COALITION for a PROSPEROUS AMERICA

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January 6, 2022

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

Re: Urgent Need to Change U.S. Policy to Protect American Investors from Risky and Dangerous A-share Investments in Chinese Companies

Dear Secretary Yellen,

We write to draw attention to the troubling continuation of U.S. investment in problematic – and often officially sanctioned – Chinese companies. It is a fact that U.S. investors are inadvertently funding Chinese companies involved in activities contrary to the national security, economic security, and human rights interests of the United States. This issue is not a mere policy concern, but also an unacceptable risk to both retail and institutional investors whose investment dollars are entangled in this sad reality. The bulk of U.S. investor exposure to known "bad actor" Chinese companies is through the holding of A-shares, or Chinese mainland companies that Americans can only access via certain investment products such as ETFs and other index funds because they are not directly listed on U.S. exchanges.

As you are undoubtedly aware, U.S. law addresses N-shares – those Chinese companies or companies contractually linked to their mainland Chinese counterpart companies -- listed directly on U.S. exchanges via the *Holding Foreign Companies Accountable Act* (HFCAA). Current law, however, neglects to address A-shares, which are securities listed on mainland Chinese exchanges (Beijing, Shenzhen, and Shanghai) and only accessible to American investors via inclusion in U.S. indices and the associated index funds derived from them.

The law also fails to address H-shares (Hong-Kong listed shares). Currently, there are over 4,200 A-share companies in American passive investment products that are not subject to U.S. securities laws and regulations for adequate investor protection and transparency purposes. The vast majority of American investors are unaware that, for example, their Exchange-Traded Funds (ETF) or mutual fund portfolios include exposure to China A-share companies that are not compliant with U.S. securities laws and, in a number of cases, have been sanctioned by the U.S. government for egregious human rights and national security abuses. *Americans should not be unwittingly financing U.S.-sanctioned Chinese companies -- period.*

The scope of the HFCAA is limited to approximately 260 U.S.-listed Chinese N-shares, and approximately 900 Chinese securities traded on the over the counter (OTC) market. This leaves more than 4,200 Chinese companies which are not covered by the same laws that generally protect American investors and govern U.S. companies publicly listed on U.S. exchanges. In other words, HFCAA only covers about 22 percent of those Chinese companies *not* covered by American securities laws, leaving 78 percent of the problem scandalously unresolved. The inclusion of Chinese companies in major American indices, and the ETFs that they spawn, provides them with access to hundreds of billions of dollars or more in U.S. retail investor dollars, *including sanctioned corporate "bad actors"*. The harm being done to scores of millions of American retail investors in the areas of human rights, national security, and investor protection is vast and strategic in scope – and has continued unabated on your watch.

Background:

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

By November 2019, MSCI had expanded its index exposure to mainland Chinese companies significantly by including mid-cap China A-shares and quadrupling the inclusion ratio of China A-shares in the MSCI EM Index from 5% to 20%. The total index weighting of China A-shares jumped from 0.7% to 3.3%, drawing in an estimated $80 billion in foreign inflows to the Chinese market. The MSCI Emerging Markets Index[1] is weighted 34.02% to Chinese securities as of December 1, 2021.

FTSE Russell followed in MSCI's footsteps and was the second major index provider to include China A-shares in its indices. In June 2019, FTSE added 1,097 China A-shares into its FTSE Global Equity Index Series (GEIS, which covers the FTSE Emerging and All-World Indices) in the first stage of inclusion (20%), drawing an expected $10 billion from U.S. passive investors. As of January 1, 2021, FTSE Emerging Markets Index[2] is weighted 35.64% to Chinese securities.

As stated above, over 4,200 largely unregulated China A-shares are presently in the investment portfolios of scores of millions of unwitting American retail investors, a number of which are U.S.- sanctioned Chinese corporate human rights and national security abusers. Our central question is this: **What are you going to do about this outrageous level of largely unregulated American investor funding of a totalitarian police state that represents the greatest existential threat to the United States in our nation's history?**

[1] Link: https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111
[2] Link: https://research.ftserussell.com/Analytics/FactSheets/temp/07c6952b-e228-4996-9801-97106a911c49.pdf

The criteria evaluated by index providers to support the selection and weighting of index constituent companies do not remotely consider an adequate range of material risks to investors, including national security, human rights, sanctions-related, legal disclosure-oriented compliance, and other considerations.

Retail and institutional investors are exposed to a wide range of publicly traded Chinese companies involved in: developing advanced weapons systems for the PLA, its Navy and Air Force, which threaten its regional neighbors and freedom of navigation in international waters; building and militarizing illegal islands in the South China Sea; facilitating the ongoing genocide of Uyghurs and other Turkic Muslims in Xinjiang; the systematic intimidation and coercive assimilation of Tibetans; the mass surveillance and government interference in people's lives in Hong Kong; the equipping of concentration camps; the international economic coercion of other nations via the Belt and Road Initiative; and the corporate trafficking in slave labor. Beyond these, additional risk factors to consider include U.S. sanctions designations, Multilateral Development Bank (MDB) sanctions and debarments, and any other "blacklists" that may present a material risk to American investors.

Today, index providers exercise virtually unchecked authority over which Chinese companies they include as constituents in their indices, especially A-share companies. This glaring lapse in U.S. regulatory authority is largely responsible for the gross fiduciary malfeasance outlined in this correspondence. The asset managers who sponsor the ETFs benchmarked against these terribly flawed MSCI, FTSE-Russell, and other indices, are equally or even more responsible for endangering American investors and our country (e.g. BlackRock, Vanguard etc.), as they have failed to excise Chinese corporate human rights and national security abusers before investing the hard-earned retirement and other dollars of U.S. retail investors. This must stop now, legislatively if necessary.

Oversight and Regulation:

Strengthened transparency, disclosure, and accountability ought to be required by the SEC. forthwith, not the mere band aids prescribed thus far. U.S. investors should be prohibited from holding China A-shares for several of the reasons cited and the lack of PCAOB audits. The SEC must require index providers to comply with U.S. securities laws and regulations that apply to other Chinese companies, meaning that PCAOB regulation should cover all Chinese companies – not simply N-shares. Even SEC Commissioner Hester Peirce said in a statement last year that she is open to exploring the need for a regulatory framework explicitly tailored to index providers.

Beyond the need for the SEC to create highly disciplined new rules for index providers and the immediate elimination of fraud-prone Variable Interest Entities, it is critical for index providers to reevaluate their Chinese corporate inclusion criteria and for malfeasant ETF sponsors to do the same.

<u>Sanctions:</u>

Far more sanctions - notably capital markets sanctions - are required to target those Chinese corporate abusers that pose asymmetric material risks to American investors and the longer-term national security, economic security, and human rights interests of our country.

The expanded use of capital markets sanctions also calls for urgent harmonization and alignment with other U.S. sanctions regimes, which is absent today. For example, when the Commerce Department's Bureau of Industry and Security (BIS) identifies Chinese "bad actor" companies to be added to its Entity List (on which there are currently some 486 Chinese companies) -- thereby imposing restrictions on the export of U.S. equipment and technology to them -- *it is simply outrageous that <u>all but 13</u> of these same companies can still raise funds from unknowing American investors in our capital markets.*

Moreover, since President Biden signed E.O. 14032, on June 3, 2021, your Treasury Department has only added nine Chinese companies to the NS-CMIC List, bringing the total list of companies on this capital markets investment ban list to a paltry 68. And, as stated above, out of the 486 Chinese companies on the Department of Commerce's BIS Entity List, only 13—less than three percent—appear on the NS-CMIC List. There are hundreds of other publicly traded Chinese military companies that qualify for -- and urgently warrant -- inclusion on both lists *but have inexplicably been given a free pass.*

For example, the Aviation Industry Corporation of China (AVIC) is one of China's largest aerospace and defense conglomerates and is included in both the CMC List and CMIC Annex. AVIC has a total of 25 publicly traded subsidiaries, most of which are directly involved in the development and production of advanced aircraft and weapons systems for the Chinese military – but only eight subsidiaries are included on the two lists.

This omission is particularly alarming when considering the policy objective behind the Chinese military companies sanctions program: to prevent U.S. capital from flowing into the Chinese defense sector, including companies that support the Chinese military. The number of Chinese companies that need to be added to the NS-CMIC List expands dramatically when including the large number of Chinese military companies that are not publicly traded but have access to raising funds in our capital markets through listed subsidiaries and their A-shares being included in ETFs.

In closing, we call upon the Treasury Department to take the lead in immediately rectifying these perilous gaps in the protection of our investors, national security, and our country's fundamental values, particularly with regard to the Chinese A-share scandal. The accompanying appendix provides but a small sampling of the Chinese companies that are included in major ETFs that many millions of Americans are unwittingly invested in. We hope this information is of value to your efforts to better safeguard America's capital markets from these and other Chinese predations, tragically aided and abetted by Wall Street firms.

Sincerely,

Zach Mottl, Chairman
Coalition for a Prosperous America

Michael Stumo, CEO
Coalition for a Prosperous America

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 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
Mr. Duane M. DesParte, Acting Chairperson of the Public Company Accounting Oversight Board

APPENDIX

Examples of A-shares in U.S. Investment Products

Defense	**Aerospace**	**Software/ AI**
Inner Mongolia First Machinery Group Co Ltd 600967.SS CSI Small Cap / SSE Composite / SSE A Share	Guizhou Space Appliance Co., Ltd. 002025.SZ China Shenzhen SE A Share Index	Inspur Software Co., Ltd. Class A 600756.SS MSCI China / FTSE China / MSCI Emerging Markets
Addsino Co., Ltd. 000547.SZ FTSE All-World Emerging / FTSE All-World x US / MSCI AC World ex USA IMI / FTSE China	AECC Aero-Engine Control 000738.SZ MSCI China IMI / MSCI Emerging Markets / FTSE All-World Emerging / MSCI China / FTSE China	Sugon (Dawning Information Industry Co., Ltd.) 603019.SS FTSE China / FTSE All-World / FTSE All-World Emerging / SSE Composite
Asian Star Anchor Chain Co. Ltd. Jiangsu (AsAc) 601890.SS SSE A Share / SSE Composite	AVIC Electromechanical Systems Co Ltd 002013.SZ MSCI China / MSCI China IMI / MSCI EM / FTSE Chin	ChinaSoft International Ltd. 0354.HK MSCI ACWI / MSCI Emerging Markets
Surveillance Tech	**Semiconductors**	**Green Energy**
OFILM Group Co., Ltd 002456.SZ MSCI China / MSCI China IMI / FTSE China/	Advanced Micro-Fabrication Equipment Inc. (AMEC) 688012.SS MSCI EM / MSCI China / MSCI China IMI / FTSE China /	LONGi Green Energy Technology Co Ltd 601012.SS MSCI China / MSCI China IMI / FTSE China
Fiberhome Telecommunication Technologies Co., Ltd. 600498.SS MSCI China / MSCI Emerging Markets / FTSE China / FTSE All-World Emerging	Ingenic Semiconductor 300223.SZ MSCI China / MSCI China IMI / FTSE China / MSCI EM (Emerging Markets)	GCL-Poly Energy Holdings 3800.HK FTSE All World / FTSE Emerging Markets

Wuhan Guide Infrared Co., Ltd. 002414.SZ MSCI China / MSCI Emerging Markets / FTSE China / MSCI BRIC	Anji Microelectronics Technology (Shanghai) Co., Ltd. 688019.SS FTSE China Small Cap / SSE Composite / DJ Global World (All)	Daqo New Energy Corp. DQ.NYSE MSCI China / MSCI China IMI / FTSE Small Cap China / MSCI Emerging Markets

These companies (while not exhaustive) represent essential industries to the Chinese economy and China's military-industrial complex. Each of these companies have ties to the oppression of ethnic and religious minorities in Xinjiang (including surveillance or forced labor) or operate in China's military-industrial complex and pose a threat to America's economic and national security.

They are not subject to capital markets sanctions and also do not comply with the PCAOB.