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U.S. Capital Markets and China: Issues for Congress

Financial ties between the United States and China have expanded significantly over the past few years. The government of the People’s Republic of China (PRC or China) has created limited openings in China’s debt and equity markets, while China’s firms have sought access to U.S. capital, debt, and private equity markets. The Rhodium Group estimates that, as of December 2020, U.S. investors held \$100 billion of Chinese debt and \$1.1 trillion in Chinese equities, while Chinese investors held \$1.4 trillion in U.S. debt and \$720 billion in U.S. equities. Many U.S. investors see growth opportunities in Chinese stocks and other financial investments.

Some Members in Congress have raised concerns, however, that U.S. investments may fund certain Chinese firms and activities that are tied to the state and efforts to advance China’s industrial, military and other goals. Congress passed the Holding Foreign Companies Accountable Act (P.L. 116-222) to address its concerns about the lack of compliance by PRC firms with the U.S. Security and Exchange Commission’s (SEC) statutory audit requirements. Chinese firms appear to use complex structures that may obscure risks, state ties, and other corporate details, complicating the effectiveness of U.S. government oversight and U.S. investors’ legal recourse.

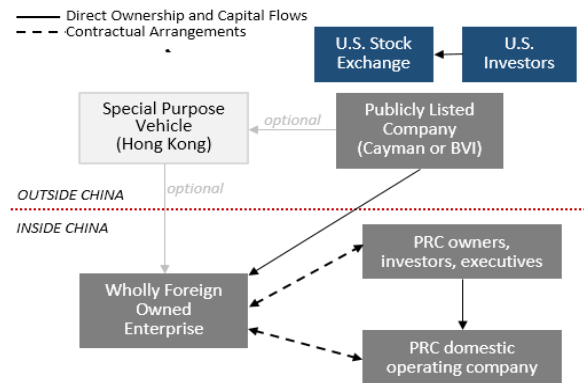
China’s Presence on U.S. Exchanges

U.S. exchanges offer China’s firms access to deep capital markets and paths to earn hard currency, build brand recognition, and expand overseas. There were 217 Chinese companies listed on the three major U.S. stock exchanges as of November 2020, up from 200 in December 2019. Some Chinese firms have delisted since 2019, but initial public offerings (IPOs) have been popular for Chinese firms in emerging industries, such as electric vehicles. China’s chipmaker Semiconductor Manufacturing International Corporation (SMIC) delisted from the New York Stock Exchange (NYSE) in 2019, but continued to trade on U.S. over-the-counter markets until February 2021, when trading stopped in response to former President Trump’s Executive Order 13959 (see below). PRC firms raised an estimated \$12 to \$19 billion on U.S. exchanges in 2020. As of October 2020, Chinese firms listed on U.S. stock exchanges accounted for a total market capitalization of \$2.2 trillion, according to the U.S.-China Economic and Security Review Commission.

In many instances, the stocks and core assets of parent Chinese firms are not listed on U.S. exchanges. Many firms use American Depositary Receipts (ADRs), a structure that allows a U.S. financial institution to sponsor a secondary U.S. exchange listing of a foreign company. The overseas parent firm’s stocks are listed in the United States through a contractual arrangement that bundles the company’s stock

certificates. Most listings of China’s large state-owned firms (SOEs) are ADRs. These ADRs include a small number of the shares that SOEs list in China, and the China-listed shares represent only a small portion of the overall firm, potentially shielding the parent and its assets from the exercise of shareholder rights and financial or litigation risk. The U.S. legal entity for Chinese SOEs is often a shell company with few assets of its own. Even when a U.S. entity is directed and controlled by an SOE parent, it has proven difficult (but not impossible) to legally establish connectivity. In U.S. litigation since 2014, the Aviation Industry Corporation of China (AVIC) has tried to deny direct ties to its U.S. affiliates and twice tried to assert immunity under the Foreign Sovereign Immunities Act (P.L. 94-583) to thwart commercial litigation despite China’s World Trade Organization accession commitment that its state firms would operate on a commercial basis. AVIC’s actions put the evidence burden on the U.S. party to show how the China parent is tied to its U.S. affiliates and why PRC state firms should not have immunity in commercial deals. The opacity of China’s system can make it hard to secure evidence, prolong litigation, and impose significant costs on U.S. investors asserting their rights.

Figure 1. Outline of the VIE Structure



Source: CRS with information from multiple sources.

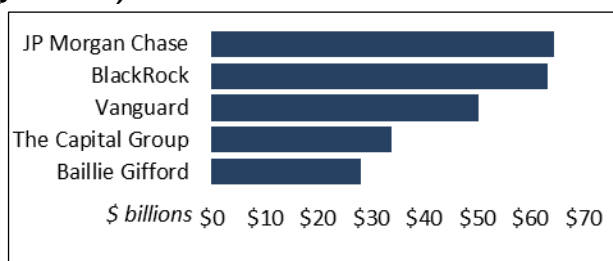
CRS estimates that two-thirds of all Chinese firms listed in the United States—including Alibaba, Baidu, and Tencent—use a variable interest entity (VIE) structure, often to address China’s investment restrictions. A VIE structure involves the owners of a Chinese firm creating an offshore holding company to which foreign investors can purchase an equity claim. The holding company is tied to the “parent” through a series of contracts and revenue sharing agreements that mimic ownership arrangements but do not provide the same rights typically afforded to investors in U.S.-listed firms. The contracts underpinning the VIE allow the Chinese owner(s) to move funds across the business while creating a firewall between the listed entity and the core assets and licenses held by the Chinese

owner. VIE arrangements appear to have no definitive legal standing in China, which may leave U.S. investors without recourse. SEC 20-F disclosures by some firms acknowledge the risks of VIEs because they are incorporated offshore, conduct most operations in China, and have executives who reside outside the United States. Some Chinese VIEs have reduced U.S. shareholder value, including for large corporate investors, by shifting business licenses and issuing off-the-books bonds. In 2010, for example, Alibaba cut out Yahoo (a 43% stake investor) in its spinoff of the online payment firm Alipay to a separate VIE, controlled by its chairman Jack Ma. In February 2021, global investors reportedly also had no alternative exit strategy or legal rights for an estimated \$10 billion invested in an offshore shell company after the Chinese government suspended Ant Financial's \$34.5 billion IPO in Shanghai and Hong Kong.

Disclosure and Auditing Requirements

While most Chinese firms are required to file an SEC 20-F annual report for foreign issuers, there are exemptions on specific disclosure requirements, particularly for ADRs. The SEC relies on China's reporting and disclosure rules, which are less extensive than U.S. requirements. Disclosure of shareholders and operations may present a conflict of interest for Chinese firms with government ties. The Chinese government prohibits the Public Company Accounting Oversight Board (PCAOB)—a nonprofit entity created by Congress that oversees audits of U.S.-listed companies—from inspecting the work of auditors based in China and Hong Kong. The inability of the PCAOB to confirm the financial health of U.S.-listed Chinese firms exposes U.S. investors in these firms to substantial risk. In June 2020, NASDAQ delisted Luckin Coffee after it was found to have fabricated sales. The Holding Foreign Companies Accountable Act (P.L. 116-222) requires firms to disclose state and military ties and a delisting from U.S. exchanges if the PCAOB cannot inspect a firm's auditors for three consecutive years.

Figure 2. Select U.S. Funds' China Stock Holdings (June 2020)



Sources: CRS with data reported in Caixin, Citic Securities, and Bloomberg.

Mutual Funds and Indices that Include PRC Firms

Five major index fund providers include PRC bonds and A-shares of firms listed on China's exchanges. U.S. pension funds have China exposure through these indices and direct holdings in Chinese firms. U.S. funds seek China exposure with an eye to potential higher returns but some in Congress and the U.S. government are concerned about potential risks. (Figure 2). In July 2020, the SEC issued an alert about U.S. exposure to China's financial markets. In May 2020, the U.S. government's Thrift Savings Plan board deferred implementing a decision to tie its international

fund to an index that includes Chinese firms in response to pressure from Congress and the Trump Administration.

Military-Tied Firms

In November 2020, the Trump Administration issued Executive Order 13959 to prohibit U.S. persons (including financial services firms) from investing in Chinese firms with military ties. Several funds initially removed certain Chinese firms from their indices, and the NYSE moved to de-list three PRC state telecom firms. Since January 2021, the U.S. financial sector has challenged the scope of the order, including corporate nomenclature and whether listed firms are tied to their China parent; Morgan Stanley said it would launch parallel indices to retain stocks in question. Also in January, the Biden Administration announced a three-month stay to review the order. Since June 2020, the U.S. Department of Defense (DOD) has identified 44 PRC military firms operating in the United States under reporting requirements established in the FY1999 National Defense Authorization Act (NDAA) (P.L. 105-261). DOD's list is not exhaustive, and is viewed by some experts as a first step in addressing U.S. commercial ties to PRC firms of concern. In the FY2021 NDAA, Congress reauthorized and bolstered requirements for DOD to identify and report on Chinese military firms.

Issues for Congress

To address its concerns, Congress might consider the potential costs and benefits of whether to:

- Expand U.S. government review and reporting on Chinese firms with state and military ties and related U.S. investment restrictions.
- Examine China's role in other areas—such as private equity and debt financing—to assess the costs and benefits of U.S. exposure and strategic implications.
- Consider additional due diligence and liability requirements for U.S. actors that represent Chinese firms; potentially seek for the SEC to further investigate and verify the accuracy and completeness of the information provided and to issue regular alerts on China investments.
- Strengthen disclosure requirements—including for investment risk and beneficial ownership—to account for state ties, opacity in China's system, complex corporate structures, and limited legal recourse. Such measures might include requiring that all firms, including ADRs, file a 10K equivalent with complete details about ownership, shareholding, and corporate ties; b) issue quarterly reports and timely updates on major changes; and c) provide separate unconsolidated financial statements for VIE contracts and controllers.
- Require Chinese firms to establish a U.S. legal presence directly tied to its China parent; b) hold ultimate beneficiaries in China legally accountable for listed firms; and c) require Chinese firms to place a significant deposit with U.S. regulators in the event of litigation.

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