksen Senate Office Building, Washington, D.C. at 10:00 a.m., Chairman Roger W. Robinson, Jr. and Commissioner Michael R. Wessel (Hearing Co-Chairs), presiding.

OPENING REMARKS OF CHAIRMAN ROGER W. ROBINSON, JR.

Chairman ROBINSON. On behalf of the U.S.-China Economic and Security Review Commission, I'd like to welcome you to today's public hearing, the Commission's final hearing of its 2003–2004 reporting cycle. During the past ten months, the Commission has convened ten hearings including field hearings in Columbia, South Carolina and San Diego, California.

We're currently in the process of compiling the findings and recommendations related to our work over the past year in our Annual Report to the Congress which will be released next month.

Our focus today is on the cutting-edge issue of China's presence in the global capital markets and the implications for U.S. investors, market regulators and more broadly U.S. security interests.

In setting out our mandate, the Congress took a broad view of the economic and security issues associated with the U.S.-China relationship. Our charge is to examine, quote, "Chinese access to and use of United States capital markets." It demonstrates that Congress recognizes that U.S. investor funding of Chinese firms through our capital markets has become a substantial component of the U.S.-China economic relationship.

Moreover, our mandated requirement to evaluate whether existing capital market disclosure and transparency rules are adequate to identify for investors any Chinese firms conducting or involved in activities harmful to U.S. security interests demonstrates Congressional concern about the identities and operations of certain Chinese firms accessing our markets.

As China's economy has grown and restructured, the Chinese government has recognized the importance of reaching out to the international capital markets. These listings open the door to an important pool of capital for Chinese enterprises, enhance the reputation of the firms involved, and could serve to advance economic reform by subjecting listing firms to intensified financial scrutiny and discipline.

The Chinese government has the final say over which Chinese enterprises will be permitted to list on international capital mar-

kets, and to date has reserved this privilege almost exclusively for state-owned enterprises. The number of Chinese initial public offerings in international capital markets is sharply on the rise this year with some market analysts forecasting the volume for 2004 to exceed $23 billion.

This development has important implications for U.S. interests. Chinese state-owned enterprises listing on international capital markets remain under the control of the Chinese government and play by corporate governance and transparency rules vastly different from U.S. norms.

With billions of dollars in U.S. investor funds being attracted by these firms, it's vital to understand whether U.S. investors are being provided adequate information about their governance and financial performance and whether U.S. regulatory requirements are sufficient to capture this concern.

As reflected in our Congressional mandate, the Commission also continues to be concerned about the potential linkages between Chinese firms and China's defense industrial complex and weapons proliferation activities.

At a minimum, U.S. investors should be given adequate information about such activities in order to make more informed decisions as to whether they want to fund such companies.

Such security sensitive activities could also constitute a material risk to investors because of the possible negative impact on share value and the reputations of these firms.

More fundamentally, the Commission is concerned about whether the U.S. Government is sufficiently monitoring this nexus and focused on the potential security implications.

The goal of today's inquiry is to hear a variety of perspectives on the objectives, methods and implications of Chinese firms' use of global debt and equity markets to raise capital, particularly our own.

This hearing takes place at a time of growing concern over corporate governance and transparency of Chinese enterprises in the wake of several high profile listings that have come under scrutiny.

For example, the U.S. Securities and Exchange Commission recently announced a probe into the New York Stock Exchange listed China Life's accounting irregularities and a trade secret theft and patent infringement suit has been brought in U.S. courts against New York Stock Exchange listed Semiconductor Manufacturing International Corp.

These cases appear to have cooled investors' appetite for Chinese IPOs, at least in the short run.

Our opening panel will provide the Commission with an assessment of the trajectory of China's presence in global capital markets. We will hear from Professor Pieter Bottelier, Adjunct Professor at John Hopkins School of Advanced International Studies and Georgetown; and William Gamble, author of *Investing in China: Legal, Financial and Regulatory Risk*, who will discuss China's capital needs and the role the U.S. and international capital markets have played and are likely to play in the future in addressing those needs. Tim Halter of USX China Index and Amit Tandon of New York Global Securities will round out the panel with an explanation of what criteria are often used when selecting Chinese enterprises for listings in global capital markets, how the

performance of Chinese companies is quantified and which Chinese IPOs are on the horizon.

During our second panel, we'll be exploring in-depth the corporate governance and other investor concerns that arise in the context of Chinese firms accessing our capital markets. Thomas Byrne, a Vice President and Senior Analyst on China at Moody's, will explain the unique aspects and challenges of rating Chinese equity and bond issues. Nell Minow, Founder and Editor of the Corporate Library, and Jeffrey Fielder, President of the Food and Allied Service Trades Department at the AFL–CIO, will discuss China's corporate governance and accounting standards, how they compare to U.S. standards, and what the implications are for U.S. investors.

Norman Bailey is a Senior Fellow for the Potomac Foundation and served as a Senior Director of International Economic Affairs at the National Security Council during the Reagan Administration from 1981 to '83. Dr. Bailey will share his views on some of the national security implications of China's presence in global capital markets.

When the Commission held its first hearing on this topic in December 2001, it was, to my knowledge, the first time that a U.S. Government body had publicly examined this emerging area of security risk. The Commission recognizes its leadership responsibility in this issue portfolio and will continue to evaluate this crucial component of U.S.-China relations for the benefit of the Congress and the American people.

With that introduction, I'd like to make just a quick comment prior to turning the proceedings over to our Vice Chairman Dick D'Amato for his opening statement. I would just point out that we did extend invitations to the Securities and Exchange Commission and the Department of Treasury to be with us as a first government panel today, but both agencies declined.

With that, I'd like to turn to Vice Chairman D'Amato for his opening remarks and then we'll turn to you gentlemen. Thank you.

[The statement follows:]

Prepared Statement of Chairman Roger W. Robinson, Jr.

On behalf of the U.S.-China Economic and Security Review Commission, I would like to welcome you to today's public hearing, the Commission's final hearing of its 2003–2004 reporting cycle. During the past 10 months, the Commission has convened ten hearings, including field hearings in Columbia, South Carolina and San Diego, California. We are currently in the process of compiling the findings and recommendations related to our work over the past year in our Annual Report to the Congress, which will be released next month.

Our focus today is on the cutting-edge issue of China's presence in the global capital markets, and the implications for U.S. investors, market regulators and, more broadly, U.S. security interests.

In setting out our mandate, the Congress took a broad view of the economic and security issues associated with the U.S.-China relationship. Our charge to examine, "Chinese access to, and use of United States capital markets," demonstrates Congress' recognition that U.S. investor funding of Chinese firms through our capital markets has become a substantial component of the U.S.-China economic relationship. Moreover, our mandated requirement to evaluate whether existing capital market disclosure and transparency rules are adequate to identify for investors any Chinese firms conducting, or involved in, activities harmful to U.S. security interests demonstrates Congressional concern about the identities and operations of certain Chinese firms accessing our markets.

As China's economy has grown and restructured, the Chinese government has recognized the importance of reaching out to the international capital markets. These

listings open the door to an important pool of capital for Chinese enterprises, enhance the reputation of the firms involved, and could serve to advance economic reforms by subjecting listing firms to intensified financial scrutiny and discipline. The Chinese government has the final say over which Chinese enterprises will be permitted to list on international capital markets, and to date has reserved this privilege almost exclusively for state-owned companies [Appendix 1, attached]. The number of Chinese initial public offerings (IPOs) in international capital markets is sharply on the rise this year, with some market analysts forecasting the volume for 2004 to exceed $23 billion [Appendix 2, attached].

This development has important implications for U.S. interests. Chinese state-owned enterprises listing on international capital markets generally remain under the control of the Chinese government and play by corporate governance and transparency rules vastly different from U.S. norms. With billions of dollars in U.S. investor funds being attracted by these firms, it is vital to understand whether U.S. investors are being provided adequate information about their governance and financial performance, and whether U.S. regulatory requirements are sufficient to capture this concern.

As reflected in our Congressional mandate, the Commission also continues to be concerned about the potential linkages between listed Chinese firms and China's defense-industrial complex and weapons proliferation activities. At a minimum, U.S. investors should be given adequate information about such activities in order to make more informed decisions as to whether they want to fund such companies. Such security-sensitive activities could also constitute a material risk to investors because of the possible negative impact on the share value and reputations of these enterprises. More fundamentally, the Commission is concerned about whether the U.S. Government is sufficiently monitoring this nexus and focused on the potential security implications.

The goal of today's inquiry is to hear a variety of perspectives on the goals, methods and implications of Chinese firms' use of global debt and equity markets to raise capital, particularly our own. This hearing takes place at a time of growing concerns over the governance and transparency of Chinese enterprises in the wake of several high-profile listings that have come under scrutiny. For example, the U.S. Securities and Exchange Commission recently announced a probe into New York Stock Exchange (NYSE)-listed China Life's accounting irregularities and a trade secret theft and patent infringement suit has been brought in U.S. courts against NYSE-listed Semiconductor Manufacturing International Corp. (SMIC). These cases appear to have cooled investors' appetite for Chinese IPOs, at least in the short-term.

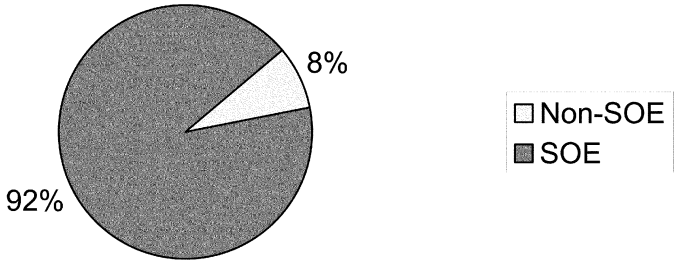
Our opening panel will provide the Commission with an assessment of the trajectory of China's presence in the global capital markets. We will hear from Professor Pieter Bottelier, Adjunct Professor at Johns Hopkins School of Advanced International Studies and Georgetown, and William Gamble, author of "Investing in China: Legal, Financial and Regulatory Risk," who will discuss China's capital needs and the role the U.S. and international capital markets have played—and are likely to play in the future—in addressing these needs. Tim Halter, of USX China Index, and Amit Tandon, of New York Global Securities will round out the panel with an explanation of what criteria are most often used when selecting Chinese enterprises for listings in global capital markets, how the performance of Chinese companies is quantified and which key Chinese IPO's are on the horizon.

During our second panel, we will explore in-depth the corporate governance and other investor concerns that arise in the context of Chinese firms accessing our capital markets. Thomas Byrne, a Vice President and Senior Analyst on China at Moody's, will explain the unique aspects and challenges of rating Chinese equity and bond issues. Nell Minow, Founder and Editor of The Corporate Library, and Jeffrey Fieder, President of the Food and Allied Service Trades Department (FAST) at the AFL–CIO, will discuss China's corporate governance and accounting standards, how they compare to U.S. standards, and what the implications are for U.S. investors. Norman Bailey is a Senior Fellow for the Potomac Foundation and served as Senior Director of International Economic Affairs at the National Security Council during the Reagan Administration from 1981 to 1983. Mr. Bailey will share his views on some of the national security implications of China's presence in global capital markets.

When the Commission held its first hearing on this topic in December 2001, it was, to my knowledge, the first time that a U.S. Government body had publicly examined this emerging area of security risk. The Commission recognizes its leadership responsibility in this issue portfolio and will continue to evaluate this crucial component of U.S.-China relations for the benefit of the Congress and the American people. With that introduction, I would like to turn to our first panel.

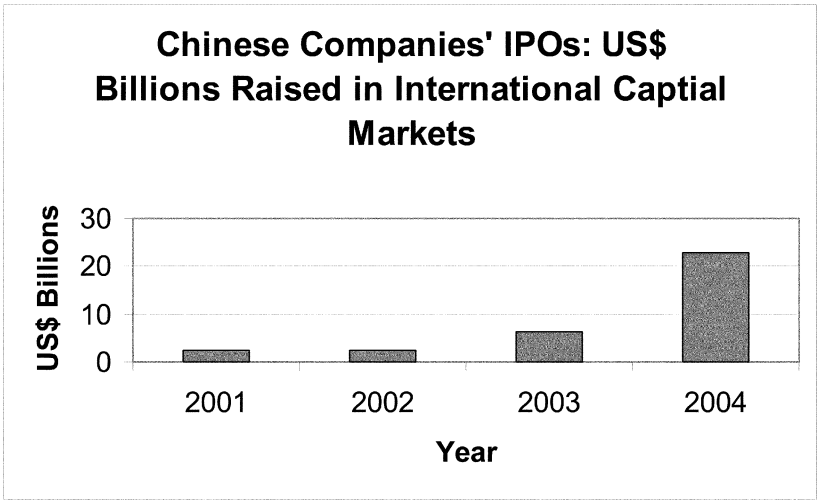
APPENDIX 1

Percentage of State-Owned v. Private Chinese Companies listed in the U.S.



SOURCE: USCC

APPENDIX 2



SOURCES: 2001-2003 Dealogic
2004 Reuters (projection)

OPENING REMARKS OF VICE CHAIRMAN C. RICHARD D'AMATO

Vice Chairman D'AMATO. Thank you very much, Mr. Chairman. And I would like to thank Chairman Robinson for focusing the Commission's attention on this important topic. I welcome today's panelists for offering your informed perspectives on this issue to the Commission.

As the Chairman discussed, the economic and security challenges for the United States stemming from China's incursion into the global capital markets is certainly one of the most unique issues in our mandate from the Congress.

The vast majority of the United States' listed Chinese enterprises, 92 percent of them are owned and operated by the Chinese state. This is in contrast to the fact that only 25 percent of the productive capacity of China is actually conducted by SOEs. So, there's a discrepancy between those firms who are state-owned and non-state-owned as to their incursion into the United States capital markets.

Questionable corporate governance, accounting practices and minority shareholder rights make this a subject of particular concern to the Congress. These issues have significant implications for U.S. investors looking to purchase stock in Chinese firms as well as financial analysts tasked with unraveling Chinese companies' complex web of relationships and finances.

These facts raise questions about the suitability of Chinese debt and equity listings in the United States' marketplace, and so-called "China funds," mutual funds focused on investing in China securities. I am concerned that U.S. investors do not have sufficient information to make informed decisions about the risk of these investments.

Furthermore, the possible links between listed state-run firms and China's military industrial complex has heretofore lacked comprehensive examination.

Is China using access to U.S. capital markets as a supplemental budget mechanism? Do investors in the United States know they're taking mutual fund positions that amount to financing the government of China?

What are SOEs? They are state-owned enterprises, economic units of the Chinese government. Mr. Chairman, in a perverse way, this is genius. Here is a real suggestion to our Congressional budget committees. Here is an idea for our appropriations committees. Here is a way to get at our budget deficit. Senator Byrd will be fascinated.

Let's float a stock in the United States Defense Department on the Shanghai stock exchange. Let's say an IPO for $10 billion. There goes two months of spending to keep us alive in Iraq. How much can we get for the dredging program at EPA? How about 10 percent of our veterans hospitals? How about 15 percent of the Brooklyn Bridge?

Mr. Chairman, SOEs are not transparent and they are not accountable. It is nearly impossible to perform proper due diligence for investors. It gets worse when the due diligence for mutual funds, which pack in more and more SOEs, is done by unknown consulting firms in Hong Kong, paid for by the mutual funds.

Is the SEC protecting the average grocer from Des Moines who buys the new Asia fund or the new China fund and gets shoddy due diligence on non-transparent economic units of the Chinese government? Are they fattening their cash accounts at our expense?

The trainload of new big IPOs coming down the track. Of Chinese SOEs, I think is heading over a rickety bridge. I resist the idea of U.S. investors buying pieces of Chinese Brooklyn Bridges and who knows what else because of Wall Street broker hype. I fear that Wall Street firms that brought us the high-tech bubble are now fast creating a new China bubble.

We need to, at a minimum, shine a big new spotlight on how to perform proper due diligence on Chinese SOEs and we have to do it fast. I would ask whether a pause in this process is advisable before we have yet another financial scandal in our markets? Taken together, all this suggests that China's need to finance its economic expansion and support its state-owned enterprises with United States investors' money demands the full attention of the United States Government.

I thank you, Mr. Chairman. I also want to commend my colleague, Commissioner Mike Wessel for his work on this hearing and in this area over the last year. Thank you, Mr. Chairman.

[The statement follows:]

Prepared Statement of Vice Chairman C. Richard D'Amato

I would like to thank Chairman Robinson for focusing the Commission's attention on the important topic before us, and today's panelists for offering their informed perspectives on this issue. As the Chairman discussed, the economic and security challenges for the United States stemming from China's incursion to the global capital markets is certainly one of the most unique issues in our mandate from Congress.

The vast majority of U.S.-listed Chinese enterprises—92 percent—are owned and operated by the Chinese state. Questionable corporate governance, accounting practices, and minority shareholder rights make this a subject of particular concern to the Congress. These issues have significant implications for U.S. investors looking to purchase stock in Chinese firms, as well as financial analysts tasked with unraveling Chinese companies' complex web of relationships and finances. These facts raise questions about the suitability of Chinese debt and equity listings in the U.S. markets, and so called "China funds"—mutual funds focused on investing in China securities. I am concerned that U.S. investors may not have sufficient information to make informed decisions about the risk of these investments. Furthermore, the possible links between listed state-run firms and China's military industrial complex has here-to-for lacked comprehensive examination.

Is China using access to U.S. capital markets as a supplemental budget mechanism? Do investors in the U.S. know they are being lured into mutual fund positions that amount to financing the government of China? What are SOE's? They are state-owned enterprises, economic units of the Chinese government.

Mr. Chairman, in a perverse way, this is genius. Here is a real suggestion to our Congressional Budget Committees, here is an idea for our Appropriations Committees. Here is a way to get at our budget deficit. Senator Byrd will be fascinated. Let's float stock in the U.S. Defense Department on the Shanghai stock exchange, lets say an IPO for $10 billion. There goes two months of spending to keep us in Iraq. How much can we get for the dredging program at EPA? How about 10 percent of our Veterans hospitals? How about 15 percent of the Brooklyn Bridge?

Mr. Chairman, SOE's are not transparent or accountable. It is nearly impossible to perform proper due diligence for investors. It gets worse when the due diligence for mutual funds, which pack in more and more SOE's, is done by unknown consulting firms in Hong Kong, paid by the mutual funds. Is the SEC protecting the average grocer from Des Moines who buys into the new "Asia fund" or "China Buckaroo fund" and gets shoddy due diligence on nontransparent economic units of

the Chinese government? Are they fattening their cash accounts at our expense? This trainload of new big IPO's of Chinese SOE's is heading over a rickety bridge.

I resist the idea of U.S. investors buying pieces of Chinese Brooklyn Bridges, and who knows what else, because of Wall Street broker hype. I fear the Wall Street crowd that brought us the hi-tech bubble is now fast creating a new China bubble.

We need to, at a minimum, shine a big new spotlight on how to perform proper due diligence on Chinese SOE's, and fast. I would ask whether a pause in this process is advisable before we have yet another financial scandal in our markets.

Taken together, all this suggests that China's need to finance its economic expansion and support its state-owned enterprises with U.S. investors money demands the full attention of the U.S. Government.

I would also join the Chairman in noting that today marks the end of what has been a diverse and prolific public hearing schedule for the Commission over the past year of our 2003–2004 reporting cycle. We held 10 hearings touching on a variety of economic and security related topics as mandated in our Congressional charter. Security issues ranged from China's military modernization efforts, cross-Strait relations, and China's involvement in the North Korea nuclear crisis. On the economic side, we examined issues such as China's industrial, investment and exchange rate policies, its progress in meeting its WTO commitments, and the implications of all this for the U.S. economy, particularly the hard hit U.S. manufacturing sector. Today, we are continuing our discussion of China's economic policies, specifically, China's presence in global capital markets. Taken together we believe these activities have established a solid foundation upon which to transmit our second Annual Report to Congress, due out next month.

Chairman ROBINSON. Thank you, Vice Chairman D'Amato. I would like to point out and second the fact that Commissioner Mike Wessel is Co-Chairman of the Capital Markets Working Group of the Commission that was formed in our first year of operation, and is Co-Chair of today's hearing. Because of the two-panel nature of the proceedings, I've been given the responsibility to administer things today, but he's very much been part of the preparation of this hearing and is on an ongoing basis the other Commissioner that has been taking the leadership position on this particular issue.

I'd like to note on the rules side that we're providing seven minutes for your opening statements. We have a little bit of latitude there, but we do have quite a full agenda for our two-panel discussion today, and five minutes for each of our Commissioners for questions and answers. I thought that in terms of order, I might go forward with the order that was outlined in my opening statement with Professor Bottelier leading off, followed by Mr. Gamble and then Mr. Halter and finally Mr. Tandon.

I also made the unconscionable error of referring to your association, dare I say this, as John Hopkins. Of course, it's Johns Hopkins. I know people have taken a tongue lashing for that before, and I don't want to be among them. So, with that, Professor Bottelier, thank you for kicking off our session.

PANEL I: TRENDS AND KEY IPOS

STATEMENT OF PIETER BOTTELIER
ADJUNCT PROFESSOR, JOHNS HOPKINS UNIVERSITY (SAIS) AND GEORGETOWN UNIVERSITY

Mr. BOTTELIER. Thank you, Mr. Chairman. My comments will be focused mainly on the background to the issues that you have put on the table, the governance issues, the regulatory issues, and I will focus on two aspects of the background. One is the domestic financial system in China, and secondly, at the macro level, is the

interaction between China's financial system and the global financial system, in particular, the U.S.

China's financial system could perhaps best be characterized as a work in progress. The financial system is dominated by banks in China. That is because the domestic bond markets and the domestic equity markets, though growing very rapidly, are still very small. So we really have to look at the banking system as the main part of the domestic financial system in China.

That banking system is a relatively new one. Only in 1984 did the current large state-owned commercial banks emerge from the central bank as separate agencies. Prior to that, China essentially had a mono-bank system. In the initial 10, 15 years of China's reform, the government used the banks primarily as fiscal agents of the state. They were responsible for the preservation of the urban employment through the state enterprise system in order to protect social stability, and they succeeded in doing that.

I think China maintained fuller urban employment and social stability for a much longer period than would have been possible if they had reformed the banking system on market principles very early like some other transition economies did.

So that's an achievement in some way, but the cost of that achievement was to accumulation of a huge problem in the form of non-performing loans on the balance sheets of these banks. This problem was not fully recognized by the authorities until the late 1990s. It was essentially hidden, but it was forced into the open by the Asian financial crisis of 1997 and 1998. It shocked the leadership into accepting the reality of their situation.

The collapse of the financial system in South Korea, I think, in November of that year did more than anything to wake them up to the realities of the NPL problem, and they began to recognize it and began to do things about it, partial recapitalization, the formation of state asset management companies in order to offload the NPLs through special system. There were also clear indications that pressure was put on the banks to begin to behave as banks and not just as fiscal agents.

That process is still going on today and will take several more years. The commitments that China has made to the WTO on the financial sector have very far-reaching consequences for China, for the world, because essentially the Chinese have agreed to integrate their domestic financial system with the global financial system by opening up very significantly on the banking side, the insurance side, the financial services side, fund management, et cetera.

The biggest challenge that lies ahead now for the United States and other WTO member countries is to ensure that this process of integration between China's financial system and the global financial system continues as smoothly as possible. If it goes wrong, if there should be a financial crisis in China for whatever reason, the consequences could be extremely serious and would undoubtedly also have major adverse consequences for the United States.

The domestic financial system is, as I mentioned, dominated by banks. It is important to mention that the stock exchanges have developed very quickly since 1990 when they opened for business, December 1990. It's an unusual kind of system that the Chinese have, in the sense that, as you mentioned yourself Mr. Chairman,

the vast majority of the enterprises are, in fact, state owned, and only a limited number of companies are listed are private. The other peculiar aspect is that listed enterprises typically only sell about one-third of the shares issued.

So about two-thirds of the shares are effectively non-tradable, except for the legal person shares (about half of the state's shares), which are not owned by the state itself but by agents of the state, normally holding companies. And increasingly, we find that the legal person shares, with the permission of Beijing, are being sold, not on the exchanges, but outside the exchanges, leading to a two-thirds privatization of a rapidly growing number of state-owned enterprises.

Well over 200 of the state-owned enterprises have, in fact, been privatized through the backdoor in this way over the past few years. So the number of 92 percent that was quoted in one of the introductory statements is probably slightly out of date now.

China's interaction with international capital markets is an extremely interesting and important subject. In theory, at the macroeconomic level, the Chinese should be able to finance all their investments from domestic savings, because they have been a net exporter of savings since 1994. Yet, of course, as we all know, they have made heavy use of the financial, international financial capital markets. For example, they've imported more than $500 billion worth of foreign direct investment. Most of it is in equity form.

They've also accessed international bond markets and have sold some NPLs on the international market. The vast majority of NPLs that they have been marketed by the four AMCs have been absorbed internally in China in various ways, debt equity swaps, debt write-offs.

Only a small amount of NPLs so far have been sold internationally. The only AMC that has been able to do that is Huarong, one of the four. Their first international auction of NPLs about two years ago was actually relatively successful. Their second auction in December of last year, however, was a total flop and resulted in few sales. In fact, 16 of the 25 bidders who appeared walked out in dissatisfaction of the quality of the documentation that had been made available to them.

China has borrowed in international capital markets, but the total amount of China's government (sovereign) debt is very limited. It's probably no more than about $50–60 billion. China's total external debt is slightly below $200 million, which is a modest amount relative to China's GDP.

Chairman ROBINSON. Billion?

Mr. BOTTELIER. Billion. The debt service on that amount is very light, less than 10 percent and declining. So the Chinese have, in fact, borrowed very responsibly. In 1998, they cut off the irresponsible borrowing that was still going on at that time by allowing one of the state banks in Guandong GITIC to go bankrupt, thereby signaling to domestic banks that they could not borrow without Beijing's permission, and signaling to the external providers of funds that they had to do better due diligence and make out what is a state guaranteed loan and what is not.

IPOs. China has raised the bulk of the money for corporate financing through the stock markets domestically, but in recent

years, particularly since 2000, have become very active in the international markets. In the early '90s, they limited themselves mostly to Hong Kong, but later began to issue also in New York and a few other exchanges.

They're now considering to open up London as a significant channel, but they haven't actually done so so far.

According to my information from the beginning of 2000 through the middle of March of this year, they have raised $24 billion through international IPOs, mostly in Hong Kong and New York, and a little more, namely 26 billion through domestic IPOs. The number of domestic IPOs is far larger than the international IPOs and the amount per issue is, of course, much smaller.

The single largest issue recently has been that of China Life, and as you mentioned Mr. Chairman, that's under scrutiny by the Securities and Exchange Commission.

I'm not an expert in securities trading in this country, Mr. Chairman, but as an economist, I am of the opinion that the existing regulatory agencies and the market can take care of scrutinizing the issue of Chinese paper on the U.S. market. The indication is, as you mentioned, that the market has cooled down significantly in response to the difficulties over SMIC and the announcement that the SEC was looking into China Life. The existing regulatory framework is adequate to deal with the situation, and the market can be relied upon to ration China's access to international capital markets.

Thank you.

[The statement follows:]

Statement of Pieter Bottelier
Adjunct Professor, Johns Hopkins University (SAIS) and Georgetown University

China's Domestic Capital Markets and Interaction with International Capital Markets [1]

The setting.

1. China's financial system is a "work in progress." Perhaps the greatest challenge is the integration of China's system with that of the developed nations, including the U.S. If this process is not well managed, e.g. if domestic financial markets in China or international capital transactions are liberalized prematurely, major problems could develop. A financial crisis in China would have significant negative side effects on the U.S. economy and put the completion of China's market reforms under WTO principles at risk.

2. Financial sector reform in China has become a top priority of the Government in recent years, particularly in light of commitments that were made upon China's accession to the WTO, December 2001. Sectoral policy changes and institutional developments, including new legislation and regulations, are unfolding at a fast pace. It is very difficult for any outside observer to be fully informed on all current developments.

Brief history of banking reform and key facts on China's external and internal debt, including NPLs.

- China had a mono bank system until 1984.
- In 1984 the responsibility for SOE financing was shifted from the budget to four newly created state-owned commercial banks (lifted out of the Central Bank), which served essentially as de-facto fiscal agents of the State until the early or mid-1990s.
- By allowing the State sector to continue expanding output and employment through easy access to State bank credit (until about 1995), China preserved

[1] A list of acronyms used in this statement is included at the end.

full urban employment and growth dynamics throughout the initial stages of its economic transformation, but in doing so, also created the NPL problem.

- Because of this unique sequencing of reforms, the modernization of China's financial sector lagged significantly behind reforms in the real economy.
- The seriousness of the NPL problem was not fully recognized by China's leadership until the Asian financial crisis of 1997/8.
- China began to take serious measures to address the problem in 1998/9, including a limited initial recapitalization ($32 bn in '98), the creation of 4 AMCs in '98 and the transfer of $169 bn worth of "old" (pre-1996) NPLs to the AMCs in '99.
- Even today, China's State banks are still struggling to become real banks.
- Banking reform is now a top priority of the Government in light of the far reaching commitments that China made as part of its WTO entry conditions and the pressure of time. The time table for final reforms is extremely tight: China's banking sector will be fully open to foreign competition from January 2007.
- The Government is now racing to get its two best performing commercial banks (CCB and BOC) fully recapitalized and ready for listing (partial privatization), probably in 2004 and 2005. The other two big state commercial banks (ICBC and ABC) are tentatively scheduled for full recapitalization and listing in 2006 and 2007. The Government will probably retain majority ownership, at least initially, in all four of these banks and try to sell part of the shares internationally.
- A major struggle has ensued over *how to share* the NPL burden between the owner of the banks (Central Government) and other creditors, local Governments, the debtors themselves (SOEs), and the Central Bank (which allocated $45 bn from official reserves to CCB and BOC on 12/31/03).
- Although the officially reported NPL ratio of the four big state commercial banks has come down significantly in recent years (to 15.2% at the end of 2003), the absolute amount of NPLs remaining on the books of State banks is still very large (about $200 billion). To this should be added the NPLs remaining on the books of AMCs and the likelihood that a wave of new NPLs will emerge as a result of the extremely high rate of credit expansion since the beginning of 2003.
- Only a small portion of China's NPLs has been sold to international buyers. The bulk is being recycled domestically (through discount sales, debt/equity swaps, debt rescheduling and debt write offs). If China could sell more NPLs abroad, it would.
- The first international Huarong NPL auction (2001) was a qualified success. The average cash return rate was 21%. The auction also led to the establishment of two China/foreign JVs to engage in NPL resolution (Huarong/Goldman Sachs and Huarong/Morgan Stanley DW).
- The second international Huarong NPL auction (December 2003) was a flop. Sixteen of the 25 bidders walked out; 5 of the 22 NPL lots received no bids at all and the cash return on 3 acceptable bids was only about 10%. This will make it much harder for China to market NPLs internationally in future.
- China's official domestic State debt is rapidly growing, but still *relatively* modest in size—about 17% GDP. However, total contingent and non-official State debt (including NPLs) is much larger, perhaps 100% of GDP or more.
- China's external debt is well managed and *relatively* modest in size ($193.6 bn at the end of 2003, or about 15% of GDP). It has a sound maturity structure and the debt service ratio is low (about 10% and declining).
- Unauthorized external borrowing by State agencies was substantially brought under control when the Government allowed GITIC to go bankrupt in 1998, signaling to foreign creditors *and* domestic agencies of the State that foreign loans are not automatically guaranteed by the Central Government. Many TICs have since been closed.
- In spite of the financial weakness of China's State banks, the banking system is essentially stable, because of the banks' high liquidity ratio and the implicit State guarantee for household deposits, which are the banks' main financial resource.

State bank lending to domestic private borrowers; inward and outward FDI.

- Domestic private companies had little or no access to China's State banks for investment credit or working capital, until recently. They were mostly dependent on own capital, "back-alley banking" and FDI.

- The record levels of FDI that entered China since the early 1990s (the accumulated total is now over $500 billion) point to China's attractiveness for foreign investors, but also to the problems in domestic financial intermediation.
- If domestic non-State enterprises had had full access to domestic credit and equity capital, the levels of FDI flowing into China would have been considerably lower.
- The domestic financial intermediation problems were partly due to "cultural" factors—the private sector wasn't trusted in China—and partly to institutional factors—State banks had, until very recently, no incentives to lend to private entrepreneurs, because of high transaction costs and State interest rate controls. Moreover, private companies often did not have acceptable collateral for bank loans.
- These problems are only gradually being resolved. In recent years, State bank lending for mortgages, including private mortgages and consumer loans, has grown faster than traditional lending to SOEs. The Constitutional amendment of March 2004 recognizing private property rights as equal to State property rights, has in principle solved the collateral problem.
- Greater State bank freedom in setting interest rates—the margins were widened on January 1, 2004—will probably lead to a significant expansion of State bank lending to domestic private companies.
- In recent years China has become more active as an investor on other countries. Chinese enterprises have invested in the U.S., Australia, New Zealand, Peru, Brazil, Kazakhstan, and other countries (in the Middle East, Africa and Europe). Among developing countries, China is currently the largest source of outward FDI ($3–4 billion p.a. in recent years).

Brief overview of domestic capital market development.

A. Bond markets.

- The Central Government began to borrow domestically for fiscal purposes in 1980, but domestic bond trading did not develop until the mid-1980s. Initially Government (MOF) bonds were force placed, essentially as a form of taxation, and not tradable.
- In the late 1980s the Government was embarrassed by defaults on bonds issued by several State agencies and corporations. The Government made good on many of them, but clamped down severely on new non-MOF bond issues.
- The only State bank that was allowed to issue a significant amount of bonds (almost half as much as MOF) is CDB, which also placed $500 mn worth of dollar denominated bonds on the domestic market in September 2003. This may be the start of a domestic China dollar market.
- Corporate bond issues fell sharply in the early 1990s, but started rising again in recent years. However, the corporate bond market remains small and issue rights are essentially restricted to large State-owned corporations (such as e.g. the 3G Corporation).
- All local Governments in China are supposed to balance their budgets; they do not have the right to issue bonds or borrow from banks, except for temporary cash flow management. Many local Governments nonetheless borrow, either informally, or indirectly through companies they own.
- China's local Governments are believed to be much more highly indebted than official sources indicate; almost all their debt is domestic.
- MOF bond issues climbed very steeply after 1997 as part of a fiscal stimulus plan designed to prevent sharp economic contraction in the wake of the Asian financial crisis.
- There have been relatively few international Chinese Government bond issues. Such bonds are all highly rated by U.S. rating agencies and sought after by institutional investors and portfolio managers.
- Domestic Chinese Government- and corporate bonds are traded on the two stock exchanges (mainly Shanghai), over-the-counter and, most importantly, in the interbank market.
- For the purpose of "sterilizing" part of the additional money supply resulting from unwanted "hot" money inflows since early 2003, the Central Bank has issued large amounts of short maturity bills that also trade on the interbank market.
- China's domestic bond markets have been growing very rapidly in recent years, but compared to the financial markets of more developed nations such as the U.S., they are still quite small, relatively illiquid and otherwise underdeveloped. Yield curves are unusually flat due to state interest rate controls.

- The emergence of large domestic institutional investors in recent years (pension funds, insurance companies, etc.) has added momentum to domestic debt market development in China and to the creation of many funds.

B. Equity markets and derivative trading.

- Informal SOE share issues and (authorized) OTC trading started in China in the mid-1980s.
- The Shanghai and Shenzhen stock markets started operations in December 1990, initially without Central Government supervision.
- CSRC wasn't established until October 1992, mainly in response to scandals and riots triggered by stock market irregularities. The first reasonably comprehensive Chinese Securities Law became effective in 1999.
- Still, in 2000, one of China's leading independent economists, Wu Jingliang, said that China's stock exchanges were "worse than casinos—at least casinos have rules."
- Many SOEs that were accepted for listing saw the stock market—at least initially—as a source of "free" capital. Most private buyers of stock were poorly informed, believing that the market could only go up; they had no interest in or influence on corporate governance. Nor could they have such influence, because minority share holder interests were (and still are) poorly protected.
- The number of registered stock owners in China is now over 70 million, but only about 10 million accounts are active.
- China's approach to listing has been to *partially* privatize—about one-third in most cases—SOEs, a unique approach, not found elsewhere.
- Of the approximately 1,300 companies listed at present, only about 20 are private, the rest are all SOEs (see below for additional comments on the partial privatization of SOEs).
- Shares of listed SOEs are divided into three categories, usually about one-third each: (1) tradable shares sold to the public, (2) legal person (LP) shares held by a state-owned parent company (in principle non-tradable), and (3) non-tradable State shares.
- Only about one-third of the total market capitalization of the Shanghai and Shenzhen stock markets (about $550 bn at present or about 45% of GDP) is tradable. There are some 70 million individual share holder accounts in China of which about 10 million are active.
- The sale of LP shares (with Central Government authorization) has led to the two-thirds privatization of over 200 listed SOEs during the past few years.
- The effect of the change from minority to majority non-state ownership of SOEs on corporate governance standards is believed to be significant.
- Similarly, international IPOs, even when the Government remains majority owner initially, are thought to be having a much greater positive influence on domestic corporate governance standards in China, than domestic IPOs.
- In 2001 China sold some State-owned shares to strengthen the National Social Security Fund, but the scheme failed and was abandoned, because market reactions were strongly negative. The question what to do with the State-owned shares (nominally worth about $170 billion at current market prices) remains largely unresolved.
- To stimulate domestic stock markets and upgrade corporate governance standards, China opened the domestic A-share markets to QFFIs in 2002.
- The Government announced in March that it eventually planned to close the B-share market. This would be an important step towards domestic equity market regularization and integration.
- The Hong Kong stock exchange and, to a lesser extent, the NYSE, have been important vehicles for the international marketing of Chinese shares.
- China is making progress in improving the quality of new listings and in the supervision of domestic stock markets, but much remains to be done. On paper, China's regulatory standards are now approaching those of Hong Kong.
- Corporate Government standards in general still leave much to be desired.
- To promote domestic capital market development the Government recently announced that additional forward and derivative trading vehicles would be authorized. This might also be a prelude to the flexibilization of China's exchange rate regime—traders need adequate hedging opportunities if/when the RMB is de-linked from the U.S. dollar and allowed to be traded in a wider band.

Domestic and international IPOs.

- During the four-year period 2000–2003, there were 119 international IPOs by Chinese corporations, mostly in HK, but also NY, for a total amount of $21.2 bn (average: $178 mn). See table below. The largest IPO was by China Life, late

2003, for $3.4 bn (now under preliminary investigation by the SEC for alleged accounting irregularities). Mainland China shares now account for about 30% of the Hang Seng index. The index did very well last year, mainly thanks to China stocks.

- In the same period there were 326 domestic IPOs for a total of $25 bn (average: $77 mn).
- The frenzy for China IPOs (e.g. China Green Holdings IPO in January was over-subscribed 1,600 times!) seems to have cooled recently as a result of the 9% price drop of SMIC shares (Semi-conductor Manufacturing International Corporation) and the 7% price drop of Tom Online (a Chinese Internet company) on their first day of trading in March. The Minsheng Bank Board scandal contributed to the recent cooling of market enthusiasm for international China IPOs.
- Additional international IPOs planned for 2004 include: CCB ($5 bn), China Netcom ($2 bn), Minsheng ($1 bn), China Post ($?), and Air China ($?).

Table. IPOs by Chinese Issuers from 1/1/00–3/17/04

	Chinese-Share IPOs		International IPOs[1]	
	Amount in US $	Number of deals	Amount in US $	Number of deals
2000	9,626.61	134	10,146.35	26
2001	4,413.04	59	2,327.48	29
2002	5,978.21	66	2,497.75	29
2003	5,037.60	67	6,296.43	35
2004	976.56	17	2,764.34	8

[1] The bulk of these IPOs was placed in Hong Kong and New York.
Source: Dealogic.

Concluding notes.

1. Although China has been a net-exporter of savings since 1994 (i.e. China had a current account surplus on its balance of payments every year), it has used (and needs) international capital markets to finance part of domestic investments (through FDI, international IPOs, loans from MDBs, loans from commercial banks, etc.). Since 2000, all those sources together have financed an estimated 17–20% of total investment in China. Inward FDI and IPO funds raised through foreign equity markets (including Hong Kong) account for about 11–14% of total investment. The U.S. is a relatively modest source of FDI flowing into China—generally less than 10% of annual FDI inflows. U.S. investments in China accounted for at most about 1% of total domestic investment in China during the past decade.

2. The amount of China's outward FDI has been growing rapidly in recent years, but still accounts for less than 10% of inward FDI. It is to be expected that China will become a more important source of outward FDI in the years ahead.

3. In theory China could finance all of its investments (about 40% of GDP 2003) from domestic savings, because the gross domestic savings rate (about 42% in 2003) exceeds the gross domestic investment rate. China's excess savings accumulated in the form of foreign assets. Approximately half of China's foreign exchange assets are held by the Central Bank in the form of official reserves ($403 bn at the end of 2003) on which returns are typically very modest. The other half is owned by companies or households and held in cash and numerous accounts, both inside and outside China. Most of China's foreign financial assets are held in U.S. dollar denominated instruments. China's official foreign exchange reserves are mostly invested in U.S. Treasury paper. The total amount exceeds accumulated U.S. private investment in China by a factor of 7–8.

4. The Chinese Government's large domestic contingency debt (in the form of NPLs and other components) presents a huge challenge to the authorities. In principle China could "fiscalize" this debt through the issue of long-term Government bonds. It has been reluctant to do so to any significant extent, preferring instead to solve the problem piecemeal. Whether this is the right approach, time will tell. The Chinese State does in principle command enough resources (State assets and fiscal power) to pay off the NPL-related debt and recapitalize the financial system, but it has not as yet laid out a definitive plan for this. The State realizes that the use of fiscal resources for recapitalization purposes may entail serious moral hazard problems and wishes to ensure that the State banks themselves contribute to their own capital base to the fullest extent.

5. Corporate governance standards in China remain seriously inadequate in many cases. Through tighter listing requirements, new legislation, education, better supervision of financial institution, pressure on State banks to assume full responsibility for their own bottom-line, the strengthening of regulatory agencies etc., the Government is making serious efforts to improve corporate governance standards. International pressures (e.g. through the listing requirements of foreign stock exchanges and regulatory agencies) are having a positive influence on corporate governance standards in China, but ultimately domestic factors will have a decisive influence on this.

6. There is no need for special measures to protect U.S. financial markets against the potentially adverse affects of inadequate corporate governance standards in China. Existing institutions and market forces can be relied upon to handle the challenges.

Acronyms

ABC	Agricultural Bank of China
BOC	Bank of China
CCB	China Construction Bank
CDB	China Development Bank
CSRC	China Securities Regulatory Commission
FDI	Foreign direct investment
GDP	Gross domestic product
GITIC	Guandong International Trust and Investment Company
ICBC	Industrial Credit Bank of China
IPO	Initial public offering
LP	Legal person
MDBs	Multilateral Development Banks
MOF	Ministry if Finance
NPLs	Non-performing loans
OTC	Over the counter (trading)
QFFI	Qualified foreign financial investor
RMB	Renminbi Yuan—China's national currency
SOE	State-owned enterprise
TICs	Trust and Investment Companies (state-owned)
3G	Three Gorges (Corporation)

Chairman ROBINSON. Thank you very much, Professor.

Mr. Gamble.

STATEMENT OF WILLIAM GAMBLE
FOUNDER AND PRESIDENT
EMERGING MARKET STRATEGIES COMPANY

Mr. GAMBLE. Ladies and gentlemen, this is a stock certificate. It's supposed to represent wealth, property and capital. But it's really just ink on paper. Contract—ink on paper. Patent—ink on paper. Regulations—ink on paper.

The only way to give value to this confetti is through the law. Economics is not just about capital and technological constraints. It is also about political legal institutions such as property rights, independent judiciary and timely enforcement.

In short, an economically efficient legal infrastructure. These institutions are critical determinants of sustainable economic growth and investment opportunities. The problems of the Chinese economy are systemic. The Chinese Communist Party has chosen power over the law. In the process, they have created a dysfunctional legal infrastructure where the Communist Party is above the law.

Without law, there cannot be any corporate governance, transparency, efficient capital markets, protection of foreign investors, or sustainable economic growth. When you lend or invest money, you are taking a risk, a legal risk. You are giving someone else power and control over your money. You hope and pray that one thing

will occur. You want that money back and how is this going to happen? How are you going to get repaid?

Well, there are only three ways to get that cash? There are only three ways to enforce a contract. There are only three ways to collect a debt.

The first is simple. Use force. Call in your muscle and threaten to beat up you debtor until they pay up. This is called a disincentive. It is sort of punitive; nevertheless loan sharks have made a very good business using this technique for years.

The second way involves what sociologists would call second and third-party social norms. In game theory, this is referred to as reputation. In China, it generally goes under the concept of guanxi or connections. It works like this. If you loan money to your brother-in-law, he doesn't pay it back, you sic your spouse on him. He pays the money because of another type of disincentive. He knows that if he does not, no one in the family will trust him or lend him money again. The overseas Chinese have made good business out of these connections for centuries.

You can do business using either force or reputation. People have done so throughout history. It is still going on. Most business transactions of the world and especially in China rely on force or reputation.

The problem is that although they work, they are not as efficient as the law, as a legal system. Specifically, they are not economically efficient. After all, there are only so many people you can know and only so many limbs that you can break.

The problem really becomes acute when you want to attract foreign investors. Foreign investors cannot use force and they do not have the connections to become crony capitalists. They must rely on the law, not just law, not just the rule of law. They need an economically efficient legal infrastructure. That means the entire system, the law itself, the courts, the regulators, the bar, the registries, the enforcement agencies must function. An efficient legal infrastructure requires legal and economic disincentives.

They must be sufficient to outweigh the enormous incentives to steal. Whether or not we obey these laws is a function of the probability of getting caught and the severity of the punishment. According to agency law and game theory, agents, managements, employees, and bureaucrats have a habit of acting in their own self-interest, as any shareholder of Enron, WorldCom or Parmalat will tell you. Without sufficient fear of getting caught, management can steal anything that's not nailed down.

Good corporate governance requires laws from five different categories of legal disincentives. If the legal system is weak or, as in China, non-existent, there is basically no corporate governance and no protection for foreign investors. You end up with a country full of Enron's. Transparency also relies on the law. More importantly, it relies on a fundamental right. It requires free speech and a free press.

Without a free financial press investigating management, there is no transparency. The Chinese Communist Party has no use for a free press. The government is always the largest shareholder of almost any listed company. When the press reports on bad manage-

ment, the value of the shares declines. The government loses money. They don't like that.

For the past 20 years, China has been blessed with spectacular economic growth bequeathed to it by hard work and savings of its people. Unfortunately, the Chinese Communist Party by overruling both the law and the marketplace has squandered this patrimony by an exceptionally inefficient allocation of hard-earned capital.

If you saw this morning's *Financial Times*, you'll see, first of all, how much the banking system has been reformed, and you also see exactly how much money in loans have gone out. Apparently, it's up to three trillion renminbi, which is, I guess, about $300 billion, which has financed the China boom over the last two years. The GITIC bankruptcy is the only one that's been allowed to date. I have no reason to believe any of the other ITICs are in better shape.

The recovery on the GITIC bankruptcy, as best as I can calculate, is approximately 2 percent. It is my hope that American investors and American market if given sufficient information will not suffer the same fate.

Thank you.

[The statement follows:]

Statement of William Gamble
Founder and President, Emerging Market Strategies Company

China's Presence in Global Capital Markets—
Implications for U.S. Economic and Security Interests

Economics is not just about capital and technological constraints. It is also about political-legal institutions, such as the protection of property rights and the enforcement of contracts that are critical determinants of sustainable economic growth and investment opportunities. The problems of the Chinese economy are systemic. The Chinese Communist Party has chosen power over the law. In the process they have created a dysfunctional legal infrastructure. Without an economically efficient legal system, the economy relies instead on second or third party social norms (guanxi/connections) to function. Such a system not only prevents sustainable economic growth. It fails to protect the property rights of foreign investors.

Part I
Size of the U.S. Direct Investment in China

1. What has been the amount raised by Chinese firms in the U.S. capital markets for the years 2001, 2002 and 2003?

Commercial paper, corporate bonds and convertible paper are just beginning to be issued by Chinese firms on their domestic markets. The government has $280 bn of Chinese Treasuries outstanding. Chinese firms get over 90% of their financing from the state banks. They have no reason to raise money on the bond market, because the bank loans are cheaper. Companies do not have to pay market rates. They pay the rate fixed by the government regardless of the risk. State Owned Enterprises (SOEs) are almost guaranteed loans that are almost automatically rolled over at maturity. Therefore, my response refers only to equity raised by Chinese firms in U.S. capital markets:

2001 Two listings—$1,720,700,000
2002 One listing—$1,434,200,000
2003 Two listings—$3,098,000,000

There are other Chinese ADR's listed on American stock exchanges. The total number is about 51 firms. Companies that do not list their initial public offerings (IPOs) on American exchanges, will do their IPOs in Hong Kong and then list their Hong Kong shares on U.S. markets as ADRs.

The Chinese have a large incentive to maintain their image as a preferred destination for foreign capital. The government is very careful in choosing companies

to list on U.S. exchanges. They pick large SOEs with the greatest appeal and potential. The so-called national champions are usually companies in traditionally blue chip sectors like oil, telecommunications, cars, shipping, pharmaceuticals, petrochemicals, insurance and utilities.

Despite the careful selection by the Chinese and the hype by the American financial community, Chinese stocks generally lose money. "According to *Barron's* magazine, a sister publication of the *Wall Street Journal*, of 208 offshore open-ended mutual funds focused on China in the five years to April 1st 2003, the average China fund lost 4.2% a year. A US$1,000 investment in these funds in 1998 would be worth US$807 today—not the story China wants people to hear. The five-year return for 23 U.S.-based China funds was only a slightly less miserable negative 3.7% a year, reducing an original US$1,000 investment to US$828." *China Economic Review*, April 12, 2004, available at http://www.chinaeconomicreview.com/index.php.

This should surprise no one. As we all should know by now, socialism does not work. Government owned companies in every country are badly managed. They end up patronage dumps with political rather than profit objectives.

2. How much U.S. portfolio investment goes toward Chinese firm listing on the Hong Kong stock exchange? What have been the characteristics of such firms, as compared to those listing in the U.S.?

Almost all U.S. portfolio investment goes toward Chinese firm listing on the Hong Kong stock exchange. An American investor, who wishes to purchase a Chinese stock, can purchase four types of investments: ADRs, H shares, Red Chips and B shares. The problem is that these stocks are generally issued by only one type of Chinese firm, a SOEs.

American Depositary Receipts or ADRs were first introduced onto American capital markets in 1927. It is a share of stock trading on an U.S. exchange, which represents an investment in shares of a non-U.S. corporation, which trade on a non-U.S. exchange. ADRs trade in dollars. ADRs in Chinese firms represent shares of stock listed on the Hong Kong stock exchange. Sometimes the ADRs will be sold directly on U.S. exchanges as part of an IPO. Other times the company will package shares already listed on the Hong Kong stock exchange as ADRs and begin to sell them in the U.S. Since an ADR sold in the U.S. is a "security" it is subject to U.S. jurisdiction and regulation by the SEC.

H shares and Red Chips are stocks of mainland Chinese companies traded on the Hong Kong stock exchange. The majority of their shareholders and business are in the People's Republic of China (PRC). The distinction has to do with the place of incorporation. Red Chips are incorporated in Hong Kong and are subject to Hong Kong corporate jurisdiction. Generally, Red Chips were companies that floated shares on the Hong Kong stock exchange several years ago. When mainland companies first started listing their shares on the Hong Kong stock exchange, they probably incorporated subsidiaries in Hong Kong to increase investor comfort levels. Companies issuing H shares are incorporated in the PRC.

A shares and B shares are shares of stock of companies incorporated and doing the majority of their business in the PRC. Both types of shares are traded exclusively on one of China's two stock exchanges, Shenzhen or Shanghai. In theory, A shares can be purchased only by Chinese nationals and B shares are available only for foreigners. In practice both A shares are owned by foreigners and B shares are owned by Chinese nationals.

There are 1,287 companies listed on the Chinese exchanges. With a few exceptions, they are all SOEs, even the ones that are ostensibly private. The beneficial ownership of Chinese companies can be opaque. It is usually hidden behind corporate shells, which invariably lead to a government entity. The government entity in turn is often controlled by a relative of a Chinese leader. The children of Deng Xiaoping, Li Peng, and Jiang Zemin always seem to turn up on the boards of many large companies or their beneficial owners.

Usually Chinese companies list both A shares and B shares. Chinese companies that list shares on the Hong Kong stock exchange almost always have shares listed as A shares and B shares. The B shares are the only way that an American investor can own the stock of a Chinese company that is not listed on the Hong Kong exchange. Historically B shares have traded at a huge discount to A shares, so no one owns them until recently when there have been proposals to get rid of the distinction.

Last year in order to boost the performance of the local stock markets, the central government approved the so-called Qualified Financial Institutional Investor (QFII) scheme. This scheme allows certain qualified foreign managed funds to invest more than $1bn directly into the A share market. It has not helped. Despite the growth

of the Chinese economy, stock prices did not increase and remain stuck in a 30 month-long slump.

Investors do not want to invest in these stocks, because as the name implies about 50% of an SOE is owned by a government entity. At some point in the future the government entity can dump their shares onto the market and send prices plunging.

3. What proportion of total funds raised by Chinese companies in international capital markets is raised in the U.S.?

I do not know the exact number. During recent IPOs, 5% of the new listings have been reserved for the Hong Kong exchange. The other 95% has been raised in the U.S. If you are trying to raise a couple billion dollars, obviously the largest markets are your best bet. I would guess that between 80 and 90 percent of the total funds raised by Chinese companies are raised in the U.S. Of course, this does not mean that these securities are purchased by only Americans. Investors from around the world use our markets.

To guarantee success of an offering, often a large share is purchased by a multinational as a strategic partner. For example, the American Insurance Group paid about $300 million for a 10% stake in PICC, China's largest non-life insurer before its $800 million Hong Kong IPO last year. Only ten percent of the offering was available to retail investors and the rest went to institutions. AIG also bought a 10% stake in the recent China Life listing. Alcoa purchased 8% of the Aluminum Corporation of China prior to its IPO in 2001. Royal Dutch Shell bought 20% or the CNOOC $1.2 bn IPO, which was also brought out in 2001.

4. What are the funds being raised by Chinese companies in international capital markets being used for?

No one knows. The problem has to do with the poor transparency and corporate governance, which I will discuss in part II. According to their prospectuses the money is used to pay long term debt, funding pension expansion, capital and streamlining production. My favorite is "general corporate purposes."

Recently, some of China's largest firms have been making acquisitions abroad. Most of these acquisitions are in the commodities areas to secure access to strategic materials like iron ore and oil. Undoubtedly, some of the money raised on international capital markets has been used to fund these acquisitions.

It is also true that large sums are simply stolen. For example, two months after a $3.5 bn IPO by China Life, the Chinese Audit Office uncovered illegal or irregular conduct at China Life involving Rmb5.4bn (US$652m) in funds. Exactly what was taken by whom from what company when, is at this time unknown. What is interesting is simply the size of the number quoted. Although huge, the amount is not unknown. Similar frauds that have been discovered at the "Big Four" state banks have run into the hundreds of millions.

5. What are the most significant expected future listings of Chinese firms in the near term, in the U.S. markets and elsewhere?

In the past year IPOs of Chinese stocks have done very well. They have been oversubscribed. Their prices have increased. The last time this happened was in 2000. With the economy growing at over 10%, at least for now, there are great expectations. Many commentators project that 2004 will be a good year for Chinese companies to float their shares. Estimates range from $15 bn to $30 bn. They include all sorts of companies.

Companies that have been specifically mentioned include a Hebei steelmaker, owned by China Oriental Group, Kingsoft, a government supported software house, Ping An, life insurance, airlines, telecommunications and specifically banks.

Banking in China is dominated by four huge state owned banks. Together they account for 70% of China's savings. Banks account for 90% of the capital for Chinese businesses. Virtually all of their loans go to State Owned Enterprises (SOEs). It is this huge volume of lending that is the principal source of China's economic boom.

The banks include China Construction Bank, Bank of China, Industrial and Commercial Bank and Agricultural Bank and they are all insolvent. Nevertheless, to restructure these banks, the government is trying to clean them up in preparation for listings. China Construction is slated for 2004 and Bank of China for 2005. Industrial and Commercial Bank will be marketed in 2006 and Agricultural Bank in 2007. The amounts they expect to raise are immense. China Construction Bank alone is hoping for $6 bn.

Part II
Corporate Governance and Transparency in China

Neither the common law nor game theory trusts agents. Agents have a bad habit. Given the opportunity, they will act in their own best interest ahead of the interests of their principals. Management, employees, bureaucrats, and other agents, unless limited by law, might steal anything that is not nailed down, as any shareholder of Enron, Worldcom, or Parmalat will tell you.

The problem with corporate governance is that the agents, the management, the employees, who are supposed to be making money for their investors, have enormous economic incentives to keep the money for themselves. It is only the existence of economic and legal disincentives that discourage the agents from acting only in their own interest.

There are basically five categories of disincentives. One derives from the marketplace and the others are based in law. The market disincentive is competition for corporate control. If management cannot run the firm efficiently, it will be bought out by someone who can.

The obvious legal disincentive is the legal duty of management (and all agents) to act with the highest care. This is generally referred to as a fiduciary duty. If management gets greedy, they can be prosecuted both civilly and criminally (e.g., Fastow, Ebbers, Stewart).

Two other legal disincentives are derived from corporate codes. Corporate oversight is one. The board of directors, especially independent directors, is authorized to rein in rogue executives (e.g., Hollinger International). The other is shareholder empowerment (e.g., Disney, Calpers). Shareholders vote to oust the board.

Finally the penultimate discipline is business failure. In market economies, incompetent executives drive their companies under. The creditors can use the law to put the company into bankruptcy and get rid of the management.

The other necessary ingredient to good corporate governance is transparency. Transparency is all about the ease of getting accurate information. It requires the fundamental legal right of free speech. Markets are about choice. Efficient choices require accurate information. Accurate information requires free speech. The financial press must have the freedom to get and publish the information. Regulators must have the power and the incentive to force managers to disclose.

Potential investments for indirect investors in China are fundamentally limited to SOEs. There are almost no legal or economic disincentives that restrict an SOE's management. There is no market for corporate control, so they don't have to worry about a takeover. The regulator, China Securities Regulatory Commission (CSRC) has a conflict. It is a government agency regulating businesses owned by the same government. If the CSRC is too diligent, the government loses money. Neither the CSRC nor the courts are independent or co-equal. Other government entities can and often do ignore their orders.

The management and the board are appointed by the main shareholder, the state or more accurately, the Communist party. Foreign investors never own more than 20 or 30%. Not enough to make a difference. SOEs are not necessarily run for profit. They are run for the goals of their principal shareholder. These goals are the political and economic goals of the Communist party.

SOEs cannot even be closed down. The 1987 bankruptcy law is ineffective and almost never used. A new one has been "in the works" for almost ten years. These zombies are kept alive by loans from state banks.

Finally, there is no way to get accurate information about these firms. There are no legal disincentives for management to make full and fair disclosures and very large economic incentives to lie. The press is allowed to go only so far. Usually they are allowed to find a few scape goats to give the impression of effective regulation and that is all.

6. How transparent are the assets or loan portfolios of Chinese state owned banks listed in Hong Kong or looking to list in the U.S.?

With the exception of the Minsheng Bank, which is partially owned by the International Finance Corporation, there is no transparency. The reality is that the banks themselves probably do not know. According to the Chinese, the Bank of China cut its nonperforming loan (NPL) ratio to less than 16 percent and the Construction Bank reduced its NPL ratio to under 12 percent. Regulators say the NPL ratio for China's overall banking sector fell by 5.32 percentage points to 17.8 percent. Last year the number was appreciably higher at 24% and the year before that it was more than 30%.

Private economists have estimated that the real ratio is between 35 and 40% or between $374bn and $749bn. I would go with the higher number. The $45 bn "bail

out" that the Chinese just took from their currency reserves to give to the banks is a drop in the bucket. It is also the second bailout. There was a massive restructuring in 2000, which in theory, turned bad loans into good bonds. These bonds are still on the banks' books as capital.

In game theory in the absence of a legal disincentive, a debtor's best move is to refuse to pay back a loan. Since the Chinese legal system does not have sufficient legal disincentives, the loans do not get paid back.

In China the vast amounts of bad loans are due to people, policy and practice. Loan decisions are based on connections or guanxi rather than on credit analysis. State banks lend to state companies based on state policy. National champions get cheap money. Efficient profitable private firms get nothing. If the reason for the loan is not based on the probability of getting it back, banking practice can be ignored. Documentation is shotty. Title to collateral is ignored if it exists. Local branches lend to local SOEs often contrary to directives from central management. No one really knows who owes what to whom.

To reduce the percentage of bad loans, the banks use three methods. They transferred the loans to Asset Management Companies in exchange for bonds at the face value of the loans. They exchanged the debts for equity in the debtor. They made more loans. The size of the new loans can be determined by the growth of the economy in the last two years. Most of these loans were probably made to the same SOEs. Like their honored ancestors, these loans will not be paid back.

The Chinese government has encouraged banks to make more loans to consumers. The problem with consumer loans is best illustrated by the example of Korea. Excess consumer lending in Korea resulted in bad debts of 1.3% of GDP and a billion-dollar bailout of a credit card company. Without credit bureaus, secured property laws and repossession infrastructure, consumer loans can be as disastrous as loans to SOEs.

The reality regarding the NPLs of China's banks is that their true size is probably not known even to banks' management. It is a reasonable assumption that they have grown appreciably over the past two years. Eventually they will threaten the viability of the Chinese economy and any Chinese investment.

7. How thorough are the transparency and corporate governance standards of Chinese firms accessing firms accessing U.S. and international capital markets?

For the reasons I described above, they are non existent. We invest in China like we invested in the dotcoms. We do not apply the same standards that we would use for other companies. As an illustration, there is the following anecdote from the *Financial Times* (4/12/04). China Mantou Fund, a Hong Kong based hedge fund tried to get some basic information from Qioa Xing a mobile headset manufacturer. They asked management the projected sales for the coming year. "We told them we were international investors and they were a listed company, and we had a right to know this information. At that point they just kind of laughed."

8. Do the Chinese firms listed in international capital markets adequately disclose their true financial situation and the full scope of their activities?

In my opinion, they do not. If there is one thing that we should have learned from the recent corporate scandals like Enron, Worldcom, and Parmalat, it is that even with the best legal system, free press, good corporate governance, honest auditors, determined well-funded independent, state and Federal regulators, prosecutors and courts, fraud can still occur. Companies in China either do not adequately disclose, spin the disclosures or simply lie.

If you do not have a legal system, a free press, good corporate governance, qualified and honest accountants, and if your regulators and courts are not independent, well-funded and subject to conflicting governmental policy, the probability that corporate disclosures will be full and accurate falls to almost nothing.

If the legal and economic disincentives within the system are insufficient to prevent management, agents and majority shareholders (Chinese governmental units) from taking advantage of huge economic opportunities, game theory correctly predicts that they will.

The other problem that is unique to many Chinese listed companies is that most of them are subsidiaries. They have been carved out of much larger companies. In order to "clean them up" for listing, many of the losses, money losing enterprises or obligations are left behind in the parent company. Without adequate definitions of property or adequate documentation, it is impossible to really know who owns what. There are no audited consolidated balance sheets. The listed company may or may not find itself liable for the losses and obligations of the parent. Even if they

do not, there is enormous pressure on the profitable listed company to divert funds to the parent, always the majority shareholder.

9. How important have international capital markets been to China's economic growth and development?

The big 'so what' question. The reality is at this point in time, not much. It has been estimated that from the first listing in 1993 up to 2002, the total capital raised from international equity markets for Chinese companies was $43 bn. While not an insignificant sum, it does not even equal the $50 bn that is invested in China annually.

The main drivers of the Chinese economy are the people of China, who save an estimated 40% of their income. In addition, it is estimated, that a majority of the billions of dollars directly invested in China annually, comes from the Chinese diaspora. They are principally located in Taiwan and Hong Kong, but they also live throughout South East Asia, U.S., Canada and Europe.

The problem is that without a legal system, the capital allocation has become grossly inefficient. For most of the Chinese people, state banks are the only place to put money other than under the floor. Over a trillion dollars have been saved and then lent to the least efficient, most corrupt sectors of the economy. The odds of getting the money back are exceptionally small. A rare and not to be repeated example of a bankruptcy occurred several years ago. The total amount recovered after the GITIC failure was about 2% on the dollar.

The enormous hole in the banks' balance sheet is not the only problem. The Chinese leadership desperately needs money to solve two other problems. Even though the SOEs have squandered the bank loans, they are still losing money. Yet since they still employ about 35% of the urban work force, they can't be closed down. The third problem is pensions. Like many other countries, China's pension system is almost entirely unfunded. The work units of the SOEs, who had this responsibility, do not have either the inclination or the ability to fund this liability.

To solve these three problems, the Chinese leaders are counting on continued formidable economic growth. Since they are running out of their own funds, they are counting on the continued attraction of the "China Play" in international capital markets. Just the fact that they are hoping to attract almost as much capital in one year as in the first ten gives you some idea of the reliance that the Chinese leadership will place on international equity markets in the future.

It has often been observed that the Chinese Communist party's only source of legitimacy is China's spectacular economic growth. There are costs for everything. The Communist leadership has the power to get things done. The problem is that what they have done is often wrong and incredibly wasteful. This profligacy cannot go on forever. To keep it going they will increasingly rely on international capital markets. The problem is that information is the enemy. The money tide could be stemmed by corporate fraud and scandals. To prevent this from happening, the government will rely on its ability to restrict transparency and corporate governance whenever possible.

A good analogy occurred during the SARs epidemic last spring. One of the country's most adventurous and liberal newspapers, *Southern Weekend*, tried to break the story about a plague in Guangdong. The government tried to suppress the news to prevent social and more importantly economic instability. Nevertheless, the story got out with detrimental consequences. For his courage, the editor in chief of *Southern Weekend* was fired. He was replaced by the official who enforced the suppression of news about the SARs. The editors of *Southern Metropolitan* have been jailed. Their paper was known for its coverage of social issues, official corruption and SARS.

International capital markets will become increasingly more important to the Chinese leadership as time goes on. It is the only deep pocket that they have yet to pick. If they are willing to cover up a modern plague to protect their power, what else will be suppressed?

Chairman ROBINSON. Thank you, Mr. Gamble.

Mr. Halter, please.

STATEMENT OF TIMOTHY P. HALTER
MANAGING DIRECTOR, USX CHINA INDEX

Mr. HALTER. I'd first like to thank the Commission for the opportunity to speak this morning. My name is Tim Halter, and I'm the Managing Director of the USX China Index, which is an index that

tracks the performance of Chinese companies that are publicly traded in the U.S. capital markets.

I'm also the President of Halter Financial Group, which is a private equity and consulting firm that has a particular focus on Chinese investments. In addition to our operations in the U.S., we have an office in Shanghai with seven employees.

I read the July 2002 Report to Congress of the U.S.-China Security Review Commission, and noted with interest that the information provided and discussed regarding Chinese companies focused primarily on Chinese companies whose stock is listed in the U.S. as an American depository receipt or ADRs.

Although the issues raised in the report regarding these companies are on point, it is important to note that these do not represent all of the Chinese companies who trade publicly in the U.S. The USX China Index tracks the performance of Chinese companies who generate the majority of the revenue from operations in the PRC whose shares are listed on the Amex, the Nasdaq or the New York Stock Exchange, and have market capitalization of at least US$50 million.

At the present time, there are 35 companies that meet this criteria and are included on the index. Of these 35, 22 are ADRs and 13 are direct listings. In addition, we have identified 36 other public companies that are listed here in the U.S. that are not currently included in our index, and of these only three are ADRs and 33 are direct listings. Therefore, I believe it will be important for the Commission to draw a distinction between ADRs and direct listings in your analysis to gain a more accurate understanding of the whole picture of Chinese companies and their participation in U.S. capital markets.

The definition of what constitutes a Chinese company is open to interpretation. Is it defined by a certain percentage of revenues generated in China or goods or services produced in China or ownership by Chinese nationals or the Chinese government?

What about a company that's domiciled in the U.S. with all of its operations though resulting from a majority ownership of joint ventures within the PRC? Is that a Chinese company? A company can have its operations in one country, be domiciled in another country, and have shareholders from many other countries. If any of these involve China, does that make it a Chinese company?

From a reporting perspective, there are three categories of Chinese companies trading in the U.S. markets. First, as I said, is the ADR, which is a company that trades its stock publicly on a foreign exchange, and in addition to the reporting requirements required by the exchange on which it's listed, it's also required to file with the U.S. Securities and Exchange Commission as a foreign filer.

The second category is a Chinese company that is also a foreign filer with the U.S. SEC, but is listed only in the U.S. capital markets. We've identified 14 of these companies traded in the U.S. Foreign filers are subject to reduced reporting requirements with the SEC and the exchanges as compared to domestic U.S. filers.

The third category is the Chinese company whose operations are held in a U.S.-domiciled corporate entity. We've identified 31 of these companies that are traded in the U.S. capital markets. This

type of Chinese company is subject to the exact same reporting requirements with the SEC as all other U.S. public companies.

It must report under the Securities and Exchange Act of 1934. It must have audited financial statements in accordance with U.S. GAAP performed by an SEC approved auditor. They're also subject to the requirements of the Sarbanes-Oxley Act of 2002 including the expanded corporate governance requirements, certifications and internal control requirements.

In addition to the SEC filing requirements, they are subject to the newly expanded Nasdaq, Amex or New York Stock Exchange requirements to obtain a listing.

Although to date, the majority of capital raised for Chinese companies in U.S. markets has been for large SOEs in IPOs, we've seen increasing interest by smaller private owned Chinese companies seeking to access the U.S. capital markets. Most of these private owned Chinese companies are raising relatively small amounts of capital here. Since 2001, there have been 20 non-SOE Chinese companies that have raised a combined approximately $800 million in private placements in the U.S. capital markets.

Note that this money was raised not in IPOs, but in private placements subsequent to the companies becoming publicly traded here. It is an active and growing strategy in China for Chinese companies to become public in the U.S. not through an IPO but by merging with an existing dormant U.S. public company and then pursuing a raise of capital through the private placement markets.

I'd like to point out because this process entails using a U.S. domiciled public entity, these companies are subject to the full reporting requirements of the SEC under the 1934 Act. We're of the opinion that the majority of Chinese companies that will enter the U.S. markets over the next several years will do so using U.S. domiciled entities.

However, these will be mostly smaller companies in terms of capital raisings. These companies will be insignificant compared to the large SOE IPOs that are coming in future years.

I'd like to speak for a moment about the increased demand by U.S. investors in Chinese stocks. The USX China Index recently completed a liquidity analysis report that showed in January 2003 $1 billion worth of volume of the USX China Index required 108 trading days.

By January 2004, one year later, $1 billion worth of volume required only six trading days. This is indicative of the demand by the U.S. investor for Chinese stocks. Last year, the USX China Index was up 104 percent.

Obviously, Chinese companies are well aware of how well Chinese stocks are performing in the U.S. Historically, many Chinese companies seeking to go public abroad had only considered Hong Kong because of its proximity and their familiarity with its system. Today, an increasing number of Chinese companies are now considering a U.S. market as their first market of choice.

It is widely accepted that the U.S. capital markets are the best in the world. In addition to raising capital, there is prestige and credibility in a U.S. listing. It is also understood by Chinese companies that our standards are high, and it's not an easy task to comply with the requirements to be a public company in the U.S.

Nonetheless, we are seeing an increased number of Chinese companies willing to attempt to meet these standards for the benefit that a U.S. listing brings.

I'd again like to thank you for the opportunity to speak and happy to answer your questions.

[The statement follows:]

Statement of Timothy P. Halter
Managing Director, USX China Index

I would first like to thank you for the opportunity to speak this morning to the Commission. My name is Tim Halter and I am the Managing Director of the USX China Index, which is an index that tracks the performance of Chinese companies that are publicly traded in the U.S. capital markets. I am also the President of Halter Financial Group, Inc., which is a private equity and consulting firm, which has a particular focus on Chinese investments. In addition to our U.S. operations we have an office in Shanghai with seven employees.

I read the July 2002 Report to Congress of the China Security Review Commission and noted with interest that the information provided and discussed regarding Chinese companies focused primarily on Chinese companies whose stock is listed in the U.S. as American Depository Receipts (ADRs). Although the issues raised in the Report regarding these companies are on point, it is important to note that these do not represent all of the Chinese companies who trade publicly in the U.S. The USX China Index tracks the performance of companies who generate the majority of their revenue from operations in the PRC whose shares are listed on the AMEX, NASDAQ or the NYSE and have a market capitalization of at least $50 million U.S. At the present time there are 35 companies that meet these criteria and are included in the Index. Of these 35, 22 are ADRs and 13 are direct listings. In addition, we have identified 36 other Chinese public companies listed in the U.S. that are not currently included in our Index and of these only 3 are ADRs and 33 are direct listings. Therefore, I believe that it would be important for the Commission to draw a distinction between ADRs and direct listings in their analysis to gain a more accurate understanding of the whole picture of Chinese companies and their participation in the U.S. capital markets.

The definition of what constitutes a "Chinese company" is open to interpretation. Is it defined by certain percentages of revenue generated in China or goods or services produced in China or ownership by Chinese nationals or the Chinese government? What about a company that is domiciled in the U.S. with all of its operations resulting from a majority ownership of joint ventures within the PRC? A company can have its operations in one country, be domiciled in another country and have shareholders from many other countries. If any of these items involves China, does that make it a Chinese company?

From a reporting perspective there are three categories of Chinese companies trading in the U.S. markets. The first is the ADR which is a company that trades its stock publicly on a foreign exchange and in addition to the reporting requirements required by the exchange on which it is listed, it is also required to file with the U.S. SEC as a foreign filer. The second category is the Chinese company that is also a foreign filer with the U.S. SEC, but is listed only on the U.S. markets. We have identified 14 of these companies traded in the U.S. Foreign filers are subject to reduced reporting requirements with the SEC and the exchanges as compared to domestic U.S. filers. The third category is the Chinese company whose operations are held in a U.S. domiciled corporate entity. We have identified 31 of these companies that are traded in the U.S. capital markets. This type of Chinese company is subject to the exact same reporting requirements with the SEC as all other U.S. public companies reporting under the Securities and Exchange Act of 1934. It must have audited financial statements in accordance with U.S. GAAP from an SEC approved auditor and they are also subject to the requirements of the Sarbanes-Oxley Act of 2002 including the expanded corporate governance requirements, certifications and internal control requirements. In addition to SEC filing requirements they are subject to the newly expanded NASDAQ, AMEX or NYSE requirements to obtain a listing.

Although to date, the great majority of capital raised for Chinese companies in the U.S. markets has been for large state-owned enterprises in IPOs, we see an increasing interest by smaller private owned Chinese companies seeking to access the U.S. capital markets. Most of these privately owned Chinese companies are raising relatively small amounts of capital here. Since 2001, there have been 20 non-SOE Chinese companies that have raised a combined $800 million in private placements

in the U.S. capital markets. Note that this money was raised, not in IPOs, but in private placements subsequent to the companies becoming publicly traded here. It is an active and growing strategy in China for Chinese companies to become public in the U.S., not through an IPO, but by merging with an existing, dormant, U.S. public company and then pursing a capital raise through the private placement markets. I would like to point out, because this process entails using a U.S. domiciled public entity, these companies are subject to the full reporting requirements of the SEC under the 34 Act. We are of the opinion that the majority of the Chinese companies that will enter the U.S. capital markets over the next several years will do so using U.S. domiciled entities. However, these will mostly be smaller companies and in terms of capital raising these companies will be relatively insignificant when compared to the large SOE IPOs coming in future years.

I would like to speak for a moment about the increased demand by U.S. investors in Chinese stocks. The USX China Index recently completed a liquidity analysis report that showed that in January 2003, one billion dollars worth of volume of the USX China Index required 108 trading days. By January 2004, one billion worth of volume required only 6 trading days. This is indicative of the demand by the U.S. investor for Chinese stocks. Last year the USX China Index was up 104%. Obviously, Chinese companies are well aware of how well Chinese stocks are performing in the U.S. Historically, many Chinese companies seeking to "go public abroad" had only considered Hong Kong because of its proximity and their familiarity with its system. Today, an increasing number of Chinese companies are now considering the U.S. markets as their capital market of choice. It is widely accepted that the U.S. capital markets are the best in the world. In addition to raising capital there is prestige and credibility in a U.S. listing. It is also understood by Chinese companies that our standards are high and it is not an easy task to comply with the requirements to be a public company in the U.S. Nonetheless we are seeing an increasing number of Chinese companies willing to attempt to meet these standards for the benefits that a U.S. listing brings.

Again, I would like to thank the Commission for the opportunity to speak to you this morning and at this point I would be happy to answer any questions that you may have.

Chairman ROBINSON. Thank you so much, Mr. Halter. Well done.

Mr. HALTER. Thank you.

Chairman ROBINSON. Mr. Tandon.

STATEMENT OF AMIT TANDON
MANAGING DIRECTOR
NEW YORK GLOBAL SECURITIES, INC.

Mr. TANDON. I'd like to first thank the Commission for the opportunity to speak today, and I will focus my remarks on the financing options available to the small- and medium-sized enterprises, that is the private enterprises of China.

My remarks will also focus upon the options, both in international markets as well as in the U.S. capital markets, for such enterprises. Now, the World Bank has recently called the private sector the most dynamic sector of the Chinese economy, and that's for good reason. Sixty percent of the GDP growth comes from the private sector in China.

The private sector is broadly defined as small- and medium-sized enterprises, township and village-owned entities as well as foreign-owned businesses in China.

Now, if one takes a look at the Chinese capital market system, consisting of the Shanghai and the Shenzhen exchanges, those are the domain of the state-owned entity. In other words, they do not, generally speaking, welcome the private enterprise in China. The listing requirements are too stringent. The waiting periods are too long.

So what is a growing company in China to do? Well, they also look to commercial banks. Now, if one takes a look at the psy-

chology of a commercial bank officer, that officer is not rewarded for making good loans to growing enterprise in China, but is certainly penalized for making bad loans. Even if a private sector enterprise in China is able to get a commercial bank loan, the time period alone is six months or one year. If a financing project has to extend beyond that time, well, that's certainly not a viable option.

Now, because of these outside financing sources being really unavailable to Chinese enterprises, they tend to look internally. For example, they'll try to raise money from friends and family, from angel investors, just like we do here in the States. They will also often finance their growth year to year from retained earnings. Now, these types of internal financing sources are, of course, limited, necessitating a capital market solution that is not available domestically.

So then naturally the Chinese enterprise looks overseas to Hong Kong and Singapore that are kind of the closest alternatives to the Chinese domestic system. I think there are a number of reasons why Hong Kong and Singapore are not good options for these companies, from kind of a business perspective. The investor access of these exchanges is highly limited. They are known as regional Asian exchanges that don't typically attract U.S. investors.

One of the primary reasons that we recommend not going for a listing on the Hong Kong is the corporate governance aspect of the Hong Kong exchange, and let me leave Singapore to the side for a moment. If you look at the Hong Kong exchange, the same body that's responsible for attracting listings governs the listings. Now that's very unusual in the global capital market system.

In the United States we have the Securities and Exchange Commission. We have the various exchanges. You divide the functions. Now Hong Kong had the opportunity to divide the function of regulating the listing with the Securities and Futures Commission and governing and earning fees from the listings in the Hong Kong Exchange, which is the Hong Kong Exchange and Clearing Division. They didn't take that lead.

So from an investor perspective, especially U.S. investor perspective, it doesn't make sense to invest in a company that can't even divide that simple conflict of interest. It's also a bad idea from the Chinese company's perspective. The relative valuations that the companies can receive on the Hong Kong or the Singapore average around 15 times the trailing year's earnings. When you compare that to the U.S. capital markets, where we're seeing average relative valuations of 30 times earnings, it's simple math.

At New York Global Securities, we think that Wall Street is the answer for these private Chinese enterprises to raise capital. In the past couple of years, there have been over 100 China-based companies that have listed in the U.S. capital markets.

Now, the bulk of those have certainly been state-owned entities, but what we're seeing is an increasing interest by Wall Street as well as the Chinese company in a listing on Wall Street.

I think that a listing in the U.S. is more a matter of process and not politics, and that's a refreshing change both for U.S. investors as well as the Chinese companies. If you meet the financial requirements and the corporate governance requirements set forth by

the exchanges and by the U.S. Securities and Exchange Commission, guess what? You can become a U.S. public company.

As a U.S. public company, the Chinese company falls under the auspices of the Securities and Exchange Commission. So, in effect, what we're doing is extending the reach of the U.S. SEC into the middle market private enterprise system in China. No exchange or no governing body is perfect, but I certainly take a much greater faith in the SEC governing the company as opposed to the Chinese domestic system or even Hong Kong or Singapore.

I just want to touch upon a couple of aspects of corporate governance in the United States and the value they have to the Chinese company. Number one, you're attracting independent board directors to the Chinese company that are often situated in the United States.

Now, these individuals have years of industry experience in the U.S. and can lend a hand to the Chinese company that becomes a U.S. public company. Also, I think that the new internal accounting procedures set forth under Sarbanes-Oxley are a valuable addition to a Chinese company seeking to globalize itself.

To conclude, the recent trend has been state-owned entities in the U.S. capital markets. The chart indicates 92 percent of the China-based companies that are listing in the United States are state-owned entities, but the trend this year and I think going forward will be for these middle market private enterprises in China to seek a capital market solution in the United States.

Thank you for your attention.

[The statement follows:]

Statement of Amit Tandon
Managing Director, New York Global Securities, Inc.

It is an honor and privilege to provide testimony to the Commission regarding the presence of Chinese companies' listings on the U.S. and international capital markets. Chinese companies have experienced relative success in the U.S. capital markets, and this is a trend that is projected to continue and intensify in the future. My testimony today will focus on the small- and medium-sized enterprises in China (SMEs) and the financing options available to such enterprises. My remarks will refer to the relative advantages and disadvantages of listings on certain regional stock markets such as Hong Kong and Singapore as well as listings on the U.S. capital markets.

The World Bank has referred to the private sector in China as the most dynamic component of the Chinese economy, and for good reason, since this sector contributes approximately 60% of the gross domestic product of the country, according to a Beijing-based think tank. China managed to attract $57 billion in foreign direct investment in 2003, despite SARS and a general downturn in the global economy. Furthermore, according to a recent article, contracted FDI surged to $115 billion, an increase of 39% from the previous year. SMEs are broadly defined to include private enterprises, township and village-owned entities and foreign-owned businesses.

The domestic capital market system in China, which generally includes two major stock exchanges, the Shanghai and the Shenzhen, is the domain of the state-owned entity (SOE). The listing requirements on these exchanges are stringent and often beyond the reach of the vibrant and growing SMEs which have not reached the critical mass to list on either of these exchanges. In addition, the waiting periods to list on these exchanges exceed three years. In fact, a recent ruling by the China Securities Regulatory Commission provides that any restructuring done by a company which is waiting to list on an exchange would serve to restart the clock on the waiting period, even in a situation in which the company was about to satisfy the waiting period. In effect, this creates a perception and a reality to the SMEs that these stock exchanges do not want them. Based upon my conversations with numerous private sector companies and entrepreneurs, this is considered to be the conventional wisdom in China.

Another major source of outside financing, in China and anywhere else in the world, is debt financing from a commercial bank. However, Chinese commercial banks do not provide a reliable financing mechanism for SMEs. From a common sense point of view, this has to do with the psychology under which commercial bank loan officers operate. Such officers are not rewarded in terms of compensation or advancement, upon the making of "good" loans to fast growing enterprises in the private sector, but are penalized for making bad loans to these enterprises. Therefore, the extension of credit to these enterprises is conservative in general. If an SME does manage a commercial bank loan, most such loans have short repayment periods, typically six months or one year, and thus do not serve as a realistic source of financing for any projects with time horizons exceeding one year.

Given the limitations of obtaining outside financing in China, many SMEs finance growth through internal financing sources such as obtaining loans from friends and family and angel investors known to the senior management. We have also seen a number of companies which have financed growth from their own retained earnings year to year. Of course such internal financing has severe limitations, thus compelling the need for another capital markets solution. For a number of companies, this other solution has been seeking a listing overseas in the Hong Kong or Singapore exchanges.

From a business perspective, a listing on the Hong Kong or Singapore exchanges, which are generally regarded as regional Asian stock exchanges, presents limited investor access relative to a U.S. listing. The market capitalization of these exchanges is far less than the New York Stock Exchange or NASDAQ; in fact the entire market capitalization of the Hong Kong exchange is encapsulated in a few of the larger issues on the NYSE or the NASDAQ. There are a number of technical reasons why a listing on these exchanges is unfavorable from the listing company and prospective investor perspectives. The relative valuation of companies listing on these exchanges tends to be much less compared to the valuations on the U.S. capital markets for similarly situated companies. Based upon our research, the average price/earnings multiple obtained by a company listing on the Hong Kong or Singapore exchanges is approximately 15. We have examined recent listings of Chinese companies in the U.S. capital markets, and our research indicates that, on a conservative basis, such companies have experienced price/earnings multiples exceeding 30 on average on the U.S. exchanges including the NYSE, NASDAQ and AMEX.

Corporate governance has become increasingly significant in recent years in the U.S. and internationally. The passage of the Sarbanes-Oxley Act in 2002, and the increasing focus on such issues internationally, has highlighted the relevance of such issues to Chinese companies seeking listings on U.S. and international exchanges. Institutional investors have been paying special attention to such issues with respect to Chinese companies. However, the Hong Kong exchange in particular continues to operate under an apparent conflict of interest. The same entity which operates the Hong Kong exchange and earns fees from such listings, Hong Kong Exchanges & Clearing, also has the authority to regulate the listings, including initial listings of companies. Most experts on the Hong Kong stock market believe that such regulatory authority should be in the hands of the Securities and Futures Commission. We believe that this makes a listing on the Hong Kong exchange a bad idea for both the listing company and investors. One of the primary reasons that companies list on stock exchanges is to attract quality investors. If the internal conflicts of interest in a stock exchange make it unfavorable to institutional and other sophisticated investors, the exchange should be avoided.

At New York Global Securities, we believe that Wall Street is the answer to the financing quandaries of Chinese companies. Our research indicates that China-based companies raised approximately $24 billion in initial public offerings in U.S. capital markets in the period 1993 to 2001, and approximately $5 billion overall in the U.S. capital markets in the period 2001 to 2003. Projections for 2004 for capital raised by China-based companies via initial public offerings range from $15 to $23 billion. This dwarfs the approximately $7.5 billion raised from new issues in the Hong Kong market in 2003.

A U.S. listing of a China-based enterprise results in a positive solution for both the company and the prospective investor. Unlike a listing in the domestic Chinese exchanges, a listing in the U.S. is a matter of process and not politics. If a company meets the quantitative financial requirements and qualitative corporate governance requirements of the relevant exchange, the company is qualified to become a U.S. listed company. As a U.S. public company, the China-based company becomes subject to the auspices of the U.S. Securities and Exchange Commission, and is accountable for all of the SEC requirements of a U.S. public company such as periodic reporting on Forms 10–K and 10–Q. Among other factors, a board of directors with independent board members, and improved internal accounting procedures serve to

increase the transparency of the China-based company, to the advantage of U.S. investors. In fact, based upon our research, China-based companies listed on the NYSE and NASDAQ presented an average return exceeding 300% in the period from 2002 to 2003.

A U.S. listing of a China-based company has relative advantages to listing over other global markets, as well as over other sources of financing available to such companies. The returns enjoyed by U.S. investors in such companies also present a unique opportunity in the global markets. The increased transparency and resultant investor legitimization of such companies is an important trend for the future of Chinese companies, and we look forward to working with more Chinese companies in the future.

Thank you for your kind attention.

Chairman ROBINSON. Thank you, Mr. Tandon.

Panel I: Discussion, Questions and Answers

Chairman ROBINSON. That was a fascinating set of presentations. I think that the issue of the small- and medium-sized enterprises finding a home on Wall Street and the discipline that's embodied in being subject to SEC regulations, not to mention the governance-related principles of the exchanges themselves. It is a compelling and positive story.

And if, indeed, that is the trend, I think that it's welcomed, and I think that Mr. Gamble reminded us of some of the fundamentals at play here as well that we have to be mindful of the exuberance with respect to Chinese IPO's that's been on display until at least recently. But I would like to turn to the Co-Chairman of our hearing and of our Capital Markets Working Group, Commissioner Wessel, for the first question.

OPENING REMARKS OF COMMISSIONER MICHAEL R. WESSEL HEARING CO-CHAIR

Co-Chair WESSEL. Thank you for being here, gentlemen. This is an important topic and your work sheds quite a bit of light on the issues that have been before this Commission. Like the two Commissioners who spoke before me, I'm somewhat alarmed that our own regulators have not chosen to appear before us because there are a number of questions I think that need to be asked about what kind of reach do we have?

The last several years, as you well know, the Enron's and the WorldCom's and many of the other corporate scandals have occurred. There have been real questions about what kind of reach do we have to the assets, both the investors as well as the employees have in terms of pension funds, et cetera, to be able to recoup some of the losses that they've been faced with.

While I understand that the numbers on the charts will change somewhat over time, 92 percent of the floats so far have involved SOEs, and in that case, what is available to our investors has been minority representations there. What kind of reach do we have? If we see malfeasance, if we see overstating of assets and phantom gains, et cetera, and our investors face enormous losses, what do you do when you have a state-owned enterprise that has the majority ownership, especially when it's with China? How do we reach this? What do we tell our investors that's going to be there at the end of the day if, in fact, there's nothing left? For all the panelists.

Chairman ROBINSON. Or any of the panelists.

Co-Chair WESSEL. Or any of the panelists? Is there some reach? As opposed to the Enron's where with the securities litigation reform in the mid-'90s, do we have an ability to tell our investors that there is something at the end of the day we're going to be able to do for them, or is this really a wholly different class of assets that they're facing in our own markets now?

Mr. HALTER. I think I'll take a shot at that, at least part of it. I think your answer, though, will have to be based upon differentiation between the types of public companies. As far as the SOEs are concerned that are listed as ADRs here, then they must first meet the requirements of the exchange on which they're listed and then the more limited requirements here in the U.S. I also might point out that we've got different regulating bodies.

We have, of course, the SEC and then we have the exchanges. The New York Stock Exchange, of course, has its own requirements. One of the things that I thought was interesting, though, is that the New York Stock Exchange has limited requirements if an entity is listed on another exchange. In other words, they're relying upon the laws of the country in which it's domiciled. I thought that was interesting and I was a little surprised by that.

So as far as the SOEs are concerned, I'm probably not the best one to speak about that. It's not my area of expertise, and I would, as well, question the ability of the reach that we might have.

As far as direct listings or companies that are listed here, those companies must meet stricter U.S. standards with audit requirements by U.S. auditors, and in this environment today, a U.S. auditor is going to think twice before they sign off on that audited financial statement without having gone there and done an ample amount. The market has a way of policing itself, and under this system when you have a liability issue that the auditors will face by signing these audits, there's at least a degree of safety that the investor has. But if you're asking what will happen if there's a problem, well, yes, although under Sarbanes-Oxley they must sign certifications. I think if you look at one of the risk factors in Sina, which is one of the big Internet companies, U.S. filer, listed on Nasdaq, done extremely well, one of their risk factors says that although the certifications are signed by the CFO or the CEO, if they're wrong, those people reside in China.

Co-Chair WESSEL. I'm sorry. Mr. Gamble.

Mr. GAMBLE. I used to do repos. You've got to find out where the car is, right. You file suit. You get a judgment. Then you go looking for the car. All right? Assume I filed a lawsuit against China Life for the stock is for fraud. I file in the southern district of New York. I have a subpoena. I get, I don't know, let's say, for example, after many years, I actually get a verdict or a judgment. I take that judgment and go over to China.

All right. I end up in Number Two Court of Shanghai. I'm before a judge. Now who pays this judge's salary? Okay. Well, the judge is paid the salary by the local guys who probably own a big chunk of China Life or the government. So he's sitting there saying, which way do I want to advance in the system? Do I want to get my kids in school? Do I want to continue to be a judge? Shall I rule for these Americans or shall I rule for the local guys?

I'm going to rule for the local guys. I'm not saying this is exclusive in China. If you want to see another system that operates like this, look at Japan where the LDP controls the career path of most of the judges. So you get the sort of judgments you would expect in that situation.

Again, let's also look at the auditing. All right. Fine. We have a U.S. auditor. Well, Parmalat just gave a U.S. auditor a little piece of paper that said we have an account with Citibank in the Cayman Islands that's worth $2 billion. Gosh and golly gee, there wasn't any account. There wasn't any $2 billion. And yet, the auditors are saying this is what they told us.

The other thing about Chinese companies, how many shells can you create in one of these things? Who owns what? For example, what is a private company? Let's take Sina.com. Sina.com has a right to operate an Internet portal in China because it has a contract that has to be enforced under Chinese law.

Now, if a local guy comes in and says, well, I'm tired of Sina.com, I want to get a piece of this action, I'm going to start my own net company and I'm going to rip up this contract, what would be an American investor's remedy? She's not going to go to Beijing and get an apology.

I'm not suggesting that there is necessarily an American regulatory method of dealing with this, but what markets do need and what markets are getting, if you read the paper, is information about the problems of the system.

Co-Chair WESSEL. Let me ask—one of the issues that we've dealt with as well is the question of materiality. The question as we've seen many of these state-owned enterprises that may have relationships with the PLA, et cetera.

Is the fact that one of these companies that's either through ADRs or directly may be proliferating or acting in violation of our own laws—is that a material fact that should be disclosed as part of all their announcements and filings? Mr. Halter is a market pro.

Mr. HALTER. Sure. If you're asking should that be a required disclosure, absolutely.

Co-Chair WESSEL. And do you view it as a material fact?

Mr. HALTER. Material fact in the sense that under what definition, I guess?

Co-Chair WESSEL. In terms of risk?

Mr. HALTER. The answer is yes. I believe that in terms of facts. And I'm a believer that the market generally can be the ultimate decisionmaker. Provide the information to the investors such as this, and I believe the market will take care of itself.

Co-Chair WESSEL. So in terms of the indices and information you put out to investors, you would want to be able to know whether this company is engaged in proliferation or other activities that could subject it to sanction later on as a material risk factor that they should be aware of?

Mr. HALTER. Absolutely. And again, if I may, just to follow on, draw a distinction between the two. It's interesting to note that the direct listed companies on the USX China Index enjoy a significantly higher valuation as a multiple of earnings as opposed to the ADRs which have less disclosure.

So I think in the market, you have a carrot and a stick. The carrot is a viable way to help influence these companies. They're looking for the greater valuations, and as a result of that are willing to go through the greater disclosure requirements.

Co-Chair WESSEL. Thank you.

Chairman ROBINSON. Vice Chairman D'Amato. Thank you.

Vice Chairman D'AMATO. Thank you, Mr. Chairman. I have two quick questions. Mr. Halter, I'm a little confused. You talked about most Chinese companies, I think, use domiciled U.S. companies to get into the marketplace here. Does that mean that our chart here, or the chart that's up there, the 92 versus 8 percent, in terms of percentage of companies that are listed isn't really 92 percent SOEs? What is the actual percentage from your understanding?

Mr. HALTER. Yes, and I think you must first ask what is your definition of a Chinese company?

Vice Chairman D'AMATO. My sense is if you see it, you know it.

Mr. HALTER. The way we have defined it——

Vice Chairman D'AMATO. —production China, owned by Chinese.

Mr. HALTER. —is a company that generates more than 50 percent of its revenue directly from the mainland China, from the PCR.

Vice Chairman D'AMATO. All right.

Mr. HALTER. So that could be a company domiciled in Hong Kong. Actually, there are companies domiciled in the U.S. There's a company that's on our index that's located in California with U.S. top level management, but more than 90 percent of the revenues are generated directly in mainland China.

Vice Chairman D'AMATO. From production in China?

Mr. HALTER. Absolutely. As a wholly owned foreign entity.

Vice Chairman D'AMATO. Well, let's take that definition then, 50 percent production in China or more.

Mr. HALTER. Yes.

Vice Chairman D'AMATO. How would that change that chart; do you think?

Mr. HALTER. Substantially. I would say then in terms, and this is a very big distinction I want to raise because what you're looking at is from a bigger, much bigger picture. In reality, from the bigger picture, our numbers are going to be quite a bit different, but yours may be more meaningful, specifically as it relates to capital-raising because if you're looking at the terms—the amount of capital that's raised—it's magnitudes greater of the SOEs doing the large IPOs.

The top-level deals that are being done, the largest IPOs, are all SOEs, raising billions of dollars. In terms of numerosity of companies, sheer numbers of companies, I believe the majority are non-SOEs, but they're much smaller. You'll have companies with market caps of $50 million, which is tiny.

Vice Chairman D'AMATO. Yes. So would it be fair to say that the lion's share of the capital that's raised is still along these kind of percentage lines that we're talking about here? Does that make sense?

Mr. HALTER. Yes, without knowing those numbers, I'd say I wouldn't necessarily disagree with them. Generally speaking, I would say that's probably true.

Vice Chairman D'AMATO. Okay. Well, then let me ask a little more generalized question because we heard the comment that the marketplace can take care of a lot of this, but we wouldn't be holding this hearing if we thought that the marketplace was working effectively in my opinion.

And I think that the question of the viability of the marketplace in the equities market has been severely compromised as a result of the scandals, the unending series of scandals that we've seen in the last couple of years. I'm talking about Enron, Tyco, Global Crossing, Adelphi, on and on. So there is a serious erosion of the sense of confidence in the marketplace.

Part of it I think is that the sense that the marketplace is dominated by several large financial firms and they make the market for IPOs out of New York. All right. We take Goldman Sachs, Morgan Stanley, they then create the marketplace for many of these IPOs or most of them. They take a fee and they're out the door.

Suppose we had a requirement that the marketplace makers in New York were required to participate in this marketplace beyond the fee, and that they had to take 5 to 10 percent of the stock and buy it and hold it for two years. Do you think that would serve as a chilling effect on the rush toward going to the marketplace with IPOs?

Anybody here. Mr. Tandon or Mr. Gamble. It may sound a little bit outlandish, but I'm talking about sense of responsibility in terms of the viability of what's being brought to the market by the people that are taking American investors' money and putting it into these IPOs.

Mr. HALTER. Before I answer, can I ask a question just to clarify the question?

Vice Chairman D'AMATO. Go ahead.

Mr. HALTER. Are you talking about the market overall or specifically Chinese companies?

Vice Chairman D'AMATO. Let's take Chinese companies because that's what we're talking about.

Mr. HALTER. So you're proposing a separate set of rules specifically for a company that's Chinese.

Vice Chairman D'AMATO. Let's start with that. Let's start with that because the question of due diligence, accountability is a very serious matter here for these companies because they're so opaque, they're not transparent, and they're being dominated by a government, the Chinese government, which maintains majority ownership and control ad infinitum. It will not give majority. So it's a different animal.

So the question is whether or not you think it would be fair and what would the result be? Would there be a chilling effect if the maker of the market, the Goldman Sachs had to take a piece of it and keep it for awhile just to ensure that they were making good decisions on what they were bringing to the market? Mr. Tandon.

Mr. TANDON. Thank you for the question. I think that the answer lies not in an investment bank holding a position in the company, but taking focused due diligence approach to a Chinese company just as it does with any other company in the world including the United States.

I think what Congress did when they enacted the Sarbanes-Oxley Act was intelligent. The focus of Sarbanes-Oxley is disclosure and corporate governance. That's where the answer lies in all due respect to the Commissioner's proposal.

Now, investment is about risk, and it's about disclosure from the company perspective. If there's adequate disclosure, then the investor theoretically has enough information to make an investment decision. Now, the returns that we're seeing from Chinese companies in the last couple of years have averaged about 300 percent.

An investor cannot have his or her cake and eat it, too. There has to be some taking on of risk in an investment whether it's a Chinese company, a U.S. company or a Mexican company or what have you. So I think that that's the focus that from an investment bank perspective should be taken with a Chinese company and any company for that matter.

Vice Chairman D'AMATO. Anybody else? Mr. Gamble.

Mr. GAMBLE. I like the idea actually because, first of all, let's talk about disclosure. How do you get a document? How do you find out anything? Well, most people sort of read it in the paper. And the problem is you can't know whether or not this 300 percent is valid unless somebody goes over and investigates. Normally we operate in a free market system on a free press. The best press journal in China is *Caijing*, which at various times has tried to investigate various stories, and of course have been stopped.

An excellent example of this is when the press tried to break the SARS story. The editors of the *Southern Weekend*, and there was another article—I think it was *Metropolitan South*—editors of both papers have been replaced by the guys who covered up the SARS story.

Now, if they're willing to do this—to stop the flow of information for something like an epidemic, what are they going to do with a few financial numbers? How do we know whether it's 300 percent? You have to remember that probably every one of those listed SOEs is a subsidiary of some other company.

Now, in order to make the subsidiary more attractive, they carved out all the nasty bits. Okay. They carved out the schools, they carved out the losses, they carved out anything they wanted to carve out. And then once this subsidiary is prettied up so it can be audited by a Western audit firm, then at which point it goes through its IPO.

The question is, is it still owned by the majority shareholder? This majority shareholder, of course, controls all the boards and can say, okay, a certain percentage of profit, for some reason, has to flow upstream to the parent because there's a lease or there's taxes or, God knows what. You can have fun with numbers any time you want to. At which point the disclosures are not particularly valid.

The basic question is how do you find that information out in a society that doesn't have a free press?

Vice Chairman D'AMATO. Thank you.

Chairman ROBINSON. Commissioner Reinsch.

Commissioner REINSCH. Thank you, Mr. Chairman. I guess I have to say following up Dick D'Amato's question, I'm probably in the minority—but I'm not sure that all of us are persuaded that ex-

isting procedures are inadequate. And listening to the testimony, I don't think that most of the panelists have made the case that existing regulatory and disclosure procedures are inadequate to the task, and particularly listening to Mr. Tandon's answer to the last question, I don't think that that case has been made.

But let's pursue that a little bit in a couple respects. Let me go back, Mr. Halter, to your response to Mike Wessel's question about proliferation. Do you think that the SEC's existing definition of materiality and existing SEC disclosure requirements are adequate to pick up the kind of thing that Mr. Wessel was talking about, and anybody else can chime in if you want afterwards?

Mr. HALTER. I'm sorry. I'm probably not qualified to answer that specifically under what SEC requires under both. By the way, they're different between ADR and domestic filers. I'm not a securities lawyer, so I probably can't answer that specifically.

Commissioner REINSCH. Okay. Well, anybody else want to take a stab at that one?

Mr. GAMBLE. Could you repeat the question, please? Whether the materiality?

Commissioner REINSCH. Whether the SEC's definition or standard of materiality is adequate under current practice to pick up the kinds of things that Mr. Wessel was talking about?

Mr. GAMBLE. Yes. The SEC, our securities regulation in this country is, from my standpoint, one of the most economically efficient if you compare it with other types of systems. I've just done a study of Indian securities regulatory authority, and they're trying to copy us and do us one better. Disclosure regulation is basically the only way to go.

The problem is, though, what happens when you have a violation. What do you do then? Your shareholder may be without remedy. I'm not saying that this means that you should have additional regulations. My feeling is the less the better.

The point, though, is I think it's very important that the investors get as much information about these firms as possible, and if you actually do the research, the information is out there for any investor to find.

Commissioner REINSCH. Well, that's a good point, and you've touched in your testimony, I think, on the fundamental issue, which is the question of different legal systems and also your comments in response to an earlier question——

Mr. GAMBLE. May I make a correction of that? It's not a question of different legal systems. It's a question of having a legal system and not having a legal system.

Commissioner REINSCH. Okay. Well, I'm not sure the Chinese would say the same thing about that. Fine.

Mr. GAMBLE. I'm sure they wouldn't.

Commissioner REINSCH. Semantics. I don't think we disagree on the concept. I think, though, you're making another point that's important, which is that in cases where the filer or the entity, whatever it is, and whatever category of Mr. Halter's it lies in, when it fundamentally is overseas and its assets are overseas anywhere, you have a problem obtaining recourse.

Mr. GAMBLE. Unless with one exception. It might be a good bet if there was a substantial presence in the U.S. market. But if

you've noticed, all the Chinese national champions, they're very successful in the home market but every time they step outside of the country, they get their hands slapped.

For example, I believe it was Hubei Electronics just got nailed by Cisco in the Southern District of Texas. The reason is because they finally started selling their products outside the country and so Cisco could nab them. So it depends. The problem is as long as the company is specifically located in China, you have a problem getting recourse.

Commissioner REINSCH. Sure.

Mr. GAMBLE. If you have assets outside the country, you have a shot at it.

Commissioner REINSCH. Good point. Let me go back in my remaining minute to Mr. Tandon's. I would infer from his testimony given the SEC and the American Stock Exchange's disclosure requirements, it's probably in our interest if we want to maximize disclosure to have more Chinese listings rather than fewer. Is that correct? Do the rest of you agree with that?

Mr. HALTER. Absolutely.

Commissioner REINSCH. Okay. So we should be encouraging that sort of thing? Is that right? Mr. Tandon?

Mr. TANDON. I agree with that statement. Let me just take a step back. I think the historical model of cooperation between the United States and China has been—let's outsource our manufacturing to China and make money that way. I think a more equitable model from a U.S perspective and any perspective is let's create a cooperation between the China-based company and the U.S. investor.

Let U.S. investors participate in the growth that's happening in China. I think that that could be done most effectively by turning the China-based company into a U.S. company.

Commissioner REINSCH. I see my time is up. I'd like to pursue that. Thank you.

Chairman ROBINSON. Thank you, Commissioner Reinsch. Commissioner Dreyer.

Commissioner TEUFEL DREYER. I'd like to start by refuting the statement that this is a matter of differences between the Chinese legal system and the American legal system. The Chinese are, in fact, acutely aware that they have a very poor legal system, as if it is a matter of philosophical first premises. They might not agree with Mr. Gamble that they have no legal system. But they are very, very aware of the deficiencies in their system. If you read *Fazhi Ribao*, the *Legal Daily*, you will find constant reference to the lack of professionalism among judges, and the problems of judges taking bribes and the existence of local protectionism in the judicial system.

Commissioner REINSCH. I hope I didn't imply that I was happy with their legal system.

Vice Chairman D'AMATO. Yes, you did.

Commissioner TEUFEL DREYER. What you did say was a difference in culture, but anyhow——

Mr. GAMBLE. Most of the judges, until quite recently, including the Supreme Court, weren't even lawyers. They were military officers.

Commissioner TEUFEL DREYER. Retired, demobilized PLA officers.

Mr. GAMBLE. Right.

Commissioner TEUFEL DREYER. I'd like to ask a question. Actually I think this is for Professor Bottelier, but perhaps any of you who wish to answer, about an article I read in this morning's *China Daily*. As you know, but some others here may not, *China Daily* is China's leading English language daily. This article stated that one of China's big four banks—I think it may have been the China Construction Bank—had succeeded in reducing its non-performing loan ratio to 8.88 percent. I see Mr. Gamble being amused by that.

Does this sound plausible to you, and if so, how did they do it? Also, am I correct in thinking that if it is plausible, would this not indicate that a milestone had been reached in China's being able to get its NPL ratio down to the safe level recommended by the Bank of the International Settlements in Basel?

Mr. BOTTELIER. Thank you for that question. Of the four large state-owned commercial banks, the Construction Bank has traditionally had the lowest NPL ratio. It is also the first one that is on the line for domestic and international listing. The definition of NPLs, I think, has significantly improved in China in the beginning of 2001 when they went to an international risk classification system as authorized or mandated by the BIS in Basel.

I believe that the reliability of the officially published NPL ratios has improved significantly in China over recent years, and that is precisely because the Chinese know that in preparation for meeting WTO conditions, they have to recapitalize these banks, and in order to recapitalize the banks, they seek foreign financial participation through private, partial privatization, which has been the traditional Chinese approach.

The first example of a Chinese state bank coming clean on NPLs was in 2001, when Bank of China listed its Hong Kong subsidiary in Hong Kong. That was the first time they had to prepare a prospectus subject to international scrutiny, and it forced them not only to come clean on the accounts of their Hong Kong subsidiary, but also the mainland bank.

That was the first time (in May 2001) that the then president of that bank, Liu Mingkang made a shocking announcement that the main bank in China still had something like 29 percent of NPLs on its balance sheet at the end of 2000, which was far higher than any public official source had ever admitted. It was precisely the market pressures that forced Bank of China to come clean on these things. I believe that the Construction Bank numbers have credibility because the Chinese know and the Construction Bank knows and their advisors—Morgan Stanley participates heavily in this—that they cannot play around these numbers if they want to list. They have to prepare a prospectus for Hong Kong, for New York and wherever else they wish to list.

The ways in which they have brought down the NPL ratios in recent years are several. (A) The banks have become somewhat more profitable themselves. The Ministry of Finance has allowed them to provision and to write off losses more than in the past.

They were always restricted in provisioning for fiscal reasons to one percent of loan portfolio. That's gone.

On top of that, the Construction Bank and the Bank of China have both received $22.5 billion from the central bank on the last day of December last year to recapitalize those banks with the objective to accelerate the listing preparation process. They were allowed, as a result of that transaction, to use a significant amount of their own accumulated profits to write down the accumulated NPLs, and that has been the major source for the rapid drop down in NPLs since the last day of last year.

Commissioner TEUFEL DREYER. The $22.5 billion that they got, is that not part of the shell game Mr. Gamble was mentioning? Then where does this money come from?

Mr. BOTTELIER. No, it's real money. It's reserves held in U.S. dollars. What the central bank got in return, that may not be real money. But that's the central bank's problem. The Construction Bank got real money, and a lot of it.

And I believe there is real progress. My concern, I must say, is not so much the old NPLs but the possibility that the tremendous expansion in credit in China, bank credit in the last 12–14 months since the beginning of 2003, may result in a new wave of NPLs in the coming years. That's my concern.

Chairman ROBINSON. Thank you, Commissioner Dreyer. I would only point out before turning to Commissioner Bartholomew, that we read yesterday with interest that the China Construction Bank had been urged by Beijing to postpone its $5 to $10 billion IPO that was scheduled for later this year into 2005 because they were deemed for a variety of reasons to be not ready for a New York Stock Exchange listing.

I don't know if it had to do with the Non-Performing Loan issue or other issues, but it was an interesting development and it would affect the estimate of 23 billion or more in new IPOs this year as a significant percentage of that figure was the China Construction Bank deal.

Mr. BOTTELIER. I have that also, Mr. Chairman. In fact, you may know that the new Chinese Prime Minister Wen Jiabao, has publicly criticized the Construction Bank last few month during a press conference in Beijing. His remarks did not specify what he was unhappy about it, but the bank was chastised for not taking certain market principles sufficiently seriously.

Chairman ROBINSON. Well, it demonstrates to me that Beijing is taking a second and third look at these state-owned enterprise candidates for New York Stock Exchange listings in light of recent developments and deciding that they would rather deal with these issues quietly at home rather than in the Wall Street Journal or elsewhere.

Mr. HALTER. May I respond to that? I think that points out that the system is working.

Chairman ROBINSON. Yes.

Mr. HALTER. The fact that we've had these problems has come to light, they're being investigated by the SEC, and it is having a direct impact on their ability to do other deals. It doesn't matter what the Chinese government wants to do in terms of bringing

their companies public in the U.S. It matters what the investors want to do and their willingness to buy them.

The question that was raised was speaking to our not believing the NPL ratios that were now announced. Well, if they're not true, they'll never raise the money. It's one of the things that we were talking about before—about being able to give sufficient information or having additional regulation disclosure. Maybe the underwriter should be making investment. The people that ultimately are buying these stocks are not stupid people.

Warren Buffett bought a very large stake in Petro China, the largest state-owned enterprise. With the disclosure existing, there was sufficient information for Warren Buffett to get comfortable to acquire a sizable position in this company.

Chairman ROBINSON. Yes. Thank you. Although 8.8 percent? I have a hard time with that. It's likely to be some multiple of that, but never mind, that's just my personal view.

Mr. Gamble.

Mr. GAMBLE. A really neat way of getting your NPLs down is to make more loans. That means the denominator gets bigger and the numerator gets smaller. And apparently according to the *Financial Times*, they've just lent, over the past two years, they've lent another two trillion, three trillion—excuse me—local currency. So that must have been an impact.

Chairman ROBINSON. Well, my apologies, Commissioner Bartholomew. Please.

Commissioner BARTHOLOMEW. Thank you very much, Mr. Chairman. Thank you to my colleagues who put this hearing together and to our panelists who are taking time out of their busy days to be here and share their expertise.

I have a couple of more general questions. One, of course, is we've heard several people say that the SEC is investigating. My sense is that the SEC has had insufficient resources to do the kinds of investigations it needs to be doing on some of our domestic companies. Do you think that the SEC has the resources it needs to be able to undertake the kinds of investigations that you're talking about needing to be done? To any of our panelists?

All right. I guess we're going to need to ask my question of the SEC.

Mr. GAMBLE. No.

Commissioner BARTHOLOMEW. No. Okay. Mr. Gamble.

Mr. GAMBLE. There was another anecdote I put in my written testimony about investment bankers going over and they said, look, we're shareholders in your company. You have to give us this information. And the management looks at them and the quote was "they just kind of laughed."

Let's see. I'm an SEC lawyer. I get a nice trip over to Hong Kong and I'm going to go look into the books of China Life. Well, the question is one of property rights, all rights. Do you own this piece of property? Well, I don't know. So you go to the registry. Do you know what it takes to get into a Chinese registry, if you can get in at all? First of all, you have to bribe the guy at the desk, and then is the information he's got correct? Who knows?

Legal systems are like ecology. You start taking one piece out of the puzzle and then the whole thing collapses. So even if they had

the resources, which I don't believe they do—I'm not an expert on the SEC—it's just how do you know? Do you have subpoena powers? Do you have any way of grilling somebody if they're wrong? No.

Commissioner BARTHOLOMEW. Okay. My other questions build on access to information, which is risk, of course, not just about what's happening at the time of listing. It's about access to information on an ongoing basis about ongoing business practices. I wondered how any of you would characterize the availability of accurate business information in real time in China?

Mr. HALTER. I'll take a stab at this one. The companies that are listed as direct listings are obligated to report on a timely basis as with all of their U.S. public companies. So they've got quarterly reports and they have got 8(k) disclosure upon any significant or material event that occurs. Entities that are foreign filers or so-called 20(f) filers are only obligated to file one document per year.

It's an annual document with audited financials that can be in International GAAP, and those are required six months after the year is ended. So in terms of it being timely, the requirements are not there. But generally what occurs, and it's back to the carrot versus the stick. Those companies that report information on a timelier basis are rewarded by greater valuations.

And so as a regular course of business, most of these companies do report on an ongoing and quarterly basis.

Commissioner BARTHOLOMEW. Mr. Gamble.

Mr. GAMBLE. Which books are you talking about? Which set?

Commissioner BARTHOLOMEW. There you go. There's a separate answer right there. Professor Bottelier?

Mr. BOTTELIER. If I may add just a comment to that question. Many things obviously are highly imperfect in China. We should realize that they had only corporate law only in 1993, a little over 10 years ago. The corporate accounting standards were only defined at the national level around that time and that the accounting standards for the financial system are even more recent than that.

The accounting profession and the auditing profession are relatively recent professions. China had no law system under the Cultural Revolution, as you recall. What is happening is a process. As a result of the process of marketization, standards are gradually being upgraded, not the opposite. The dynamics of what's going on is important to keep in mind.

None of the four big state banks, for example, have been audited to international auditing standards until recently. To prepare for WTO and listing, the Construction Bank is currently working with KPMG.

Bank of China has also engaged an international auditor for the first time. They never did that, and I think these are, I think, important dimensions of what you're looking at to bear in mind.

Bank of China has also engaged an international auditor for the first time. They never did that in the past, and I think these are important dimensions of what you're looking at.

Mr. TANDON. I think part of the Commissioner's question the answer lies in economic interests. We're operating under an assumption that the Chinese management does not want to cooperate with

the regulatory authorities in the United States in terms of provision of accurate business information and financial information to the relevant entity here, being the SEC.

I think that operating assumption may be flawed because the economic interests of the management is to provide accurate information such that they can comply with the periodic reporting requirements and the Qs and their Ks, and thus obtain good valuations of the company going forward.

Listing on a U.S. exchange is an expensive proposition. I don't think that a Chinese management or a Chinese CEO undertakes that process lightly. They're spending a lot of hard-earned money to become a listed company and to pay SEC lawyers, SEC registered accountants in the United States to comply with the regime under Sarbanes-Oxley.

I think that the economic interest of the management is certainly to provide that type of information to attract a greater pool of investors, to get better valuations of the company, and to make the stock price go up.

Mr. GAMBLE. In this country, Bernie Ebbers and Fastow had an economic interest not to disclose. I don't see that these people are that much different than Chinese managers. I don't think Chinese managers are any different from American managers. No one likes an audit. No one, because all their warts show. So on the contrary, I would believe that any management anywhere is going to try to make things look at clean as possible. That's where their economic incentive is.

Chairman ROBINSON. We're in the closing moments here. Commissioner Becker.

Commissioner BECKER. Yes, thank you. I appreciated your testimony very much. There's been a tremendous amount of questions asked in different ways, all leading to the same thing.

First, let me ask you just a very cursory question. Do these companies pay dividends?

Mr. GAMBLE. I believe some of them do, but it's dividends to what or to whom is another question.

Commissioner BECKER. We've talked about investments a lot. Most investors like to see some dividends, which leads me to a follow-up to what Commissioner Wessel was talking about in the beginning. If somebody sees a problem that they want to raise, he asked, how do you go about doing this?

The answer was very unsatisfactory. I think in your minds it's also very unsatisfactory. Look at it a step down the road. Investors who don't even know the questions to ask, what information do they get back from the state-owned enterprises which lets them make a decision if there is something in there they don't like? I'm getting the feeling that there is very little information that comes back in that regard.

Mr. GAMBLE. In game theory, whoever wins the game is the guy who has the most economic incentives. Okay. Whoever—the player who gets the most chips at the end of the game wins.

My view is, and I think everything becomes quite consistent if you look at the actions of Chinese government in this light. Their view is to insure that as much capital as possible is flowing into

China. I think they will take any and all action in order to make sure their PR makes their companies look as good as possible.

In Rhode Island, we had a problem with Blue Cross. Rather than cleaning up their corporate structure, they hired a high-powered PR firm from Boston. So I believe that's what they're going to do. I don't think that they will release any information unless it's pried out of them.

Commissioner BECKER. Okay. I want to jump to the opening testimony that we had, Professor Bottelier. You stated in the first paragraph if domestic financial markets in China or international capital transactions are liberalized prematurely, major problems could develop. I don't know quite what you mean by this?

Are you talking about transparency? Governance issues? Are you talking about exchange rates? Just what are you talking about, and to what degree? I'm assuming from this that you're telling us nobody should rock the boat from the way it is right now.

Mr. BOTTELIER. There's a narrow and a broad answer to that question. Let me start with the narrow one. China has agreed in 1996 to abide by Article VIII of the IMF on current account currency convertibility. That means the Chinese currency is convertible but only for current account transactions.

Where they maintain effective controls, or as effective as they can, is on capital account transactions, including borrowing and lending outside. The Chinese cannot put their savings outside. Foreigners cannot bring large amounts of money into China without permission. So there is a system of control for capital account transactions.

And that is what I was talking about in my introductory statement. In the past, we have seen that countries such as Thailand and Indonesia, that quickly liberalized all transactions, go to 100 percent convertible currency before they have developed an adequate supervisory system for their financial system, expose themselves to enormous risks.

The Asian financial crisis would not have occurred if Thailand had not had an open capital account. They opened it prematurely. China should not open its capital account before they have their house in order domestically, for example before they have been able to liberalize interest rates. They are moving in that direction.

A slightly broader answer to your question: because whilst we are talking here about Chinese access to American markets, what is going on at the same time is that the Chinese are opening gradually their own domestic stock markets to foreign investors.

They have, as of last year, licensed about eight or ten qualified foreign financial investors, including several U.S. companies, who obtained a license to invest up to "x" hundred million dollars in the domestic Chinese stock market. That is also American money, international money, being invested in Chinese paper.

Even if you were to succeed in controlling Chinese access to American capital markets, you only have the story, because the money goes also the other way, directly to the Chinese stock markets.

Commissioner BECKER. I've got one more question, and I'm going to keep it as brief as I can and hope you will too. What we're talking about is state-owned enterprises, some 75 percent, as I under-

stand, of the company that's coming on to our capital market, our SOEs.

Is this troubling to you that state-owned enterprises are tapping the United States capital market?

Mr. BOTTELIER. It's very hard to be extremely brief because, if you don't understand the historical background to that, it's easy to be upset about the wrong things. China, until recently, only had state-owned enterprises. They are privatizing a lot of them very rapidly. They are privatizing them in all sorts of ways. One way I mentioned is the sale of legal person shares domestically outside the stock exchanges, which has led to the effective privatization of at least 200 state-owned enterprises in the last two years.

That process is going on. It is not that the Chinese government wishes to hang on to all these state enterprises. They have stated that they eventually want to hang on to about a thousand. The rest can go. So I'm not troubled by the notion that these are state enterprises because that's all they had. There was no private enterprise until recently in China.

The private enterprise system is growing much faster than the state enterprise system. For the time being we must accept, if you want to do business with China, you must be willing to do business in some cases with state enterprises. That is the reality of the situation.

Chairman ROBINSON. Regrettably we'll have to——

Commissioner BECKER. I'd like to know if anybody else has a quick comment on this.

Mr. GAMBLE. First of all, in terms of privatization, it's always fascinating to me how often the kids of China's leaders end up on the board and as beneficial owners of some of these shares. It's just exactly what's basically happened in Russia when the oligarchy, they came in and got the shares.

I also want to point out with Morgan Stanley, they also happen to employ the daughter I believe of Zhurongji.

Chairman ROBINSON. Commissioner Mulloy.

Commissioner MULLOY. This question is for Mr. Bottelier and then if others have comments. As you know, the trade imbalance with China is a big issue here politically in this year. And we've had hearings on exchange rates.

Now, Secretary Snow seems to be taking the policy of asking China to move to a market-based currency as his solution to the exchange rate issue. Your comment about liberalizing China's capital markets I think would be contrary to what Snow is trying to do. Is that correct? Or I mean, other people like Fred Bergsten said no, no, you can't move to a market-based currency. You should significantly repeg upward and then move to a market system more gradually. Is that where you are?

Mr. BOTTELIER. Well, I think I fully understand what Secretary Snow is trying to do, and I believe that that is the right thing. He is advocating to the Chinese to move as fast as they can to a fully convertible currency. A floating currency without full convertibility on the capital account makes no sense.

Commissioner MULLOY. Correct.

Mr. BOTTELIER. So that's why the two have to move in tandem, and they cannot do that tomorrow. It would be far too risky.

Commissioner MULLOY. It would take a long time; correct?

Mr. BOTTELIER. Well, I would say it may take 5 to 10 years.

Commissioner MULLOY. Okay. Thank you. That is why Secretary Snow's proposal makes no sense. Secondly, I wanted to ask you this. You've talked a lot about the loans, the non-performing loans in the state-owned enterprises, and then how the government is pouring a lot of money in to buy those loans down so that the state-owned enterprise can be marketed.

The question is what is the implication for trade flows between us and China of these huge subsidies to these state-owned enterprises by buying off their non-performing loans? Does that really impact on China's ability to undersell in the U.S. market in terms of people who are competing with these state-owned enterprises here?

Mr. BOTTELIER. That's a complicated question because not all the NPLs that have accumulated in the Chinese banking system are the result of bad business practices or inefficiencies. A lot of them date back to the time that these enterprises also functioned as the social security system. They provided the housing, the hospitals, the schooling, so the fact that the government is now bailing out many of these enterprises by making good on these NPL 100 percent to the dollar is not necessarily a subsidy the way we normally understand that word. So I would not—this is a very complicated concept.

Commissioner MULLOY. I know it's very complicated. I'm just asking would this be—do these guys export into the U.S. market from these state-owned enterprises? And I understand half of China's exports are made by foreign affiliated companies in China, but the state-owned enterprises are doing a lot of exporting to this market.

Mr. BOTTELIER. That's correct.

Commissioner MULLOY. Does that impact on the companies here, which are competing with the Chinese state-owned enterprise imports?

Mr. BOTTELIER. I would have to think about it, Commissioner. I do not immediately see all the implications of that.

Commissioner MULLOY. Does anybody else have a comment on that? Mr. Gamble?

Mr. GAMBLE. I would say yes.

Commissioner MULLOY. What would it be?

Mr. GAMBLE. If your cost of capital is zip, in other words, you don't have to pay very much interest, you're paying interest of 1 percent, or if you can get a loan even if your balance sheet is a disaster and you don't have to make a profit, that means that you can cut your prices.

Commissioner MULLOY. That's my view. This Commission has recommended that we use our countervailing duty laws to deal with this issue and that presently our countervailing duty laws don't apply to non-market economies, and we've recommended that they be applicable to non-market economies.

Mr. GAMBLE. Let's say, for example, one of the reasons why American companies cannot compete in China, and first of all I believe the number for foreign firms exporting from China is probably—I don't know—the number I remember is like 75 percent, be-

cause the problem is that the state-owned companies don't work very well.

But the problem is if you go in and compete against a Chinese company, first of all, the Chinese company doesn't necessarily have to make a profit. It's a government-owned company. It may be interested in full employment rather than making a profit.

Two, it controls the regulation of your local environment so the things that you make may not be allowed on their roads or in their houses.

And the third thing is the loans. Your cost of capital is zip. So obviously that means you can cut your prices.

Commissioner MULLOY. Do either of the other two witnesses have any comment on that issue?

Chairman ROBINSON. We are—okay—briefly, if you don't mind.

Mr. BOTTELIER. A short supplementary comment if I may, Mr. Commissioner. If Chinese state-owned enterprises have unfair cost advantages because of subsidized credit, I think that there you have a very serious point, and that's an unfair trade practice, which should be subject to countervailing measures. I agree with that.

But that's not what I meant earlier. I think you posed the question about subsidies in the context of the resolution of China's NPL problem. I see it in a sort of broader context. Subsidies can rise, because some Chinese enterprises still have access to state credit to cover up losses.

Commissioner MULLOY. Thank you very much.

Chairman ROBINSON. I'd like to thank this panel very much for what were an insightful set of remarks that are going to enrich our report writing, which is underway now, and with that, I'd like to excuse Panel I and invite Panel II forward. We're trying to keep this a compressed hearing, we will not break, but rather go forward as soon as we possibly can.

Thank you.

[Whereupon, a short break was taken.]

PANEL II: CORPORATE GOVERNANCE AND INVESTOR CONCERNS

Chairman ROBINSON. Okay. We'd like to convene our next panel. And we'll try to keep this on time best we can. We're going to be hearing from Nell Minow today, Editor of the Corporate Library and a world renowned corporate governance expert; Dr. Norman Bailey, a Senior Fellow at the Potomac Foundation and former Senior Director of International Economic Affairs and Special Assistant to the President for National Security Affairs at the Reagan National Security Council; Thomas Byrne, Vice President of Moody's Investor Services, with a trade record on China; and Jeffrey Fiedler, President of FAST over at AFL–CIO.

And if I may, I'd like to begin in that order, if we could with Nell Minow kicking this session off. Thanks.

STATEMENT OF NELL MINOW
FOUNDER AND EDITOR, THE CORPORATE LIBRARY

Ms. MINOW. Thank you very much, Mr. Chairman and thanks to the Commission for inviting me to be here today. I really salute you for your important and thoughtful work and it's a great privilege to be a part of it.

Just a word about my organization so you know where I'm coming from. I'm the editor of an independent research firm, the Corporate Library, located in Portland, Maine. We specialize in corporate governance in the U.S. and internationally, and we believe, and this is really the core of my presentation today, that corporate governance is not something that we do because it is nice to do or it's pretty to do.

It's something that is an essential element of the risk assessment of any investment, and we believe, for example, that if people had looked at the corporate governance of Enron, Global Crossing, Tyco, et cetera, they would not have been as surprised by what went wrong at those companies.

So in the United States, of course, we've addressed some of the fallout from the corporate scandals of 2002 with legislation like Sarbanes-Oxley, with regulatory initiatives coming out of the SEC, with the New York Stock Exchange listing standards, but vastly more important than anything that we can do on the regulatory and legislative side is, and is appropriately, the market response, and the market has recognized that governance is a risk factor.

Moody's in particular has been a great leader in this field, and I was delighted to see that Moody's for the first time ever downgraded the debt of an American company purely on the basis of its corporate governance. And I think we're going to see a lot more of that. The D&O liability insurers, the vote against management at Disney, all of this shows you that the market is responding the way markets do. The market understands that governance is a risk factor.

Globally, how do we apply the issue of corporate governance? I'm the last person ever to suggest that we should try to impose our system, which I don't think is so great on everybody else. In fact, I've asked the World Bank if the United States could be included as an emerging economy so that we could get the benefit of their emerging economy assistance program on corporate governance.

But I think the World Bank has done a very good job in identifying what the three priorities are and then asking each country to tell us how it is going to meet these three priorities. Those priorities are independence, accountability and transparency. So as I talk about corporate governance in China just a little bit today, I want to keep those three things in mind.

American investors are eager to participate in the growth of China's economy and there have been many encouraging developments there in the field of corporate governance. Particularly we want to salute the work of Laura Cha, the Deputy Chairman of the China Securities Regulatory Commission. Thanks to her work and others, one-third of the directors of China's more than 1,200 listed companies will have to meet strict standards of independence, including having one professional accountant on the board, and no director can serve on more than five boards. Those are really good rules. We should adopt those rules here in the United States.

However, there still are some significant concerns with corporate governance in China, and you heard a little bit in the earlier panel about the difference between appearance and reality or between the law and the practice.

I think the primary concern that I want to raise also which was addressed in the previous panel, is that issue of state control. I direct your attention to a 1997 study by World Bank economists on corporate governance in China, showing that ownership structure (both the mix and concentration) has significant effects on the performance of stock companies.

There's a positive and significant correlation between ownership concentration and profitability. That's a good thing. The effect of ownership concentration is stronger for companies dominated by legal person shareholders than for those dominated by the states.

So they raise very significant concerns about the state control and a number of factors, including labor productivity.

The second concern is the ability and independence of the directors. In an article in this new book, *International Corporate Governance*, Professor Viner says, "in no other major economy does there exist such a vast gulf separating corporate governance enshrined as code and regulation from corporate governance as practiced."

I think that's a very telling statement to keep in mind, and so as we talk about caveat emptor and the ability of the market, including investors like Warren Buffett, to make decisions about their investments in China, we want to make sure that they understand not just what is said to be the practice but what is actually the practice.

John Plender, who I think is one of the most thoughtful people writing about business, wrote in *Financial Times*, "the trouble is that enforcement is well nigh impossible as long as the state is still a controlling shareholder in so many companies. Too many independent directors are simply stooges of the state or cronies of the executive directors. They're rarely paid more than their travel expenses and few believe they will escape the egregious related party transactions that disadvantage outside shareholders and mar the Chinese government landscape."

So independence is great. We really appreciate that, but we want to make sure it's genuine independence.

Third, I want to draw your attention to what I call exploitation of loopholes. The current *Forbes* magazine has a very troubling article about Chinese companies exploiting loopholes to list on American exchanges. They mention China Cable and Communication with zero revenues and, as they say, "iffy assets." That's a technical term. *Forbes* said it had no prayer of going public even in China but through a reverse merger that set up another organization in the British Virgin Islands and then made itself a subsidiary of that, and then it merged with a shell U.S. company with no operational history in a decade we've got to plug up the loopholes on our side, people—it was able to list on the Nasdaq and raise $4 million from U.S. investors. Four other Chinese companies have done the same this year, an attractive alternative to the slow and expensive process of going public in China where 1,000 companies are waiting for review by Chinese securities authority and only one in ten are expected to be successful.

I think that's probably a good thing. It shows there is some sorting ability there. CTC Cosmetics did a reverse measure along these lines in 1997 and has been delisted with some scandal attached to

that, so we have to be very, very careful about working with the Chinese government to make sure we don't permit loopholes in administering governance standards.

And my final point is the viability of effective oversight. In order to have a strong corporate governance system, it has to be directed not just at the supply side, what the companies are doing, it has to be directed also to the demand side. You have to make sure there's a shareholder community that is capable of exercising shareholder rights. When things are not going well, you have to make sure that you have regulators, accountants, rating agencies like Moody's that can do the right thing.

I'll leave you with one quote that I think is very important. Liu Dongsheng said, "corporate governance is the core of the corporation system. That is why the perfection of the corporation corporate governance is very significant for deepening of state-owned enterprise reform in the establishment of a modern enterprise system."

Well, I completely agree with that. I just want to make sure that they put our money where their mouths are and I'm very encouraged, especially by the cooperation of the CSRC and the Shanghai Stock Exchange with the Global Corporate Forum's Private Sector Advisory Group funded by the World Bank and the OECD led by Ira Millstein in a very successful meeting with over 200 business leaders in Shanghai earlier this year, and I look forward to seeing them continue to work together.

Thank you very much. I'd be glad to answer questions.

Chairman ROBINSON. Thank you, Nell. Dr. Bailey.

STATEMENT OF NORMAN A. BAILEY
SENIOR FELLOW, POTOMAC FOUNDATION
FORMER SPECIAL ASSISTANT TO THE PRESIDENT AND
SENIOR DIRECTOR OF INTERNATIONAL ECONOMIC AFFAIRS
AT THE NATIONAL SECURITY COUNCIL

Dr. BAILEY. Thank you very much. Mr. Chairman, Members of the Commission, I'm pleased to have this opportunity to appear before the U.S.-China Economic and Security Review Commission on a topic that is on the cutting edge of our bilateral concerns with China. I also wish to applaud the Commission's leadership on this important national security issue. Yours is the only organization of the U.S. Government to be examining this crucial matter on an ongoing basis.

I'm particularly pleased to appear before a commission chaired by my very good friend and former colleague on the staff of the National Security Council, Roger Robinson. Roger and I worked on many important issues together in the White House including the LDC debt crisis of the 1980s, designing and implementing the program that came to be known as "Follow the Money" to trace the financing of various activities contrary to the interests of the United States, and not least, designing and implementing the economic aspects of the strategic plan that ended in the destruction of the Soviet bloc and the triumph of the West in the Cold War.

Today, the Commission is hearing about various dimensions of China's presence in the U.S. and other international capital markets, including recent examples of Chinese offerings and the woefully inadequate corporate governance practices associated with Chinese debt and equity offerings in this country and abroad.

I would like to add to the governance equation an issue of great importance to investors and to our country, namely, the national security aspects and implications of China's fundraising on U.S. exchanges. In short, Chinese entities coming to our markets have largely been black boxes in terms of full disclosure, minority shareholder rights, the true nature of the activities of these firms domestically and overseas and their parent subsidiary and affiliated companies, as well as the material risks that exist for American and other investors.

One category of these material risks has periodically surfaced in the security arena. For example, the vast majority of Chinese entities tapping the U.S. capital markets are state-owned enterprises. Each of these companies is often engaged in a wide range of activities from manufacturing refrigerators to the skins of ballistic missiles.

Some Chinese firms listed or traded on U.S. exchanges have been identified with arms smuggling, military related production, and intelligence-related activities. There is at least a possibility that Chinese firms associated in the past with the proliferation of weapons of mass destruction and ballistic missiles are already in or headed toward our markets and the portfolios of unsuspecting American investors.

A central problem is that Chinese companies with these types of security-related ties are involved in the sale of dual-use equipment and technology, with both civilian and military applications, are not inclined to disclose these activities in their SEC filings or prospectuses. For their part, the U.S. investment banks bringing these equity and debt offerings to our markets may also not be equipped to ferret out these kinds of associations and activities that can represent a material financial risk to investors and a potential danger to U.S. security interests.

It is for this reason that the Executive Branch should be urged by Congress to institute an intelligence review process of the type we implemented during the Reagan Administration in dealing with similar commercial financing linkages to security related concerns.

At that time, the National Security Council assumed the lead role in coordinating the bulk of these activities, including a highly classified "Follow the Money" initiative on the financial side of U.S.-Soviet relations.

The fact is that only when the competent financial agencies of the Government, such as the Treasury, the SEC, the Federal Reserve and so on, are sharing information and analyses with the security community, that is the NSC, the CIA and the Departments of Defense and State, that a meaningful result is achieved in the areas of investor protection and broader U.S. security concerns.

To my knowledge, no such interagency process is in place today that is designed to systematically review Chinese entities, particularly state-owned enterprises, listing or traded on U.S. exchanges.

To its credit, the Commission has recommended these kinds of steps to the Congress in the past and should continue to press ahead with such action items now. The quest for greater disclosure and transparency has been well served, for example, by the recent establishment of an Office of Global Security Risk at the SEC, but

that office is mandated to concentrate on companies doing business in U.S. sanctioned countries, not China.

This gap in investor awareness and information needs to be addressed as a governance initiative. China will almost surely ramp up its exposure in the U.S. capital markets dramatically over the next two to three years. In a relatively short time that exposure could total over $150 billion or more.

This would mean that millions of Americans are holding often nontransparent Chinese equities in their public pension systems, mutual funds, 401(k)'s and other portfolio holdings. To avoid a future Chinese Enron like the kind that could eventuate if a Chinese proliferator were to list successfully, for example, on the New York Stock Exchange, the Executive Branch needs to work in partnership with investment banks and other private sector market players and regulators.

For its part, the Congress needs to insist on the formation of some kind of interagency capital markets working group concentrating on Chinese debt and equity offerings in our markets and evaluating the true identified and global activities of these enterprises and their senior managers.

This group should also examine Chinese securities listed in Hong Kong on mainland exchanges that are traded in the U.S. and held by U.S. institutional investors. Specifically, it is more likely that security-sensitive Chinese firms will be purchased by U.S. investors out of Hong Kong or China itself as the disclosure requirements for such entities are generally more lax than those of U.S. exchanges.

This is particularly the case for Chinese companies listed on under-regulated domestic exchanges. The Congress then needs to conduct oversight of the findings and activities of such an interagency capital markets working group to ensure that investors receive adequate data to make properly informed investment decisions.

Recent examples of Chinese offerings like the problems that surprised investors in China Life are instructive with regard to the potential and future consequences of the U.S. Government playing no role whatsoever in monitoring security-related concerns associated with Chinese entities entering our capital markets.

Although it is clearly not the Government's job to assess risk or to perform due diligence for investors, there is little prospect that even the finest commercial due diligence could identify proliferation related abuses or other covert activities that could later harm the share value of the offending company.

Mr. Chairman, Members of the Commission, in closing, I think we can welcome benign commercial Chinese entities that seek to fund themselves in our capital markets, particularly as the requirements of our markets can help discipline and reform these Chinese enterprises.

Nevertheless, we must not permit the wrong sorts of Chinese enterprises to attract the retirement and other dollars of average American investors to help underwrite the proliferation of weapons of mass destruction, the procurement or development of state-of-the-art military systems that could one day be used against U.S.

forces, or other malevolent activities within China or abroad that could damage vital U.S. security interests. Thank you very much.

[The statement follows:]

Statement of Norman A. Bailey, Senior Fellow, Potomac Foundation
Former Special Assistant to the President and Senior Director of International Economic Affairs at the National Security Council

I'm pleased to have this opportunity to appear before the U.S.-China Economic and Security Review Commission on a topic that is on the cutting-edge of our bilateral concerns with China. I also wish to applaud the Commission's leadership on this important national security issue. Yours is the only organization of the U.S Government to be examining this crucial matter on an on-going basis.

Today the Commission is hearing about various dimensions of China's presence in the U.S. and other international capital markets, including recent examples of Chinese offerings and the woefully inadequate corporate governance practices associated with Chinese debt and equity offerings in this country and abroad. I'd like to add to the governance equation an issue of great importance to investors and our country, namely the national security aspects and implications of China's fundraising on U.S. exchanges.

In short, Chinese entities coming to our markets have largely been "black boxes" in terms of full disclosure, minority shareholder rights, the true nature of the activities of these firms domestically and overseas (and their parent, subsidiary and affiliated companies) as well as the material risks that exist for American and other investors. One category of these "material risks" has periodically surfaced in the security arena.

For example, the vast majority of Chinese entities tapping the U.S. capital markets are state-owned enterprises. Each of these companies is often engaged in a wide range of activities from manufacturing refrigerators to the skins of ballistic missiles. Some Chinese firms listed or traded on U.S. exchanges have been identified with arms smuggling, military-related production, and intelligence-related activities. There is at least a possibility that Chinese firms associated in the past with the proliferation of weapons of mass destruction and ballistic missiles are already in, or headed toward, our markets and the portfolios of unsuspecting American investors.

A central problem is that Chinese companies with these types of security-related ties or involved in the sale of dual-use equipment and technology (with both civilian and military applications) are not inclined to disclose these activities in their SEC filings or prospectuses'. For their part, the U.S. investment banks bringing these equity and debt offerings to our markets may also not be equipped to ferret out these kinds of associations and activities that can represent a material financial risk to investors and a potential danger to U.S. security interests.

It is for this reason that the Executive Branch should be urged by Congress to institute an interagency review process of the type that we implemented during the Reagan Administration in dealing with similar commercial financing linkages to security-related concerns. At that time, the National Security Council assumed the lead role in coordinating the bulk of these activities, including a highly-classified "Follow the Money" initiative on the financial side of U.S.-Soviet relations. The fact is that it is only when the competent financial agencies of the government (e.g. the Treasury, SEC, the Federal Reserve, etc.) are sharing information and analyses with the security community (e.g. NSC, CIA, and the Departments of Defense and State) that a meaningful result is achieved in the areas of investor protection and broader U.S. security concerns. To my knowledge, no such interagency process is in place today that is designed to systematically review Chinese entities, particularly state-owned enterprises, listing or traded on U.S. exchanges.

To its credit, the Commission has recommended these kinds of steps to the Congress in the past and should continue to press ahead with such action items now. The quest for greater disclosure and transparency has been well-served, for example, by the recent establishment of an Office of Global Security Risk at the SEC, but that office is mandated to concentrate on companies doing business in U.S.-sanctioned countries, not China. This gap in investor awareness and information needs to be addressed as a governance initiative. China will almost surely ramp up its exposure in the U.S. capital markets dramatically over the next two to three years. In a relatively short time that exposure could total over $150 billion or more. This would mean that millions of Americans are holding often non-transparent Chinese equities in their public pension systems, mutual funds, 401(k)'s and other portfolio holdings. To avoid a future "Chinese Enron" like the kind that could eventuate if

a Chinese proliferator were to list successfully, for example, on the New York Stock Exchange, the Executive Branch needs to work in partnership with investment banks and other private sector market players and regulators.

For its part, the Congress needs to insist on the formation of some kind of interagency capital markets working group concentrating on Chinese debt and equity offerings in our markets and evaluating the true identities and global activities of these enterprises and their senior managers. This group should also examine Chinese securities listed in Hong Kong on Mainland exchanges that are traded in the U.S. and held by U.S. institutional investors. Specifically, it is more likely that "security-sensitive" Chinese firms will be purchased by U.S. investors out of Hong Kong or China itself as the disclosure requirements for such entities are generally more lax than those of U.S. exchanges. This is particularly the case for Chinese companies listed on under-regulated domestic exchanges. The Congress then needs to conduct oversight of the findings and activities of such an interagency capital markets working group to ensure that investors receive adequate data to make properly informed investment decisions.

Recent examples of Chinese offerings, like the problems that surprised investors in China Life, are instructive with regard to the potential future consequences of the U.S. Government playing no role whatsoever in monitoring security-related concerns associated with Chinese entities entering our capital markets. Although it is clearly not the government's job to assess risk or perform due diligence for investors, there is little prospect that even the finest commercial due diligence could identify proliferation-related abuses or other covert activities that could later harm the share value of the offending company.

Mr. Chairman, in closing, I think we can welcome benign, commercial Chinese entities that seek to fund themselves in our capital markets, particularly as the requirements of our markets can help discipline and reform these Chinese enterprises. Nevertheless, we must not permit the wrong sorts of Chinese enterprises to attract the retirement and other dollars of average American investors to help underwrite the proliferation of weapons of mass destruction, the procurement or development of state of-the-art military systems that could one day be used against U.S. forces, or other malevolent activities within China or abroad that could damage vital U.S. security interests.

Thank you very much.

Chairman ROBINSON. Thank you, Dr. Bailey. Mr. Byrne.

STATEMENT OF THOMAS J. BYRNE
VICE PRESIDENT AND SENIOR CREDIT OFFICER
FINANCIAL INSTITUTIONS AND SOVEREIGN RISK GROUP
MOODY'S INVESTORS SERVICE

Mr. BYRNE. Thank you, Chairman Robinson and Members of the U.S.-China Commission for inviting me to share a credit rating agency's perspective on this discussion of China's use of international capital markets as part of the country's economic development strategy.

The scope of the Commission's interest in China's use of capital markets covers both equity and bond markets. Today, of course, the Commission is focusing on the equity markets. At Moody's, however, the heart of our work is on the bond markets.

Although the number of Chinese companies listed on international stock exchanges has grown at a rather steady clip, Moody's rates only a small number of companies that are listed on either the Hong Kong or the New York Stock Exchanges.

When Moody's assigns credit ratings on Chinese entities, we are careful to distinguish sovereign risk from corporate risk. In fact, in practice, we take the cue provided by China's Ministry of Finance. Although we raised the sovereign's foreign currency credit rating one notch to A2, which is an investment grade rating, in 2003, reflecting the sound external credit fundamentals of the government itself, we noted in our most recently published quarterly credit opinion that the creditworthiness of all other issuers domiciled in

China should be assessed separately from the sovereign, taking into account their fundamental creditworthiness.

This is consistent with the government's external debt management and foreign exchange control policies. This has also been a consistent practice in our rating approach to Chinese corporations, at times to the displeasure of important corporations who think that their franchise or name alone merits a high rating, equal or close to that of the sovereign, that is the government of the PRC.

Most of the China domiciled firms that Moody's rates are financial institutions, 14 in total. Moody's rates about half a dozen nonfinancial corporations of which only a couple are listed on the foreign stock exchanges. The total amount of debt rated is about $10 billion including Hong Kong domiciled issues whose ultimate parents may be in China.

In addition, Moody's also rates about five billion in bonds issued by the sovereign, the Ministry of Finance.

The dollar value of these rated issues are relatively small in the context of China's substantial use of external financing and its external development strategy. However, Moody's expects more firms to tap the international bond markets in the years ahead. In anticipation, our corporate analysts have started to analyze industrial sectors, which are likely to have a larger profile in the international capital markets.

I will turn to their observations on credit concerns shortly, but briefly just to provide some context, I'll sketch China's external financing patterns. Foreign direct investment, of course, dominates the landscape and the balance of payments with a total stock of over $500 billion invested since the open door policy was announced in 1978.

On a flow basis, FDI continues to eclipse all other forms of external financing, even after scaling down the officially reported numbers that probably include offshore shell companies or some other conduit that allows mainland companies to register the source of investments as non-resident to take advantage of preferential tax treatment granted to foreign invested enterprises.

FDI inflows amounted to $53 billion in 2003, of course much larger than the figures, the potential figures that the Commission cites on the board. Of this, in 2003, only $4 billion came from American firms.

FDI is certainly a key element in China's economic development strategy. Yet it is also as important or even more important in a good number of other developing countries. The trend in China's annual FDI inflow equates to about 4 percent of the country's GDP since the mid-1990s. Other countries have had higher ratios. Slovakia and the Czech Republic, for example, FDI has reached 10 percent. The record in my books that I have seen is set by a smaller economy, an advanced economy, Ireland, where it has reached 20 percent.

In fact, the IMF has noted in a recent study that China's experience is not unusual in comparison with the historical experience of the other industrializing Asian countries.

In contrast to FDI, stock and bond portfolio investment inflows have been much lower and sometimes even negative, even in years of heightened IPO activity. The average annual numbers have fluc-

tuated from a negative 0.7 billion to a positive $8 billion in the period 1997 to 2003, although the figure for 2003 is an estimate because the 2003 balance of payments statistics were not formally released yet.

Even with the flurry of completed IPOs from China last year and those expected this year, which the bullish sell-side predictions say could reach $25 billion, which again is consistent with your number, I think that the total inflow will still be rather modest and even to achieve that, China will have to overcome some constraints.

The constraints on China's use of the international capital markets lie in Beijing's current policy regarding state enterprise reform, to the extent it's willing to let enterprises reform; its external debt management policy which, of course, has been cautious and conservative; as well as the current state of corporate governance, meaning the improvement of corporate governance.

These constraints are self-imposed and to some extent self-inflicted to the extent that greater changes are not made in a more accelerated pace.

The central authorities have also taken a lesson from the experience in the past when they allowed local entities to tap the international capital markets with very little regulation. A number of provincial investment entities went bankrupt and defaulted on their international debt obligations in the late 1990s. The authorities did not bail out the creditors, neither domestic nor foreign, thereby minimizing moral hazard in the system which is good over the long run, but it also affected international investors' confidence in China and therefore better corporate governance would certainly help improve the flow of capital into China in the future.

China could potentially induce a much greater inflow of foreign investment in its listed companies in my opinion if it shifted its ownership policy towards large and important state-owned enterprises and banks. Although the China Life and SMIC IPOs were very big, the government only relinquished partial ownership, retaining majority ownership of shares and control of firms.

Elsewhere in Asia, we see that, for example, in the case of Korea, you could gauge what could come into a country if there's a more robust liberalization policy. Foreign investors, foreign portfolio equity investors last year pumped in 13.5 billion into the domestic stock market in Korea. Foreign investors now own more than 40 percent of the shares listed on the Korea stock exchange. Also, foreign investors own more than 60 percent of Pohang Iron and Steel Company, a flagship state-owned enterprise that the government completely privatized, eliminating limits on individual and foreign ownership.

Turning to the corporate ratings, Moody's has noted that some common analytical themes are apparent throughout the industries that we're focusing on in China. One is the prospects for growth. Another is the evolving regulatory regime with its consequent uncertainties, and another is a lack of transparency, not only in regard to government policy, but also to corporate structures and practices.

Because the State Council is the ultimate majority and controlling owner of China's important state sector companies, political pressures can be brought to bear on a company's operating strategy

as well as on a company's fortunes through mergers or acquisitions forced by the government.

In addition, China has yet to develop a rigorous legal framework that clearly sets out the rights of creditors. Another systemic challenge is the difficulty in acquiring sufficient and reliable data. Because weak or opaque corporate governance structures can affect earnings in a company's equity base, Moody's approach to rating China domiciled corporations is to stress strong credit fundamentals which would include low leverage, high liquidity and a strong earnings prospects.

This approach is not unique to China, as Moody's rating approach to U.S. corporations has in some instances built in what we call a ratings cushion where elements of corporate governance are considered weak.

Two cases—one recent case in point is that in Tyson Foods where we cite that the rating is, in fact, constrained by weak corporate governance as well as regulatory or legal regime issues.

Chairman ROBINSON. Mr. Byrne, we're running——

Mr. BYRNE. Okay.

Chairman ROBINSON. No, we have some time, but if you wouldn't mind moving.

Mr. BYRNE. I'm near the end. Thanks. On the other hand, good corporate governance has also been an explicit factor supporting an upgrade for rated entities in Moody's, and that case has been Wells Fargo.

Regarding government support in China, we feel it's a double-edged sword. It certainly benefits financial institutions where, and it's probably proper in the case of financial institutions, so that systemic stability is protected. However, in the case of corporations, we feel that it is—over the long run introduces too many uncertainties and therefore is a rating negative factor at times.

To summarize, I think that the recent flurry of Chinese firms tapping the international capital markets is best taken as a Chinese strategy as a catalyst reform of the system and not necessarily as a means to finance the system as a whole because of the low share that this provides to the total financing to the system.

However, the potential for providing investment and financing for the system as a whole would be greatly increased once China opens up its domestic capital markets to foreign participation and when foreign investors are confident enough to participate in these markets.

Thank you.

[The statement follows:]

Statement of Thomas J. Byrne
Vice President and Senior Credit Officer
Financial Institutions and Sovereign Risk Group, Moody's Investors Service

Thank you, Chairman Robinson, Commissioner Wessel and Members of the U.S.-China Commission for inviting me to share a credit rating agency's perspective and to discuss China's use of international capital markets as part of the country's economic development strategy.

Moody's opinions on the creditworthiness of the Chinese government and the country's financial and non-financial corporations dates back to 1988 when the rating agency assigned an A3, investment-grade rating on the foreign currency obligations of the government. Moody's ratings on China have since expanded, mostly in the financial sector, including the big four state-owned banks. Moody's has relatively few ratings on non-financial corporations, domiciled in the mainland or in Hong

Kong, reflecting the nascent developmental stage of China's financial markets, which have been dominated by bank rather than capital market intermediated funding. Moreover, the government has been cautious in allowing state sector firms to tap international markets for funding, mindful of the weak credit culture in the state-sector dominated economy and its desire to protect the creditworthiness of the sovereign.

When Moody's assigns credit ratings on Chinese entities, we are careful to distinguish sovereign risk from corporate risk. In fact, and in practice, we take the cue provided by China's Ministry of Finance. Although we raised the sovereign's foreign currency credit rating one notch to A2 in 2003, reflecting the sound external credit fundamentals of the government itself, we noted in our most recently published quarterly Credit Opinion that "the creditworthiness of all other issuers (domiciled in China) should be assessed separately from the sovereign, taking into account their fundamental creditworthiness. This is consistent with the government's external debt management and foreign exchange control policies." This has also been a consistent practice in our rating approach to Chinese corporations, at times to the displeasure of important corporations who think that their franchise or name alone merits a high rating equal to that of the sovereign—the government of the PRC.

The scope of the Commission's interests in China's uses of international capital markets covers both equity and bond markets. Moody's focuses on the latter. Although the number of Chinese companies listed on international stock exchanges has grown at a rather steady clip, Moody's rates only a small number of companies that are listed on either the Hong Kong or New York stock exchanges. Most of the China-domiciled firms rated by Moody's are financial institutions, 14 in total. Moody's rates about half a dozen non-financial corporations, of which only several are listed on foreign stock markets. The total amount of rated debt is less than $10 billion, including Hong Kong domiciled issues whose ultimate parents are in China. In addition, Moody's also rates about $5 billion in bonds issued by the sovereign, the Ministry of Finance.

These numbers are relatively small in the context of China's substantial use of external financing in its economic development strategy. But Moody's expects more firms to tap the international bond markets in the years ahead. In anticipation, Moody's corporate analysts have started to analyze industrial sectors which are likely to have a larger profile in the international capital markets in the future. I will turn to their observations on the credit concerns shortly, but first I will complete a sketch of China's external financing patterns.

Foreign direct investment dominates the landscape, with a total stock of around $500 billion invested since the Open Door Policy was announced in 1978. On a flow basis, FDI continues to eclipse all other forms of external financing, even after scaling down the officially reported numbers that include offshore shell companies or some other conduit that allows mainland companies to register the source of their investments as nonresident to take advantage of preferential tax treatment granted to foreign-invested enterprises. In my opinion, some of this so-called "round tripping" is in the investment inflow from Hong Kong, which comprises about one-third of annual inflows. Other sources are offshore financial centers—the British Virgin Islands and Cayman Islands in recent years have channeled more FDI than the European Union, than the U.S, and than Japan, individually. FDI gross inflows amounted to $53 billion in 2003, up from an annual average of about $43 billion in the years after the 1997 Asian financial crisis. Of this, only $4 billion come from American firms in 2003.

FDI certainly is a key element in China's economic development strategy, yet it is also as important or even more important for a good number of other developing countries. The trend in China's annual inflows of FDI equates to about 4 percent of the country's GDP since the mid-1990s. In the cases of Slovakia and the Czech Republic, the share is much larger, at times reaching 10 percent of each country's GDP. The record in this category belongs to an advanced, albeit much smaller, economy, Ireland, where FDI has at times reached 20 percent of GDP. In addition, the IMF notes that the magnitude of FDI in China has not been unusual in comparison with the experience of other newly industrializing East Asian economies.[1]

In contrast to FDI, stock and bond portfolio investment inflows have been much lower (and sometimes negative on a net basis), even in years of heightened IPO activity. The annual numbers have fluctuated, ranging from a negative $0.7 billion to a positive $8 billion, rounded off between 1997 and 2002 (China has not yet released its 2003 balance of payments statistics). Even with the flurry of completed IPOs from China last year and so far this year, most likely the level of portfolio invest-

[1] "The Global Implications of the U.S. Fiscal Deficit and of China's Growth," Chapter II, World Economic Outlook. IMF. April 2004.

ment inflows this year will not vary greatly from the upper bound in recent years. Moreover, it would be very difficult for such inflows to approach anywhere near the level of FDI inflows, in my opinion, even if bullish sell-side predictions are realized, that foreign IPOs could range from $15 billion to $25 billion in a good year with favorable liquidity and interest rate conditions. The absolute level of portfolio investment inflows into China have been less than those recorded by smaller economies in the region, and far below amounts received by Japan or other advanced economies.

The constraints on China's ability to expand its access to the international capital markets lie in Beijing's current policy regarding state enterprise reform and external debt management, as well as the current state of corporate governance. These are both self-imposed and self-inflicted. The central government's conservative policy towards external debt management inhibits or precludes corporations from gaining approval to raise debt unless they can be assured of receiving a credit rating in line with, or close to, that of the sovereign. The central authorities have taken a lesson from the experience of the provincial international trust and investment companies, a number of which went bankrupt and defaulted on their international debt obligations in the late 1990s. The authorities did not bail out creditors, neither domestic nor foreign, thereby minimizing moral hazard, but also making international investors, as well as Moody's, more wary of assessing credit risk at the sub-sovereign and corporate level.

China could potentially induce a much greater inflow of foreign investment in its listed corporations if it shifted its ownership policy towards large and important state-owned enterprises and banks. Although the Bank of China, China Life, and SMIC IPOs were very big, the government only relinquished partial ownership, retaining majority ownership of shares and control of the firms. In contrast, the case of Korea provides a gauge to assess the unrealized potential of a more robust liberalization policy. Foreign investors, among the largest being American, invested $13.5 billion in domestic firms listed on the Korean Stock Exchange (KSE) alone in 2003. Foreign investors now own more than 40 percent of the shares listed on the KSE, and own more than 60 percent of Pohang Iron and Steel Company, a former flagship state-owned enterprise that the government completely privatized, eliminating limits on individual and foreign ownership.

A gradual opening of Chinese firms to foreign share-holding seems prudent, however, in view of the evolving nature of China's place and responsibilities in the global economy, as well as its adaptation to global capital market practices and norms. Indeed, only in the past few years has the central government begun to comply with standards set by the International Monetary Fund for timely and full disclosure of macroeconomic and national financial data. China's subscribing to the IMF's basic criteria, the General Data Dissemination Standard, means that it has started to provide to the global capital markets balance of payments data consistent with international practice. However, China's national statistical capabilities and transparency are not yet up to the level of the IMF's Special Data Dissemination Standards, by which most emerging market countries active in the global capital markets subscribe. Moreover, the IMF standards do not directly address the issue of data quality, in which China has made progress (in the early 1990s much of the country's domestic and external financial data were a state secret) but there remains much room for improvement, although various agencies should be given credit for striving in this direction.

Turning to Moody's work on China corporate ratings, our fundamental credit analysts have started to publish research on China's leading companies and industries. This initiative is being done to build a foundation for credit analysis of unrated Chinese companies and their industries. This is not the same thing as publishing a rating, but is being done in anticipation of future demand for more ratings, both by Chinese companies themselves and by the market. Moody's has already published extensively on the banking industry (where we have published credit ratings on 14 institutions, and have also published financial strength ratings on 12 of these institutions). Non-financial published ratings are on companies in the telecommunications, power generation and oil and gas sectors. Moody's has also started to look at the airlines industry and will turn to other sectors in the future.

Moody's has noted that some common analytic themes—prospects for strong growth, evolving regulatory regimes and consequent uncertainty, and a lack of transparency not only in regard to government policy, but also to corporate structures and practices. Because the State Council is the ultimate majority and controlling owner of China's important state sector companies, political pressures can be brought to bear on a company's operating strategy as well as on a company's fortunes through mergers or acquisitions. These are the companies with the highest profile in the international capital markets. In addition, China has yet to develop

a rigorous legal framework that clearly sets out the rights of creditors. Another systemic challenge is the difficulty in acquiring sufficient and reliable data. Moody's believes that such studies will contribute to strengthening transparency and analytical knowledge of China's corporate structures.

Because weak or opaque corporate governance structures can affect earnings and a company's equity base, Moody's approach to rating China domiciled corporations is to stress strong credit fundamentals, including low leverage and high liquidity. This approach is not unique, as Moody's rating approach to U.S. corporations has, in some instances, built in a ratings "cushion" where elements of corporate governance are considered to be weak.[2] On the other hand, good corporate governance has been an explicit factor supporting an upgrade of a U.S. financial institution.[3] Government support is a double-edged sword in China. Such support is a strong positive credit factor in the banking industry (where there is a wide discrepancy between credit ratings and financial strength ratings, which exclude outside support to an institution from the government or shareholders, which is one and the same in China's case).

In the case of corporate ratings, a company's status as a state-owned entity is not an automatic credit enhancement, even in strategic industries, and can be a cause for concern. For example, companies listed on foreign stock exchanges pay dividends to their parents, which retain 70 percent of the equity, if not more. These dividend payments help the parent fund its social welfare obligations (e.g., housing, health and education) to its employees. But this practice inhibits the listed company to retain earnings for its own use, and thereby hampers the listed companies financial flexibility.

Such factors will continue to be crucial ratings concerns. In the past we have communicated them in our published opinions on rated companies, from one of which I quote: "The rating also incorporates the relatively undeveloped regulatory policy governing the telecommunications industry and the consequent uncertainty as to future market structure. Moody's expects greater competition in the industry . . . although the lack of clear, rule-based regulations created uncertainty as to how competition will be introduced. . . . Moody's also takes into consideration the possible negative effect on bondholders should the central government implement policy that serves the nation's interests, possibly at the expense of the rated corporation's profitability, leverage, and growth prospects."[4]

In summing up, China's access to the international capital markets is not likely to be a dominant and steady source of financing until state control of the economy is liberalized further, predictability is enhanced in regulatory and legal systems, and until confidence is enhanced by improved disclosure, transparency and governance. If China progresses on these fronts, foreign investment in Chinese companies listed on the domestic stock exchange would potentially attract far greater financing inflows than the current flurry of IPOs on foreign stock exchanges in Hong Kong and New York.

Chairman ROBINSON. Thank you very much, Mr. Byrne.

Mr. Fiedler.

STATEMENT OF JEFFREY L. FIEDLER, PRESIDENT
FOOD AND ALLIED SERVICE TRADES DEPARTMENT, AFL–CIO (FAST)

Mr. FIEDLER. Thank you, Mr. Chairman. I will not go through my entire testimony since it covers a lot of the ground that we covered in the first panel and other panelists, but I want to emphasize a few things and actually maybe clear up what I think are some problems from the earlier panel.

The issue of materiality is critical. Everybody has said that, but one has to understand how materiality works in the United States to understand how it ought to work everywhere. You can't legislate what is required to be disclosed on every kind of company. For instance, in the United States, a hospital company versus a mining company versus a steel company, materiality is different.

---

[2] Moody's April 7, 2004 press release confirming the rating for Tyson Foods, Inc. cites this reason as a factor.

[3] Moody's September 25, 2003 press release upgrading Wells Fargo Bank cite this reason as a rating factor.

[4] China Mobile Credit Opinion, January 2002.

So there's a dynamic process where the SEC staff, civil litigation, interact. As a matter of fact, this is a true case: I sued Wal-Mart some years ago for failing to disclose $30 million worth of insider transactions where the law said you had to do it at $60,000, but the SEC for 20 years didn't catch it because Sam Walton was an icon or for some reason.

So I have very little faith in the SEC, and the SEC staff is not charged with determining the specifics of every company's disclosure.

Now, let me give you an example. Mr. Reinsch asked, I think, or one of the panelists, do you think that China ought to have different rules? No, not on foreign issuer rules. That they're a foreign issuer, everybody should have the same rules. But there is a difference in materiality on what goes on in China and what goes in Indonesia and what goes on in the United States.

Example: Nowhere in the Huaneng registration statement, their 20(f)s, 6(k)s, whatever they call them for foreign issuers, is it disclosed that Li Peng's son runs Huaneng Power.

Now, if Neil Bush ran a power company in the United States, I would say to you it is not material to disclose that his brother is the President of the United States because we have a different political system. But in China, I think it is important that Li Peng's son's relationship be disclosed. I mean that it is important that personal relationships be disclosed. For instance, if I recall correctly before Huaneng Power was allowed to list in the United States, the State Council had to approve it. His father was on the State Council.

And there are all kinds of essential dynamics like that that are unique to China and the way business is done; therefore, that are material. Now, the SEC if they're not even interested enough to appear before your committee here clearly are probably not so interested in looking at all the issues I'm talking about. I would have some suggestions for you in a little while about how you go about getting that information. They will be somewhat gratuitous but may be useful.

Let me read you a quote from the Deputy Director of the Development Research Council of the State Council from an OECD corporate governance conference in Shanghai in February of this year:

"Government investment is not entirely for the purpose of capital growth. More importantly, it is a supplementary means of maintaining state control and exercising the functions of government."

Now, let me see if I got this right. They weren't just interested in raising capital for China Life; they were interested in strengthening China Life for domestic political reasons in China. Now I think that's probably true. Okay. But it's undisclosed in the China Life registration statement what the government interest was in China Life's raising capital in the United States.

I would go to one other quote that is actually in the disclosure—if I can quickly find it—where basically in the China Life disclosure they say, we're government-owned so we may make decisions. The government may force us to make decisions that are not in your best interests. That's a paraphrase.

Question: Is it material to give some recent examples of government decisions that were not in the interest of shareholders? I would submit to you that it is very material and it is unique to China. And, therefore, materiality for Chinese companies is dif-

ferent as materiality for every company in the U.S. equity market is different.

I would say to you that another hearing here ought to consist not of folks like us, but of investment bankers and lawyers who, by the way, have a legal responsibility under U.S. securities laws in the conduct of due diligence even for ADRs, I believe now. They probably have a greater legal responsibility for regular U.S. equity issues, but they still have some legal responsibility.

They are the ones who are conducting this due diligence. Just have the people that actually do the due diligence, and I think that you would have a very instructive hearing when you ask people what are the problems you have in gathering information. Mr. Gamble was giving you many not so humorous references to the difficulties of gathering information. I think it's extremely difficult.

Now, from the point of view of the trade unions, we're not interested in institutional investors taking our members' money and putting it at risk in China. I mean there is a reason for ERISA, the Employment Retirement Income Security Act. The question of prudence is real to us. I don't care if Warren Buffett loses his money. It really doesn't matter to me, but what does matter to me are the 13 million people we represent and the investment managers who invest their money.

I'm probably concerned about mutual fund investments because they represent individuals doing stuff on their own, and there's little disclosure on mutual fund investments available to those people. They tend to be less sophisticated investors and I think they ought to stay out of the China market.

I do believe that the SEC is ill-equipped for all the reasons that everybody has talked to you about to really enforce the U.S. securities laws, and the reduced laws that exist for foreign issuers, including Chinese companies. By the way, nobody has ever really explained to me a good reason why foreign issuers should have lesser standards than U.S. companies.

Let me see if I got this right. I want to raise a billion dollars. I'm a Chinese company; I'm a U.S. company. So you're still getting a billion dollars whether you're one company or the other, but one company, the U.S. company, has to disclose more and the Chinese company has to disclose less? I don't see where there is any equity in that discussion. I think the lesser requirements for foreign issuers is because we have a lesser ability to enforce stronger requirements.

Thank you.

[The statement follows:]

Statement of Jeffrey L. Fiedler
President, Food and Allied Service Trades Department, AFL–CIO (FAST)

My name is Jeffrey Fiedler and I am President of the Food and Allied Service Trades Department, AFL–CIO ("FAST"). Allow me to thank the Commission for the opportunity to present our view of PRC participation in the capital markets.

I will focus my remarks on PRC participation in the U.S. capital markets, mainly the equity markets, and raise some issues that I believe merit the further attention of the Commission and its staff.

The AFL–CIO has two primary interests in this issue. One, we are firmly committed to protecting the retirement security of the millions of people our affiliates represent; and two, we are firmly committed to the establishment of freedom of association in China as a necessary predicate to the development of a real form of democracy in that country.

Therefore, at the onset, let me make clear that we are opposed to institutional investors handling the pension monies of our members investing in either the PRC stock market, or in purchasing American Depository Receipts (ADRs) of those PRC companies listed on the stock exchanges in the United States. You may recall that we made a determined effort (with considerable success) to discourage institutional investors in this country from investing in the PetroChina IPO.

The operation of the capital markets is understandably complex. Regulatory mechanisms differ greatly from country to country. But, despite these differences the need for investor protection is universal. Rather than get into the vagaries and nuances, allow me to focus on some key elements critical to the continued success of the U.S. equity market and whether PRC companies measure up.

Disclosure of company information, in all its many aspects, is central to the success of the equity market in the United States. There are many laws, rules and regulations governing disclosure and the Securities and Exchange Commission oversees most, but not all, aspects of the process in the United States.

The key concept underlying disclosure is "materiality." Simply put this is information about which "an average prudent investor ought reasonably be informed." It is impossible to legislate with specificity exactly what information is "material" for every company or every industry. Therefore, in the United States this is handled in some respects by the staff of the SEC and in others by shareholder litigation. With regard to the latter it is important to point out that in the United States investors have a private right of action. They may sue a company for, among other things, failing to disclose "material" information.

Another hallmark of the U.S. system, which was recently buttressed by the passage of Sarbanes-Oxley, is the role of independent directors. The new legislation, stock exchange rules, and public pressure from investors as a result of a string of scandals, has placed renewed emphasis on the importance of independent directors.

Another critical part of the system is the role of independent auditors in making certain that company financial information is properly maintained and disclosed to shareholders.

The last aspect of the system I will address is the legal responsibility that investment banks have when they underwrite initial public offerings or new stock issuances. To some extent these responsibilities are shared by law firms involved in the offering process. Investors rely upon the lawyers and investment bankers performing adequate "due diligence" before a stock is offered for sale.

Before examining China and PRC companies against these elements, it should be said that despite the fact that the United States is probably the most transparent country in the world with the most vigorous securities regulation system investing in the equity market carries considerable risk and, as our recent scandals demonstrate, scofflaws abound and constant vigilance is more than justified.

While I am most concerned about the ADRs of PRC companies, one cannot think about them without understanding the environment within China.

China remains a non-market economy. The government remains controlled by the Chinese Communist Party, despite its ongoing identity crisis. While the Party may lack a truly communist ideology, it clearly still believes completely in maintaining its own power. In the interest of full disclosure, permit me to state at this point that we believe that giving PRC companies access to the U.S. capital markets strengthens the continued existence of the current government and the Chinese Communist Party and their repressive rule. We would deny them this access.

That being said, the reality is PRC companies can raise capital in the U.S. market.

Some 50 PRC companies are listed on various U.S. stock exchanges; the vast majority owned substantially by the government.

It is my understanding that Chinese companies must first receive approval from the State Council before beginning the process of registering their IPO in the U.S. This means that the Chinese government as a matter of policy decides which companies can raise capital. The political considerations within the policy decision itself are unknown.

Similarly, most analysts concede that the Chinese government has a role in the selection of management as well as members of the Board of Directors, including the so-called independent directors.

The role of Chinese government decisionmaking in business raises a number of issues. One must question whether or not decisions are being made for business or political reasons or some varying combination. Quite clearly, the role state enterprises play within China's political economy remains important. It would be too much, though, to believe that management makes its own decisions without worrying about what government officials think.

This decisionmaking dynamic, which is no doubt different from company to company, is never, in my opinion, fully illuminated in the filings required by the Securi-

ties and Exchange Commission. Rather, we are presented with boilerplate disclosure such as appears in the recent China Life Insurance Company Limited registration statement:

> "CLIC (China Life Insurance (Group) Company, the controlling shareholder) is a state-owned enterprise. Accordingly, the PRC government has the power, through CLIC, so long as CLIC holds the majority of our shares, subject to our articles of association and applicable laws, to control the composition of our Board of Directors and, through the Board, to exercise significant influence over our management and policies."

The filings also state:

> "As our controlling shareholder, CLIC will be able to exert influence on our affairs and could cause us to make decisions or enter into transactions that may not be in your best interests."

Investors are not afforded any meaningful recent examples of the government's role in China Life's decisions. This is a serious omission for as Chen Qintai, Deputy of the Development Research Center of the State Council wrote in a paper presented in February at an OECD sponsored corporate governance conference in Shanghai:

> "Government investment is not entirely for the purpose of capital growth; more importantly, it is a supplementary means of maintaining state control and exercising the functions of government."

Furthermore, there is no information about the role individuals in management or on the Board currently have in the Chinese Communist Party. There are a mere three (3) mentions of the word "communist" in the entire China Life registration statement. All concern the previous positions of one of the non-executive directors of the company. The current Party status of all key people is omitted, as if this is irrelevant in a country where Party status is clearly material to the personal advancement of executives and directors of state enterprises. There is also no mention made of the existence of a Communist Party Committee at China Life and who heads it. Some of the smaller issue ADRs have more extensive mentions of directors current Party positions in the 20F's filed with the SEC (see attached sample of director bios), but none have any mention of the role of the Party in corporate decisionmaking. I do not believe that this omission leads to the conclusion the Party has no role in company operations.

China has been characterized in a classic understatement as "opaque." It is never been deemed "transparent," although many would have us believe that it is becoming "more transparent." The issue is whether China is transparent enough for prudent investors.

Transparency goes to the heart of "due diligence." It is not naïve to ask how U.S. investment banks and lawyers involved in the underwriting of initial public offerings actually conduct their due diligence, particularly on state enterprises. What company documents do they examine? Are they given access to government documents? If not, why not? If so, are these only public documents? Do they have access to "neibu" documents? Are they allowed to examine portions of the minutes of State Council meetings during which matters concerning China Life, for instance, were discussed? Since personal and familial relationships are so important in China, how is it the investment bankers and lawyers determine if company executives are related to regulators, or high Party officials? How do they determine if corruption is a problem in the company? How is it that those conducting due diligence determine if company executives are engaging in related party transaction with themselves or relatives? How open are Chinese banks to revealing a company's repayment history? And, there are many more such questions of fundamental interest.

In a country in which "state secrets" include all manner of what most people would deem simply embarrassing information, due diligence, as we know it, is difficult, if not impossible. My suspicion is that our investment banks have simply lowered their standards to deal with the inherent obstacles created by a lack of transparency.

Independent auditors are critical to investors having confidence in the financial information PRC companies disclose. The accounting industry in China remains in its infancy.

Chris-Devonshire Ellis, a Senior Partner at Dezan Shira & Associates in Beijing, writes this month in "China Briefing":

> "A number of times recently, Chinese firms preparing for IPOs, and some even after IPOs, were found to have engaged in illegal window dressing and misrepresentation or were exposed for having fraud problems. Consequently, some had to delay their flotations. Big accounting firms and

banks should be alert to the risk that their own staff may accept bribes or other advantages from Chinese SOEs seeking a listing."

China Life, the most recent PRC ADR offered on the New York Stock Exchange, has been the subject of reports of major accounting fraud by its predecessor company. The ADR price, of course, dropped on the news. While the new company itself is not apparently liable for the fraud, there are many questions about what China Life knew about ongoing Chinese National Audit Office investigations. And, from our point of view, it would be interesting to know if the U.S. investment banks and lawyers involved in the IPO knew anything about the problems.

China Life, like many other companies offering ADRs in the U.S., keeps at least three sets of financial figures: one to comply with PRC accounting rules, another to comply with Hong Kong standards, and a third to comply with U.S. foreign issuer standards. All of this, in a environment rife with corruption and fraud, leads a reasonable person to question the veracity of any and all financial reporting.

As stated earlier, independent directors are a critical element in corporate governance. Many of the so-called independent directors of PRC companies are former senior officials in the Chinese government. Independent seems to mean simply not employed by the company in question. It is difficult for an investor to evaluate the real independence of these directors without more detailed and reliable related party transaction reporting, information on their compensation, and their continuing relationship with the government and the Communist Party. Therefore, one cannot consider them truly independent in the sense we know independence in the U.S.

Corporate governance is not simply a matter of government regulation. In the United States, we rely strongly on civil litigation to keep corporations honest. China is still a country without the rule of law. While there is a growing body of corporate law, it is still rudimentary, and its use does not appear to have any significant deterrent impact on illegal conduct. In the case of fraud involving ADRs, U.S. investors can sue the company in the United States, but the chances of recovering damages from a company whose assets are largely, if not totally, in China are virtually non-existent. U.S. investors suing in China would be a relatively pointless exercise.

Shareholder activism is integral to corporate governance. It is absent from China as is activism of many other kinds largely because freedom of association does not exist. It does not stretch the imagination to believe that shareholder activism as we know it would be considered subversive by the Chinese government, especially since most of the listed companies are majority state owned. Investigative news reporting concerning companies, common in the U.S., is rare in China and has, in some cases, resulted in the arrest of the reporter. Therefore, in China sole reliance upon the government to ensure compliance with the securities laws is the unfortunate reality, and will continue to be for the foreseeable future. This will inhibit the real development of a corporate governance system.

Investing in Chinese companies, whether in the form of ADRs or on Chinese exchanges, is in my view, one of the riskiest investment propositions available. Speculators and gamblers of other sorts are welcome to lose their money, but American mutual funds and institutional investors should not take such risks.

In conclusion, allow me to suggest the Commission look into the following issues in the future:

1. How U.S. investment bankers and lawyers conduct due diligence in China, and what obstacles do they specifically face that are fundamentally different from obstacles in the United States?
2. What unique problems do experts at the Securities and Exchange Commission perceive concerning questions of material and disclosure regarding PRC companies listing in the United States?
3. Examine U.S. foreign issuer related securities laws and regulations to see if they are adequate to the task of dealing with non-market countries securities. Examine whether exemptions granted to foreign issuers as a matter of law are still justified.

Thank you.

Panel II: Discussion, Questions and Answers

Chairman ROBINSON. Thank you, Mr. Fiedler. That was very illuminating, as were all the comments from the panelists. So with that, I'd like to open the question period, and turn to the Co-Chairman of today's hearing, Commissioner Wessel.

Co-Chair WESSEL. Thank you, Mr. Chairman and thank you all for appearing here today. This has been an illuminating day about

many of the challenges, and while we appreciate the expertise of the first panel, it was surprising that some of the questions that arose seemed to stump them.

That's troubling because it means that many of the issues, for example, access to capital, should there be malfeasance, corruption, et cetera, access to capital the small investors are probably out of luck.

Mr. Byrne I'd like to ask you a question regarding materiality within your area of expertise as it relates to the debt issuance. If a company such as Ford were doing business in China with a major proliferator that was under sanction, would that be something that you would want to know as you looked at their overall operations in rating the company?

Mr. BYRNE. Commissioner Wessel, I should preface any response I make to you that I am a sovereign analyst and not a—first of all, I'm not an accountant; I'm not a lawyer, not even directly responsible, just indirectly participate in the corporate ratings. So in regard to—we try to—just your general answer is when we do a rating on China, we try to see what possible environment in which a company operates and what negative consequences could happen if the management chose to act in a way that wasn't in the interests of the investors, the shareholders.

If there is some political problem with the board, the management, or something like that, the way we react to that is to build a cushion so that we'd want even stronger fundamentals to offset any potential surprise because we realize in looking at Chinese companies, you don't always see what you get, so therefore we would like to see a lot of what we can see to offset any potential surprise.

Co-Chair WESSEL. Any of the other panelists, any comments on that situation?

Mr. FIEDLER. Yes, I want to be careful in naming names. NORINCO was sanctioned by the United States for proliferation issues, I believe, with Iran. And there was a two-year bar on NORINCO parents and subs doing business in the United States. I will have to—you allow me to reserve correction—one of the first companies ever brought public in the United States, China's company Ek Chor Motorcycle, was substantially owned by NORINCO. I do not know as of today whether or not it still is.

But if it were, does it fit under the sanctions or has anybody thought about it? Has anybody caught it?

Number two, the sanctioned company NORINCO is in dozens of joint ventures with U.S. companies in China. The question, clearly the sanctions do not cover the continued conduct of business with NORINCO on the part of U.S. companies. Whether it ought to or not, we all probably have opinions. My opinion is it should.

Is it material? That's a question of the size of the joint venture vis-à-vis the size of the U.S. company. But this is an unexplored territory that could be explored in about a week's worth of work.

Co-Chair WESSEL. Ms. Minow, if I could ask you with regard to the corporate governance and overall issue. Mr. Fiedler talked about the 13 million union members whose pensions are covered under ERISA. I don't believe there's been a defined benefit plan, if I remember correctly, created in the last three or four years. So

increasingly workers are prey to the markets, if you will, and have limited information.

Mutual funds, the open-ended funds are flooded with so much money. The workers hear about 8, 10, 300 percent returns and they're told to diversify their investments and China looks great. So they throw their money at a mutual fund. Many of those investments, however, happen in companies that are not listed on U.S. exchanges.

Ms. MINOW. Yes.

Co-Chair WESSEL. How does the information flow through to that investor or does it at all?

Ms. MINOW. It often doesn't. Of course, mutual funds are obligated to describe the parameters of the investment, whether it's large cap/small cap, U.S./non-U.S., but with regard to the risk factor of non-U.S. listed companies, I don't think that they do a good job of warning investors what the potentials are, and the one thing they do say is something I wish investors would take more seriously, which is that past performance is no guarantee of future performance.

But you're right. People get dazzled by the returns and the potential and I think that that is a very significant concern. Increasingly, as you know, people invest in the market through intermediaries and we give them a lot of trust, whether they're pension fund fiduciaries or whether they're mutual fund companies, and I think we do need to be a lot more careful about the risks, the sovereign risks and the national security risks and the corporate governance risks, as we make these available to investors.

Thank you for the question.

Co-Chair WESSEL. Thank you.

Chairman ROBINSON. Commissioner Reinsch.

Commissioner REINSCH. Thank you, Mr. Chairman. Dr. Bailey, I think I heard you say in your testimony—I may not be quoting you correctly—that a number of companies that are listed on various American exchanges are trafficking in missiles or other elements of WMD.

Can you mention which ones those are?

Dr. BAILEY. If you don't mind, Commissioner, what I will do is present the Commission with a printed list. I have no particular desire to be sued by anybody with reference to any accusations or allegations made in open hearing.

Commissioner REINSCH. Well, we certainly don't want you to be sued either, Norman. That's fine. I think we're for disclosure. That's what we've been talking about, so we'd be happy to have you disclose. We've been having difficulty getting that information from other people, so if you've got it, that would be great.

I think Mr. Fielder has raised the key issue of this hearing, I think, which is materiality and I'm glad you did. As someone whose own paltry investments are largely mutual funds, I think I fall into your category of less sophisticated investor. So I will ask less sophisticated questions to validate that.

You seem to be saying, and I suspect Ms. Minow might agree with you, but I'd like to have her comments afterwards, that different standards or different definitions of materiality are appro-

priate for different situations. And you used the Li Peng as opposed to Neil Bush example, which I thought was intriguing.

Let's assume for the moment that that's correct, and I'm not sure that I agree with that, but let's assume that. Who should make those decisions and how do we decide what materiality means for the Chinese or for anybody as opposed to what it means for the Americans?

Mr. FIEDLER. Let me first say that what I observed is materiality is not a clear definition.

Commissioner REINSCH. I know, and I thought you were on the verge of saying something very profound.

Mr. FIEDLER. No, well, everybody thinks that it's so easy and it is not.

Commissioner REINSCH. Exactly.

Mr. FIEDLER. Now, the dynamic, so let's take China, for instance, or actually the United States. The investment banks in my view have a huge role in determining what is material. They disclose it, plus the precedent of determinations in litigation in the United States says what is key.

There is a financial threshold of 3 percent of assets or revenue for financial materiality. Outside of financial materiality, the definitions start to go. So, for instance, quality of health care delivery, suits on wrongful death and neglect in nursing homes, we may differ on whether or not that is material. It's still an ongoing fight in the United States.

So investment banks, in my view, by the conduct of their bringing companies public, are the chief determinants of materiality. The SEC has great confidence in them. Oh, Goldman Sachs, Citibank, Morgan Stanley, these are real good people; therefore, we won't spend a lot of staff time. If they think it's material, fine.

And so that's how the reality—now, Fiedler, you can sue if you don't like it, but Mr. Gamble has explained that that's a fairly——

Commissioner REINSCH. Let me interrupt you for a minute, Mr. Fiedler, because I'm going to lose my time here.

Mr. FIEDLER. Yes, I'm sorry.

Commissioner REINSCH. No, the Commission is tasked with making recommendations to the Congress. I don't think we're going to tell—well, maybe we are going to tell the Congress that the Congress ought to pass some law that relates to Goldman Sachs. I think it's more likely that Congress is going to want to address the SEC and other regulators about this question. What's your advice to us about what we should tell the SEC on materiality?

Mr. FIEDLER. The SEC needs to take a unique view of China and how business is conducted and the realities of China in determining whether it clears material for IPOs, ADRs or non-ADRs direct on any Chinese company coming to the United States.

Commissioner REINSCH. Well, let's parse that into a couple parts. One, in your view, is China unique? There is no other country for which they should be adopting the same approach?

Mr. FIEDLER. They probably do to some other countries. Okay. I'm saying that there are unique aspects to China, just as there are unique aspects to hospital companies versus steel companies that require different disclosure for companies that do all of their own business in China. So in other words, and my point earlier was

that Li Peng's son's relationship is more important in China than it is in the United States.

Commissioner REINSCH. Yes, but that's an example of the past that we can probably agree on. I'm trying to figure out how you deal with this in a regulatory manner——

Mr. FIEDLER. It's still current and should be disclosed.

Commissioner REINSCH. Okay. Agreed. But I think the question I'm still trying to deal with is how you structure a statute or a regulation to get these things addressed in the future?

Mr. FIEDLER. You don't do a statute or regulation. You say to the SEC you guys have not been doing a very good job on materiality and look at it. For instance, there is grossly different disclosure in small issuers on ADRs on the chairman of the company being the head of the Communist Party Committee of the company. And then there are big companies where that is totally omitted.

Now, I'm sure it's possible that there is no Communist Party Committee head who's chair of that company, but there's a Communist Party Committee in that company. What's the role of the party in these companies if the chairman of the company runs the party and runs the company? That is very different from France, from Spain, from Germany.

So there are conditions that exist in China that are unique and that should be deemed material to investors in the United States.

Commissioner REINSCH. Is it different from say Indonesia?

Mr. FIEDLER. It's different now. Probably less different than it would be when Sukarno was running the country and Golkar was running the country.

Commissioner REINSCH. Well, I'd like to continue this, but time is up. I did promise Ms. Minow a chance to make a comment and I don't want to foreclose that.

Ms. MINOW. Thank you very much. I appreciate it and I think it's a very thoughtful question, and I'm going to give, I think, a slightly revolutionary answer, but I think you can't use the usual models in a situation like this one. And because materiality is like the famous definition of pornography—we know it when we see it, but it's very hard to define it—I think what you have to do rather than try to come up with a definition of materiality is come up with a structure by which regulators and shareholders can ask questions which the company then must answer, and determine materiality that way.

So that FAST or even in China a shareholder would be able to ask what kinds of relationships directors and managers have and what kinds of side benefits are going on, et cetera, et cetera, and that company would have to answer.

Commissioner REINSCH. Thank you. That's really worth pursuing, but I'll leave that to my colleagues to do that. Thank you.

Chairman ROBINSON. Thank you, Commissioner Reinsch. Before turning to Commissioner D'Amato, I was intrigued by your question, and I have less fear of suit. I would only say that going back to Jeffrey Fiedler's point on NORINCO, I mean NORINCO is a serial proliferator. It's been precluded from the American markets by import controls for two years. Can qualified institutional investors buy its A shares out of Shenzhen and Shanghai markets today? The answer is yes.

Has anyone thought of that fact? My answer is probably no, nobody thought of it. Look at Poly Technologies, a PLA arms dealer of multi-billion dollar proportions at least in the past, owned by one of the teachers' retirements systems of one of our States, China International Trust and Investment Corp., headed by Wang Jun, an alleged arms smuggler, with some responsibility for the attempt to move some 2,000 AK–47s to West Coast street gangs, and the list goes on. I don't think it's a mystery that there have been companies that have been associated with security-related concerns that have surfaced in the past. I think they've been covered extensively by the press, including *Investors Business Daily*.

So Dr. Bailey can answer your question, but there is no dearth of information about examples of security-related risk concerns have arisen. Please.

Commissioner REINSCH. Not shopping for your own portfolio though, I take it?

Chairman ROBINSON. I'm not holding any of those companies I can tell you. Vice Chairman D'Amato.

Vice Chairman D'AMATO. Thank you, Mr. Chairman. First of all, I want to compliment Commissioner Reinsch on that line of questioning. I think it's a very appropriate line of questioning. I would like to follow up on it.

It seems to me, Mr. Fiedler, that unfortunately I think you're wrong. I think you really have to put in statute to the SEC what you want them to do if you can get to it, and the reason is that if you don't do it, they won't do it.

Mr. FIEDLER. You can't do that with materiality.

Vice Chairman D'AMATO. Really? Well, I think you have to take a shot at it because my question here, following up, Mr. Reinsch, is how are we going to help the average American individual investor who is probably going to invest in mutual funds and doesn't have a clue where his money is going.

And the question is how do we get to the point where he does have a clue and can make an informed decision? That's a long road but that's a road that is worth pursuing because in this case, we do have a uniqueness on the part of China, that you have a very powerful dictatorship which is running an economy and explicitly running it for purposes of improving the power of the Chinese state.

And so, what's happening with its companies has a very strong state nexus. So the question of materiality and due diligence on the part of the SEC for the individual investor is what you have to get at. It seems you have to get due diligence here on the part of the SEC that gets to the elements. If it's China, it's probably going to have the ingredients that it must be examined by a U.S. Government entity or you're not going to get to the information.

And that's going to have to be the SEC, I think, unless you can find somebody else to do it. If you have an interagency working group, as Dr. Bailey proposed, maybe that would be of great help. Maybe you have an interagency working group that gives the SEC the kind of in-depth information that it can make judgments about materiality that it can pass on to the investors.

But it seems to me we have a problem here in that we're going to have more and more mutual funds. They're going to contain

more and more Chinese SOEs. The Chinese system shows no sign of changing in terms of the legal foundations or the way it's run. So we have to deal with it as it is.

So the question is, again, begging the question, how do you get to the point where an average individual investor in a mutual fund knows where his money is going and can make a judgment? That's the question it seems to me. Is it hopeless?

Mr. FIEDLER. Nell, you want to go first?

Vice Chairman D'AMATO. Either one. Ms. Minow, how do you get there? What are the elements that you have to identify for the SEC that they have to address——

Ms. MINOW. Right.

Vice Chairman D'AMATO. —for these individual investors in terms of all these mutual funds that are going to spring up?

Ms. MINOW. Mr. Vice Chairman, it would be my greatest dream that some day you would convene an entire commission just to address that subject because that is a crucial question. Unfortunately, if I ask the Members of this Commission to raise your hand and tell us about your mutual fund holdings: do you know what their portfolio stocks are? Does anybody? Nobody knows that. And the reason we buy mutual funds is because we don't want to bother our heads with it. We want to get on with our lives.

And it is because we trust them to do a better job than if we sat at our computers and tried to pick stocks ourselves. So it's very, very, very difficult and all you can do is to bring up the same kind of materiality question that we've been talking about with regard to individual companies, and just say to the mutual funds, there are specific items of risk that we want to make sure that people understand before they put their money with you and they have got to be up front.

But, as with any kind of a disclosure requirement, you can lead a horse to water but you can't make them think, and very often, very often people tend to ignore that stuff.

Mr. FIEDLER. I'm on the hopeless side for the moment for all the reasons that she testified to earlier, Mr. Gamble, that and to my earlier point that due diligence and regulation and materiality is a dynamic thing that has many parts, some of which include shareholder activism, and a free press, a legal system where there is timely recourse. And we have all those things here and we still had Enron, WorldCom and all these other things.

So absent the key elements operating in a functional way in China, you're never going to get this disclosure. Getting the information is simply too hard.

Vice Chairman D'AMATO. Thank you.

Chairman ROBINSON. Yes, Commissioner Dreyer.

Commissioner TEUFEL DREYER. My question was prompted by Mr. Byrne's comments on FDI, but if anyone else has opinions I would be delighted to hear them. Mr. Byrne mentioned that China's FDI is only about 4 percent of GDP. Is that correct?

Mr. BYRNE. Yes, that's correct, Commissioner.

Commissioner TEUFEL DREYER. My impression is that it's a fairly important 4 percent because it provides the difference between the deficit in the state budget and being able to pay bills in China. And even though it's only 4 percent, should there be a loss of foreign

confidence in China's economic health and stability, would you or anyone else imagine that that would have reasonably severe repercussions within China in terms of social stability or would it just be a temporary blip and a causer of minor tensions?

Mr. BYRNE. Thank you for the question, Commissioner. The way we see things is, actually capital controls still exist in China, so therefore you have to differentiate the risks and the source of risks.

The state budget is not financed through external financing. The state budget is financed domestically so you're talking about the confidence of domestic residents and the ability of domestic institutions and their willingness to hold securities denominated in renminbi issued by the government.

The FDI really doesn't come into play in financing the state budget. It helps finance state-owned companies, but these aren't in the state budget. Also, China has such huge holdings of official foreign exchange reserves that any interruption or drop in foreign direct investment inflows could certainly be tied over for some time before any shocks went through into the balance of payments.

Commissioner TEUFEL DREYER. Mr. Fiedler, did you want to add anything to that?

Mr. FIEDLER. I'm not an economist. The distinction between money that comes into China from overseas and then lands there now as domestic not being used in the Chinese budget is a little strange to me.

Commissioner TEUFEL DREYER. Dr. Bailey.

Dr. BAILEY. FDI is much less likely to represent a security threat than the use of the equity or debt markets simply because the companies that engage in foreign direct investment in China control that investment and the money is used, generally speaking, in the vast majority of cases for what it's supposed to be used for and is easy to trace.

If you say you're going to build a factory, you're going to fill it with machinery and equipment, either the factory is there after awhile or it's not there. In the case of equity and debt financing, the portfolio and debt financing, the situation is very, very different. Money is fungible. Let's say, Company X, a state-owned enterprise borrows $250 million or $500 million or a billion dollars on the debt market or issues a billion dollars worth of stock, it may say that the funds are going to be used for X, Y and Z, but there is really very little possibility of tracing that afterwards.

We found that out in working together on the Soviet Union and that's what induced us to develop the "Follow the Money" program. In other words, when the East German Foreign Trade Bank borrowed money from Western banks, that money ended up not financing East German exports of which there weren't very many, but funding terrorist camps in Libya and that in turn resulted in the financing of the people who blew up the disco in Berlin which killed a number of U.S. servicemen.

Commissioner TEUFEL DREYER. My concern, of course, is that if people do invest money and bad things happen, in other words, the factory is not built, and that can have a certain effect on employment, on a number of other things; correct?

Dr. BAILEY. Yes, of course, but the kinds of concern that many people are expressing now with reference to China, these people

would presumably be much happier if the factories were not built than the fact that those factories are built and then export goods to the United States.

Commissioner TEUFEL DREYER. Ms. Minow, did you want to add anything? Thank you.

Chairman ROBINSON. Thank you, Commissioner Dreyer. Commissioner Bartholomew.

Commissioner BARTHOLOMEW. Thank you, Mr. Chairman, and thank you to our witnesses who have brought their expertise before us. I have to say I'm always particularly pleased to see the talent of women included on our panels. So thank you, Mr. Chairman, for making sure that that happened.

A comment and then a couple of questions. I was pleased to hear that Mr. Fiedler mentioned the importance of a free press. As I was listening to the interaction between Mr. Fiedler and Commissioner Reinsch about the difference between the relatives of Chinese officials participating and the relatives of U.S. politicians participating in business practices, of course, we have a very vigorous investigative press corps in this country, and they have a tendency to uncover Presidential siblings' business activities and make that information public. And I think that our press corps is a very important piece of the information that takes place.

Mr. FIEDLER. Certainly less dangerous.

Commissioner BARTHOLOMEW. The question I have, though is that it really struck me that we're talking about not two sets of information but different ways that information is being used. One is the way that American investors understand information that's provided. I can understand concerns about that. But I'm still trying to get a handle on how analysts and investigators are getting access to information in China, and if they are getting access to the information that they need to make independent judgments about what's taking place?

Mr. Byrne, in particular, I'm wondering how do your analysts do their judgments? Are they getting access to the information they need?

Mr. BYRNE. Thank you for the question, Commissioner Bartholomew. First of all, I should say that the Chinese authorities basically control our access to the Chinese market, and that we have only looked at a handful of Chinese companies relatively speaking, and the Chinese have been very—the Chinese authorities have been very careful to cherry pick those companies that it thinks are best and probably have the cleanest balance sheets and the best disclosure standards.

But our practice has been that in general those few companies that we've looked at have been cooperative, have disclosed information that was sufficient enough for us to come out with a rating. Now, in some cases, the company was unhappy with the rating and therefore the rating was never published and they did not tap the international capital markets.

But again I think what we're seeing is that, as the previous panel, Dr. Bottelier pointed out, there's a dynamic in process where companies are undergoing improvement in their reporting, their disclosure, their governance standards, and it's these companies that the government is allowing the outside world to take a look at.

Commissioner BARTHOLOMEW. Mr. Fiedler, I know you've done a lot of work on Laogai companies, and I presume there's some accounting practices that take place there that people looking from the outside don't necessarily know. Do you have any comments on access to information?

Mr. FIEDLER. Well, yes, it's hard to do, and I can give you an example, and since you made reference to Laogai, we found out some years ago, Dun & Bradstreet crediting reporting service listed 99 Laogai camps in its China directory, by the way, only three of which were listed as prisons. The rest were the company names for those prisons, and I'm sure that Dun & Bradstreet didn't do that consciously.

They accepted state statistical bureau information. If you read the *China Life* registration statement, they list the sources. They said *China Insurance Annual* is the source of our information. The question of credibility of Chinese statistics information, I just think it's very hard. Now, everybody knows it's hard so some level of information is possible to get, but it's not the level that we need to invest and risk people's money, in my view.

Commissioner BARTHOLOMEW. Ms. Minow, did you have something you wanted to add?

Ms. MINOW. Thank you, Commissioner. I just wanted to emphasize the point that the biggest problem with access to information is when there is a gap between what is stated to be true and what is actually true. If you don't have a good enforcement mechanism in place, then there is no possible way to get information.

Commissioner BARTHOLOMEW. Thank you. And then another question which was engendered by Mr. Byrne's testimony—we've heard from a couple of other people too this concept that interest or desire for FDI will help create movement for change and reform in China and indeed some people are saying it does so.

But when you look at the numbers, there is so much FDI pouring into China, do companies really decide that they need it so much that they are willing to make the changes that we are arguing need to be made? Is there that much of a need, stretching out even over the course of the next decade perhaps, that it really is going to serve as incentive for reform?

Mr. BYRNE. Commissioner, I'm not sure exactly what you mean by what we need or we intend that or we hope that money would be used for, but certainly if you look at the track record, the big increase in foreign direct investment is correlated with productive use of that capital that makes many people unhappy in that it builds export capacity.

As it was mentioned before, one of the statistics is that 50 percent of China's exports or a little more are now provided by foreign invested enterprises. So I think in general it's true to say that money that comes in in FDI is actually used for economic, bona fide economic purposes, as Dr. Bailey pointed out.

Commissioner BARTHOLOMEW. I think what I'm trying to understand is whether there is sufficient desire for FDI or that the FDI can be gotten without having to make the reforms, whether people will just choose not to make the reforms or whether it is going to be enough to do this market reforming or business practice reforming endeavor that some people have said they see happening?

Mr. FIEDLER. They've raised a lot of money with a slow reform process. So——

Commissioner BARTHOLOMEW. Yes, I think that's the answer to the question I'm asking. They can continue down this path.

Mr. FIEDLER. I think so. Until there is a major scandal.

Commissioner BARTHOLOMEW. Okay. Thanks.

Chairman ROBINSON. Thank you. Commissioner Becker.

Commissioner BECKER. Thank you, Mr. Chairman. I've got one question that's troubling me. I'd like to direct this to Dr. Bailey. Do you believe that the security of the United States is being affected either positively or negatively by opening our capital markets up to the state-owned enterprises?

Dr. BAILEY. I think the way it's been done with reference to China particularly, my answer to your question is yes. Opening capital markets in and of itself doesn't affect the national security of the United States. It may affect all kinds of other things, but it doesn't affect the security of the United States. As I said in my written testimony, we should welcome benign companies, Chinese or from wherever, using our capital markets. After all, that's what they're for.

And the fact that the world comes to our capital markets is a tribute to their depth and breadth. What we do need to do, however, is two things: make sure that companies that can be identified as clearly as proliferators are not given access to our capital markets, and, secondly, that the American investors have access to the kind of information that would be required for their making an intelligent decision, whether they want to invest in certain Chinese enterprises or not.

If they don't pay attention to where their money is going, that's their problem. But they should have the opportunity to know. They should be offered the information. If they don't consume it, that's another story. I don't really quite agree with the members of the panel who said that nobody ever pays any attention to what stocks are in the mutual funds. I know all kinds of people who spend about half their time pouring over the stocks and bonds that are in their mutual funds and pension funds.

I think that full disclosure of the state-owned enterprises would, in fact, have a very substantial dampening effect on the ability of these enterprises to use the U.S. capital market, and in any case, they should be held to these standards. They and everybody else should be held to the highest possible standards of disclosure.

Commissioner BECKER. Would anyone else on the rest of the panel have any comments? Okay. Let me just ask one last short question to Mr. Byrne. I think you're the only one on the panel who's an investor consultant of a site, right? I think so anyway—do you fall under that category?

Mr. BYRNE. Well, technically speaking, Commissioner, we're not consultants. We give an opinion on the creditworthiness.

Commissioner BECKER. Okay. That's good enough. They asked the last panel the question whether or not any of the companies that we were talking about—the SOEs—paid any dividends, and they just sort of stared at me like they didn't know what I was talking about. Would you have a comment on that?

Mr. BYRNE. I don't know if I can improve, Commissioner, on the other responses other than it's actually a difficult question to answer. If you look at my experiences from a macroeconomic perspective, it's just very difficult to get data on an aggregate sense on what the profits of companies are.

I'm not talking about necessarily dividends on equity holdings, but dividends going to foreign direct investment.

Commissioner BECKER. Well, that's the first thing that investors ask here in the United States.

Mr. BYRNE. The data quality and the data issues in China are still an evolving practice in general, so I don't know particulars. My expertise is not at the micro level, but I just know in the macro level, it's still a difficult thing to carefully and clearly define on exactly what the flows are in dividends and profits going to foreign-invested enterprises.

Commissioner BECKER. Well, how is an investor to know whether or not this is a profit institution or if this is an institution that's providing jobs for the state?

Mr. BYRNE. Well, I would think that the investor knows if the issue is whether the investor is reporting that information to the tax authorities in China and to the other regulatory authorities.

Commissioner BECKER. Comments from anybody?

Mr. FIEDLER. The publicly traded companies, one can determine quickly whether or not they pay dividends or not. I just don't know the answer specifically how many companies are paying dividends.

Commissioner BECKER. Can you give me any reason why an investor would want to invest in a company, an SOE company that is established to provide jobs?

Ms. MINOW. That's a superb question. I appeared not long ago at an event sponsored by the Securities and Exchange Commission to address securities regulators from emerging economies. So there were people there from about a hundred different countries, and one of the former Soviet representatives got up and said, "We believe that the primary purpose of a corporation is not shareholder value; we believe that it's job protection."

I said, "Thank you very much for telling us that; no one is going to give you any money. Why would they?"

Commissioner BECKER. That's right.

Ms. MINOW. And so you're 100 percent right. I agree with you completely and that is what disclosure is all about.

Commissioner BECKER. Yet we're led to believe that some of these SOEs might exactly fall in that category.

Ms. MINOW. All of them do. As far as I'm concerned, all of them do that or are in the even more virulent category of maintaining state control through the political process, and personally I would not invest in a company like that because I understand what that risk is. I just want to make sure that everyone else has that same understanding of the risk. But I think you're asking exactly the right question.

Commissioner BECKER. Thank you.

Chairman ROBINSON. Thank you, Commissioner Becker. Commissioner Mulloy.

Commissioner MULLOY. I guess this would be directed mainly to Mr. Fiedler and Ms. Minow. I feel comfortable, and as Chairman

Robinson mentioned, we're trying to do a report now, and there are lots of recommendations that come on exchange rates, trade and other things.

I'm not as familiar with capital markets, and one possible recommendation that I just want to get your views on is that we require mutual funds that are invested in Chinese firms to disclose when they subcontract, say, to Hong Kong firms their due diligence on the stocks that they're going to put in their mutual fund.

Mr. FIEDLER. The fact that the mutual fund subcontracts the due diligence to somebody else doesn't absolve them of their responsibility.

Commissioner MULLOY. So is that a good or a bad recommendation in your view or a needless recommendation?

Mr. FIEDLER. I think it's probably a needless recommendation.

Commissioner MULLOY. And what about you?

Ms. MINOW. I think it's a good recommendation because while it doesn't absolve them of responsibility, it does tell us something about at what level the decision was made and I think that that's, going back to what seems to be our overall theme today of materiality, I think that's a very material fact.

Commissioner MULLOY. Okay. Do you have any thoughts?

Mr. FIEDLER. I'm not sure it tells us whether the decision was made. It tells us where the due diligence work was done. I mean, look, if I think that you can't do due diligence really well in China, what difference does it make to me that it was done by somebody in Hong Kong?

Commissioner MULLOY. Okay. Thank you.

Chairman ROBINSON. Well, thank you very much, panelists. This has been another, as I say, illuminating discussion for us and we're very grateful for your time. We'll be sending you transcripts of this hearing, so you'll have a chance to review your own remarks. We will publish the proceedings soon thereafter.

I think this has been a very important session for the reason that I believe we're the only government body that systematically looks at China's presence in the capital markets and we'll be establishing some metrics that we can use for the Congress in our ongoing evaluation that we'll be conducting. So we're most grateful to all of you.

Ms. MINOW. Thank you very much.

Chairman ROBINSON. And with that, I'd like to just thank our staff who did a superb job preparing for this hearing, both Josh Eisenman and Carmen Zagursky. It was a terrific briefing book, and there was a tremendous amount of work that went into preparing this hearing because, again, very few fare looking at this key issue area. So I want to thank them very much, and we'll consider this meeting adjourned.

Thank you.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

STATUTORY MANDATE OF THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Pursuant to Public Law 108–7, Division P, enacted February 20, 2003

RESPONSIBILITIES OF THE COMMISSION.—The United States-China Commission shall focus, in lieu of any other areas of work or study, on the following:

PROLIFERATION PRACTICES.—The Commission shall analyze and assess the Chinese role in the proliferation of weapons of mass destruction and other weapons (including dual use technologies) to terrorist-sponsoring states, and suggest possible steps which the United States might take, including economic sanctions, to encourage the Chinese to stop such practices.

ECONOMIC REFORMS AND UNITED STATES ECONOMIC TRANSFERS.—The Commission shall analyze and assess the qualitative and quantitative nature of the shift of United States production activities to China, including the relocation of high-technology, manufacturing, and R&D facilities; the impact of these transfers on United States national security, including political influence by the Chinese Government over American firms, dependence of the United States national security industrial base on Chinese imports, the adequacy of United States export control laws, and the effect of these transfers on United States economic security, employment, and the standard of living of the American people; analyze China's national budget and assess China's fiscal strength to address internal instability problems and assess the likelihood of externalization of such problems.

ENERGY.—The Commission shall evaluate and assess how China's large and growing economy will impact upon world energy supplies and the role the United States can play, including joint R&D efforts and technological assistance, in influencing China's energy policy.

UNITED STATES CAPITAL MARKETS.—The Commission shall evaluate the extent of Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests.

CORPORATE REPORTING.—The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China and incentives that China may be offering to United States corporations to relocate production and R&D to China.

REGIONAL ECONOMIC AND SECURITY IMPACTS.—The Commission shall assess the extent of China's "hollowing-out" of Asian manufacturing economies, and the impact on United States economic and security interests in the region; review the triangular economic and security relationship among the United States, Taipei and Beijing, including Beijing's military modernization and force deployments aimed at Taipei, and the adequacy of United States executive branch coordination and consultation with Congress on United States arms sales and defense relationship with Taipei.

UNITED STATES-CHINA BILATERAL PROGRAMS.—The Commission shall assess science and technology programs to evaluate if the United States is developing an adequate coordinating mechanism with appropriate review by the intelligence community with Congress; assess the degree of non-compliance by China and [with] United States-China agreements on prison labor imports and intellectual property rights; evaluate United States enforcement policies; and recommend what new measures the United States Government might take to strengthen our laws and enforcement activities and to encourage compliance by the Chinese.

WORLD TRADE ORGANIZATION COMPLIANCE.—The Commission shall review China's record of compliance to date with its accession agreement to the WTO, and explore what incentives and policy initiatives should be pursued to promote further compliance by China.

MEDIA CONTROL.—The Commission shall evaluate Chinese government efforts to influence and control perceptions of the United States and its policies through the internet, the Chinese print and electronic media, and Chinese internal propaganda.

LIST OF WITNESSES, COMMUNICATIONS, AND PREPARED STATEMENTS

	Page
Bailey, Norman A., Senior Fellow, Potomac Foundation, former Special Assistant to the President and Senior Director of International Economic Affairs at the National Security Council	51
Prepared statement	54
Bottelier, Pieter, Adjunct Professor, Johns Hopkins University (SAIS) and Georgetown University	9
Prepared statement	12
Byrne, Thomas J., Vice President and Senior Credit Officer, Financial Institutions and Sovereign Risk Group, Moody's Investors Service	55
Prepared statement	58
D'Amato, Vice Chairman C. Richard	
Opening remarks of	7
Prepared statement	8
Fiedler, Jeffrey L., President, Food and Allied Service Trades Department, AFL–CIO (FAST)	61
Prepared statement	63
Gamble, William, Founder and President, Emerging Market Strategies Company	17
Prepared statement	19
Halter, Timothy P., Managing Director, USX China Index	24
Prepared statement	27
Minow, Nell, Founder and Editor, The Corporate Library	48
Robinson, Chairman Roger W., Jr.	
Opening remarks of	1
Prepared statement	3
Tandon, Amit, Managing Director, New York Global Securities, Inc.	28
Prepared statement	30
Wessel, Michael R., Hearing Co-Chair	
Opening remarks of	32