

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

Before the House Committee on Financial Services, Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets on October 26, 2021

WRITTEN TESTIMONY

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Coalition for a Prosperous America (CPA) thanks the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee for holding this hearing exploring the risks to American investors posed by non-vetted Chinese companies’ exploitation of our free and open capital markets. CPA is a nonprofit, bipartisan organization representing the interests of 4.1 million households across the country who are engaged in domestic production through our agricultural, manufacturing and labor members.

Risks to Investors Posed by China’s Manipulative Behavior, Fundraising Schemes, Lack of Disclosure and Accountability, and Gaps in U.S. Law

Variable Interest Entities (VIEs)

Unlike in the United States, the government of the People’s Republic of China (PRC) restricts foreign ownership in Chinese companies in a wide array of what it deems to be "strategic" sectors. These sectors notably include many of China’s most profitable technology firms and internet companies. In order to list overseas and access foreign capital, Chinese firms often use the Variable Interest Entity (VIE) structure to subvert Beijing’s foreign ownership limits. While there is dissent in China regarding whether or not U.S. dollars or the Chinese renminbi are better for these sensitive industries, as of now, the dollar prevails as the currency of choice.

To raise capital, Chinese parent companies set up a shell company outside of China (often incorporated in the Cayman Islands), which mirror the value of the parent via a contract, and list on an American exchange. Unbeknownst to the vast majority of American investors, rather than owning shares of a Chinese company (Alibaba Group, for instance), they are in fact invested in a Cayman-based company with no assets or operations. Further, the legal validity of a VIE contract has not been explicitly confirmed by the Chinese government. This leaves American investors entirely devoid of legal recourse to recuperate their losses in the event of delisting or fraud and no minority shareholder rights. These shell companies in the Caymans, and other offshore locations, enjoy foreign issuer status and yet are not subject to the U.S. securities laws that would provide material risk information and protection to American investors.

Recently, Securities and Exchange (SEC) Chairman Gary Gensler discussed this issue and outlined steps the SEC is taking to protect American investors. These steps include pausing IPO approvals for Chinese companies; asking SEC staff to enforce higher disclosure standards for listed Chinese companies (only) to make information more readily available to American

investors, including political and regulatory risk posed by the CCP and warnings on what the government of China could do to significantly change the rules in the middle of the game.

Americans must not be complicit in funding Chinese companies engaged in industries or activities that undermine American values, economic, and national security interests. Congress should take action to protect American investors from the risks associated with scandalously deceptive VIEs and their questionable legal status, beginning with informing American investors of whether their money is, in fact, invested in Chinese shell corporations domiciled in the Cayman Islands with no real equity ownership rights or investor protections whatsoever. This dubious financial structure should be terminated, as it is "unreformable".

A-shares, Indices, and ETFs

Over the last nearly two decades, basic investor protection measures required by law in the U.S. for inspecting the audits of public companies have been evaded by U.S.-listed and traded Chinese companies. The Chinese government is the only foreign government which does not comply with the required third-party financial audits of companies listed in the United States and has sought special waivers for non-compliance with U.S. law.

Last year, the *Holding Foreign Companies Accountable Act* (HFCAA) was signed into law, and the SEC is now working with the Public Company Accounting Oversight Board (PCAOB) to implement the law to bring Chinese companies into compliance with U.S. securities laws. This is welcome progress, but the new law only covers Chinese companies listed on a U.S. exchange, or N-shares.

The HFCAA neglects to address A-shares (securities listed on mainland Chinese exchanges and only accessible to American and foreign investors via inclusion in indices and associated index funds) and H-shares (Hong-Kong listed shares). For example, there are over 4,200 such A-share companies in American passive investment products that have basically never seen the regulatory light of day and little, if any, diligence. The vast majority of American investors are unaware that their Exchange-Traded Funds or mutual fund portfolios includes exposure to China A-share companies that are not compliant with U.S. securities laws and, in some cases, have been sanctioned by the U.S. for egregious human rights and national security abuses.

The scope of the HFCAA is limited to approximately 260 U.S. -listed N-shares, and approximately 900 securities traded on the over the counter (OTC) market but neglects to include the A-shares present in indices and Exchange-Traded Funds (ETFs) tracking them, which, as mentioned earlier, leaves over 4,200 Chinese companies not covered by the same laws that protect American investors and are required of U.S. companies. Put another way, HFCAA only covers about 22 percent of the problem, if we consider the problem to be Chinese companies not covered by American securities law, leaving 78 percent of the problem yet unresolved. Exposure to these indices through ETFs amounts to hundreds of billions of dollars or more in U.S. investment.

Congress must therefore pass a similar act like HFCAA to address the glaring problem facing U.S. investors.

Risks to Investors Posed by Lack of Disclosure and Accountability of Chinese Companies

Disclosures

Many criteria are considered to be required material information to investors, but often this information neglects to include important and financially significant information on key risk factors such as political or national security risk posed by the location or type of investment being made. In order to protect American investors from unknowingly investing in Chinese corporate bad actors – including enablers of genocide and other gross human rights violations, the Chinese Communist Party (CCP), Chinese military companies, the Chinese civilian-military fusion operations, the Chinese surveillance technology regime, and the list goes on.

The Committee should work closely with the SEC to promulgate rules that require greater disclosures of national security, human rights and political information that is material to investor protection, as well as reassess the definitional standard of a foreign issuer to ensure that the highest degree of scrutiny and protection is brought to bear against companies that pose a heightened risk to American investors.

ESG Standards

As the SEC pursues implementation of new rules and definitions regarding environmental, social, and governance (ESG) standards, it is paramount that an approach be taken to include national security, human rights and political factors into the analysis of both social and governance factors when providing information to American investors and investment managers.

This would include such information as a company's status as being a sanctioned entity by the U.S., ties or connectivity to forced labor, linkages to state-owned enterprises and dubious foreign governments, genocide or other gross human rights violations, support for foreign militaries or the military industrial / civilian-military fusion operation of a foreign government (notably those considered to be an adversary of or non-allied with the U.S.), and connection to surveillance technology companies and those in the technology sector that have linkages to international espionage or the construction of a "surveillance state".

Chinese solar companies are an excellent example whereby a company could have a false positive rating under ESG for its efforts on renewables. But the company in question has direct links to forced labor and using dirty-coal fire power plants to manufacture its product. This real-world example should serve as a template for how companies should receive a negative rating in ESG. ESG must be inclusive of forced labor, and related U.S. government sanctionable activities.

It is highly troubling that of the at least 440 Chinese companies on the Commerce Department's Entity List, only 4 of them –less than 1% - are on the Treasury Department's Office of Foreign Assets Control (OFAC) list of sanctioned companies, thereby imposing an investment ban via capital markets sanctions per Executive Order 14032 and the establishment of the Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List). This means that companies that are sanctioned by our government and denied access to U.S. technology, components, equipment, and other services are still allowed to raise large sums of capital from unsuspecting American retail investors and enjoy all of the global prestige of being listed or

traded on the world's deepest and most voluminous markets. This is a scandalous double-standard that must be reconciled immediately. Simple improvements to ESG standards and sharing information with investors such as U.S. sanctions status would greatly enhance investor protection and improve the efficacy and quality of what is ESG.

Risks to Investors Posed by the Gaps and Inconsistencies in Imposition of U.S. Sanctions

The Global Magnitsky Human Rights Accountability Act

The U.S. has a robust sanctions arsenal, including the individual and targeted sanctions of the *Global Magnitsky Human Rights Accountability Act* that freeze assets or block property, eliminate access to visas, and imposes other punitive measures for criminal activity. However, this law has untapped potential when it comes to punishing bad actor companies and protecting American investors. While companies affiliated with sanctioned individuals have been listed in previous executive orders implementing the *Global Magnitsky Human Rights Accountability Act* sanctions (the first in 2017), companies are not formally targeted by this law. And until the capital markets sanctions imposed by Executive Orders 13959, 13974, and now 14032, U.S. sanctions did not focus on purely financial and capital markets activities of bad actor corporations – instead, they primarily targeted the individual. While targeting individuals is meritorious, there is room for greater Congressional and Executive action to enhance the *Global Magnitsky Human Rights Accountability Act*, or establish new laws covering corporate bad actors and capital markets activities. Congress must clarify its intentions, or pass new laws, that create a requirement that the State Department, in consultation with Treasury, report semi-annually on the presence of PRC-incorporated companies in U.S. capital markets (including in passive investment funds and products), and their ties to activities that violates internationally recognized human rights or represent a national security risk to the U.S. The resulting list of companies must then be placed on the capital markets sanctions NS-CMIC List. Chinese corporate human rights abusers, for example, or companies engaged in militarizing illegal man-made islands in the South China Sea, should not be permitted to attract funds, often in the billions of dollars, from unwitting American retail investors. It is that simple.

Capital Markets Sanctions and the Office of Foreign Assets Control

Since June 3, 2021 — the date that President Biden issued Executive Order (EO) 14032 — not one Chinese company has been added to the OFAC Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List). There are hundreds of companies, some of which are already sanctioned in some fashion by the U.S., that are well past due in being added to this list. It should be obvious by now that American retail investors, numbering over 100 million, should not be – and generally do not wish to be – holding in their Exchange-Traded Funds (ETFs) and other passive investment products, the equities and debt of Chinese companies that can be proved to be associated with, or tied to, the genocide underway against the Uyghurs and other religious minorities in Xinjiang; trafficking in slave labor; equipping concentration camps; manufacturing advanced Chinese weapons systems designed for use against American forces; and several other malevolent activities which undermine America's national security and fundamental values.

If Treasury will not take immediate action on its own, then this Committee must put forward legislation to adequately protect American investors and, for example, prohibit investment in

companies on the Commerce Department's Entity List. Moreover, according to EO 14032, Chinese surveillance technology "used to facilitate repression" is deemed a "national emergency," while Chinese corporate use of forced labor gets a free pass in our capital markets? A case in point are the Chinese solar companies which are raising large-scale funds from unsuspecting American retail investors to be used to further savage our domestic renewable energy industry. Congress must pass legislation to permanently establish the use of capital markets sanctions and broaden the language of EO 14032 to include forced labor and other Chinese corporate human rights abuses and harmonize the Commerce Department's Entity List and the OFAC NS-CMIC List in such a way that all companies sanctioned on one list are covered by the other.

Congress has made clear in an overwhelming bipartisan fashion that it believes China must be held accountable for its genocide and other egregious human rights abuses as well as corporate national security threats. One step in that process includes protecting retail American investors, including state public employee retirement systems, from investing in companies that undermine our security and values. Moreover, publicly traded subsidiaries of companies already on the NS-CMIC List that serve as the parent companies' funding vehicles on U.S. exchanges should have been added to the NS-CMIC List months ago. One example of this includes Aviation Industry Corporation of China (AVIC) that is listed as a Chinese Military-Industrial Company (CMIC) per the Treasury Department but has several publicly traded subsidiaries, including for instance AviChina Industry & Technology (2357.HK), which continues to attract American investment in the MSCI ACWI and Emerging Markets indexes, and is held by the New York State Teacher's Retirement System (NYSTRS) as of September 30, 2021. Congress must bolster the list and require the inclusion of subsidiaries and parent companies where clear financial linkages and ownership stakes exist.

Lastly, Chinese enterprises that are reported by our Department of Defense to be Chinese Military Companies (CMCs) must also be subject to capital markets sanctions and placed on the OFAC NS-CMIC List immediately. Specifically, legislation should be introduced to strengthen action already taken in last year's National Defense Authorization Act (NDAA) to place all companies listed on the DOD 1260H Chinese Military Companies Report list on the NS-CMIC List administered by the Treasury Department.

Appendix A:

Letter to Secretary of the Treasury Janet Yellen, October 19, 2021:



October 19, 2021

The Honorable Janet L. Yellen
Secretary of the Treasury
1500 Pennsylvania Ave. NW
Washington, DC 20220

Dear Secretary Yellen,

We are writing to bring to your and your Deputy's attention the very troubling fact that since June 3, 2021 — the date that President Biden issued Executive Order (EO) 14032 — not one Chinese company has been added to the OFAC Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List).

This is nothing short of astounding, as there have been many Chinese companies – a number of them already sanctioned by the U.S. via being placed on the Commerce Department's Entity List or other designations – which have committed, or enabled, egregious human rights and national security abuses and urgently warrant being added to the NS-CMIC List.

It should be obvious by now that American retail investors, numbering over 100 million, should not be – and generally do not wish to be – holding in their Exchange-Traded Funds (ETFs) and other passive investment products, the equities and debt of Chinese companies that can be proved to be associated with, or tied to, the genocide underway against the Uyghurs and other religious minorities in Xinjiang; internationally-recognized human rights violations throughout China; trafficking in slave labor; equipping concentration camps; manufacturing advanced Chinese weapons systems designed for use against American forces; militarizing illegally-claimed islands in the South China Sea; and several other malevolent activities which undermine America's national security and fundamental values.

Take the case of the five Chinese polysilicon companies that were added to the Entity List on June 24, 2021, for engaging in forced labor against Muslims in Xinjiang. Two of the five – Hoshine Silicon Industry (Shanshan) Co., Ltd. (SHA:603260) and Xinjiang Daqo New Energy Co., Ltd. (SHA:688203 – are traded on U.S. exchanges via passive investment products. In the case of the latter, its parent company, Daqo New Energy Corp. (NYSE:DQ), is listed directly on the New York Stock Exchange. A third, Xinjiang GCL New Energy Material Technology Co., Ltd., is a subsidiary of publicly traded GCL Energy Technology Co., Ltd.

These Chinese companies were placed on the Entity List for trafficking in slave labor, and hence are, in effect, denied access to American equipment, technology, components and services. How can it then be judged as acceptable by the Treasury Department to have these same companies funded by unwitting American investors and imbued with the marketable prestige of being traded in the world's deepest and most voluminous capital markets?

Moreover, why is it that, according to EO 14032, Chinese surveillance technology "used to facilitate repression" is deemed a "national emergency," while Chinese corporate use of forced labor gets a free pass in our capital markets? This is even more troubling in the case of Chinese solar companies which are raising large-scale funds from unwitting American retail investors to be used to further savage our domestic renewable energy industry.

Indeed, of the 440 Chinese companies (including those Hong Kong-based) on the Entity List, only 4 also appear on the NS-CMIC List. That represents less than 1%. This is simply unconscionable. If the reasons for this scandalous disparity include such excuses as "forced labor" not being covered by EO 14032, then this Executive Order needs to be broadened forthwith to include it and other Chinese corporate human rights abusers.

Congress has made clear in overwhelming bipartisan fashion that it believes China must be held accountable for its genocide, egregious human rights abuses, and use of forced labor. Democrats and Republicans alike will surely be concerned and demand corrective action by the Treasury Department once these and other facts are placed before them — as they surely will be — not to mention retail American investors, including state public employee retirement systems. After all, it is *their money* that is being subject to epic fiduciary malfeasance.

Moreover, verifiable subsidiaries of companies already on the NS-CMIC List that serve as the parent companies' funding vehicles on U.S. exchanges should have been added to the NS-CMIC List months ago. The Administration has claimed that the NS-CMIC List is dynamic and designed to "live and breathe." If so, the Administration needs to change course and strengthen the List's vital signs that are rapidly fading.

With regard to capital markets sanctions, we urge you to implement the following measures:

- Place all companies listed on the DOD 1260H Chinese Military Companies Report list on the NS-CMIC List.
- Place all companies on the Department of Commerce's Entity List onto the NS-CMIC List, and vice versa.
- Add more companies to the NS-CMIC List pursuant to the surveillance technology and broader human rights requirements, including forced labor.
- Expand and clarify the language of the EO to include covering subsidiaries of parent companies which are raising funds for the parent company and/or participating in the odious activities that justified the parent company being sanctioned.

In addition to numerous new Chinese military and surveillance companies being placed on the NS-CMIC list, as well as the inclusion of Entity List companies, we urge that you also

coordinate with the SEC immediately with the intention of: 1) instituting new disclosure requirements for the thousands of Chinese A-share companies (a significant number of which are U.S.-sanctioned), drawn directly from Chinese domestic exchanges and placed into American passive investment products (notably ETFs), that are held by scores of millions of unknowing U.S. investors; 2) demanding similar disclosure requirements for the hundreds of Chinese companies traded on the Over-the-Counter market; and 3) eliminating altogether the unreformable, scandalously deceptive Variable Interest Entities served up to American investors by Chinese shell corporations domiciled in the Cayman Islands and perhaps elsewhere, with no real equity ownership rights or investor protections whatsoever.

Madame Secretary, the protection of American retail investors, our national security, and the fundamental values of our nation are all at stake here. We understand the pressures you and your team face from Wall Street. However, the Treasury Department cannot put the profits and well-being of Wall Street and the Chinese Communist Party above America's national security and economic interests. Capital markets sanctions are arguably the most fearsome and effective non-military deterrent and penalty vis a vis the Chinese Communist Party ever devised by our country.

We can no longer watch in good conscience as this exceptionally powerful policy tool languishes under your stewardship. The hard-earned retirement and investment dollars of a large percentage of the American people are unwittingly underwriting genocide-enablers and other Chinese corporate human rights and national security abusers aiding the Chinese Communist Party. This is an empirically provable fact happening on your watch. You must take action to put an end to this now.

Please let us know your thoughts and action plan concerning these urgent matters at your earliest convenience.

Sincerely,

Coalition for a Prosperous America
Fight for Freedom. Stand with Hong Kong.
Hong Kong Watch
Victims of Communism Memorial Foundation

Cc: The Honorable Antony Blinken, Secretary of State
The Honorable Lloyd Austin, Secretary of Defense
The Honorable Gina Raimondo, Secretary of Commerce
The Honorable Marty Walsh, Secretary of Labor
The Honorable Katherine Tai, U.S. Trade Representative
The Honorable Avril Haines, Director of National Intelligence
The Honorable Jake Sullivan, National Security Advisor
The Honorable Brian Deese, Director of the National Economic Council
The Honorable Jerome Powell, Chairman of the Federal Reserve
The Honorable Gary Gensler, Chairman of the Securities and Exchange Commission

