March 19, 2021

“Testimony before the U.S.-China Economic and Security Review Commission”

U.S.-China Financial Ties

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The Irrelevance of Ownership

China’s is a largely state-owned economy and becoming more so. The private sector is the arena in which China's political elites accrue wealth, while the state profits from a laboratory of technologies and business models that, if successful, can be absorbed into national ownership. While many of China’s firms start off as private and are initiated by ambitious entrepreneurs, they necessarily become un-private as they trade away control in return for the permissions and resources needed to scale up.

In the domestic market, there is no way to circumvent this process; in the export market, as long as companies are net contributors of foreign exchange to the country, there is more flexibility. But it is also probably true that, by virtue of the stranglehold that government- and elite-controlled private equity funds now have on capital markets in China, most Chinese firms do not really start out as private any longer.

Only trusted, connected individuals can break through regulatory barriers to win the licenses that enable groups like Huawei and Alibaba to vault over regional and sector barriers and aggregate cash from depositors all over the country. The individuals who emerge to head the major “private” groups must have three characteristics:

- high-trust connections to elites
- the ability to sell investors on their businesses through China Dream investment stories (that is, a strong spiel)
- the business skills required to manage expansion and acquisition initiatives.

What they do not necessarily have to possess is the capability of building a coherent and commercially sensible business that has high probability of surviving as a going concern.

The reality of this illicit ownership pattern creates a mutuality of interest between state and private players across a broad swath of China's economy. Throughout the reform era, China has pursued a policy of not investigating or holding accountable Mainland-domiciled entities for fraudulent behavior abroad, no matter how blatant or egregious. In fact, by intent, the Mainland provides a reliable safe haven for Chinese capital-market fraudsters. To strengthen this legal shield, in the recent decade, China has passed a

series of regulations that prohibit anyone on the Mainland from providing evidence in any legal proceeding outside the Mainland without specific written permission of China's Supreme Procuratorate. This restriction makes financial crimes committed in the U.S. by Chinese entities impossible to investigate and remedy.

In the capital markets, as Chinese companies compete for favor with political authorities, they can expect to gain access to capital without the basic prerequisites related to performance and history, to be relieved of transparency requirements as to ultimate beneficial ownership, and to be given leeway to manipulate data related to performance. The foregone requirements, of course, are all basic, established pillars of orderly markets in the U.S. There is manipulation and abuse, to be sure, but the U.S. regulatory system strives to support principles of access to financing based on accurately assessed performance independent of elite ownership. In China, these principles are systematically compromised.

Ultimately, whether public or private, Chinese companies are always vulnerable to asset seizures and their executives to losing wealth (any number of billionaires over the last decade), liberty (Jack Ma, for example), and even life (for example, Xu Ming, the founder of Dalian Shide Group).

The upshot is that U.S. efforts to regulate Chinese companies based on ownership are doomed to fail. Ownership has become a concept handy for private enrichment but not as a limitation on the reach of the state.

Government control

Since the corporate reforms of the 1990s, shareholding and its close cousin, beneficial ownership, have created a sturdy conveyor belt for wealth to government elites. But one of the most important innovations of the reform era has been the extension of government control well beyond ownership. Ownership now may define the portion of company proceeds due to particular institutions or individuals, but it does not determine control.

Within state-owned companies, regulations are not needed, because administrative controls enable government officials to appoint or remove executives and control company assets. Outside direct state ownership, government control is exerted by several other means. They include:

- **Regulatory approvals**. Governments control the right to engage in various businesses, the right to exchange Renminbi for hard currency, the level of permitted production, the right to borrow money, and whether staff may be laid off at scale. These controls mean that government support is the key to profitable operations at scale, which in turn means that all businesses that reach a certain scale try to align their activities with the interests of particular regulators. The

quid pro quo is that when regulators request that a business carry out a given agenda, the business complies.

- **Asset price controls**: Typically, local governments control the price of land and utilities and provide the lowest prices to the most compliant businesses. In a few areas of the economy, the government also regulates the prices of finished goods.
- **Extra-legal detention**: There are many examples of "control at a given location" of family members of an individual the Chinese government wants to influence.

Chinese corporations and governments share powerful incentives to bring in capital investment: it is the principal tool with which they are able to meet government-set growth targets. To attract capital, both companies and Chinese government agencies at every level hide or alter economic data. Simply put, data are for marketing purposes, not for analytical pursuits. As China's economy worsens, the deception becomes worse. Covid-19 has created a panoply of ostensibly justified measures that enhance data obscurity.

Clash of Civilizations

The mutuality of interest between the Chinese state and Chinese companies leads to several asymmetries in the U.S.-China financial relationship. Simply put, the U.S. legal system is a poor tool against the Chinese government's concerted efforts to shield its companies from accountability. Some of the consequences are as follows:

- Chinese companies that go public have strong incentives to fake results. There is no legal liability: the chance of earning millions is good, and the worst case is simply not earning millions. Even without setting out to commit fraud, many companies slip into small lies that get bigger. The Chinese market is highly volatile, due to abrupt regulatory changes and the ebb and flow of investment capital, while public markets tend to penalize companies for lack of predictability. Most rational players will initially commit a little bit of fraud to smooth their numbers and gradually embrace complete and egregious fraud. Of course, some companies are designed from the outset to defraud investors.
- China has no incentive to allow U.S. regulators and auditors access to working papers of Mainland enterprises to assure their accuracy and compliance with U.S. requirements.
- The approval requirement for businesses and the need for business scopes to be affirmatively declared remain the silver bullet that enables the Chinese government to sign international market access agreements and yet curtail market access.
- Intellectual property protections remain extremely weak. There are several reasons for this, but the most basic is the mismatch between short-term bureaucratic incentives and the longer-term resource commitments required for technological success. Bureaucrats want to see results within at most two years

of providing funding to a start-up. Because they know this is unlikely, they rig the game by shifting existing payments to the new company or requiring the company to replicate an existing, market-tested technology, then guaranteeing a market for it. There is a powerful incentive to steal IP and scale up quickly with copycat products. This has the cumulative effect of commoditizing valuable technologies and driving down their price, so that all members of the ecosystem lose money. It is not a formula for creating competitive technologies. The best defense is to protect intellectual property, but this cannot be done only through the court system.

- The freedom from incarceration of foreign nationals involved in a legal dispute, real or invested, is no longer guaranteed.

Specific impediments to due diligence include the following:

- China's 2010 "Law of the People's Republic on Guarding State Secrets" attaches draconian penalties for transferring information the government considers sensitive overseas, including by sending an email to someone outside of China or via an email server that is based in another territory. This has made it challenging for U.S. authorities to obtain any financial or ownership information a Chinese company may consider damaging.
- Particularly since 2015, when the economy took a dive, China's government has successively banned data sets that formerly were public. These include financial statements from companies, detailed trade statistics from Customs, and detailed banking records.
- Local governments massage or fail to disclose critical data on real estate, consumer spending, and foreign direct investment, among other subjects.
- Under pressure to meet economic targets, trade associations distort the collection and reporting of economic data.
- Listed Chinese companies seeking to boost their share prices inflate results without consequence. This adds to pressure on U.S. public companies to report rosy results in line with their peers.

The Political Goals

Since its emergence from the socialist era, China's national goal, to the extent there is one, has been the accumulation of capital and the personal enrichment of leaders. There has been scant attention to international alliances, the success of Chinese firms in international markets, soft power, cultural reach, or, inside China, investment in the human capital and institutional capacity required to reach a higher level of development.

For four decades, the people of China have been more or less content to continue facilitating the Chinese Communist Party's monopoly on power, because the Party has guaranteed them economic growth, upward mobility, and national pride. Xi Jinping has adopted a more aggressive international stance, largely because the Party's ability to

provide these benefits is rapidly diminishing. Xi's increased need to demonstrate nationalist strength could pose dangers to U.S. interests and regional security.

But more dangerous yet is the developmental ledge at which China stands now. Having grown very quickly since the 1980s, China has not had time, or perhaps the political will, to invest in human capital in rural areas, which still make up two-thirds of the nation in population terms. China's per-capita income ranked 75th in the world in 2016, according to the CIA, behind Algeria and Thailand. China's level of high school attainment is lower than that of South Africa or Mexico. Standards of health are extremely low in rural areas. All these facts are likely to hamper China's ability to move up the income scale and continue to satisfy the expectation of its people for upward mobility.

The last decade has seen massive investment in physical infrastructure and real estate, sharply widening the wealth gap and creating a vast landscape of dead assets. The nation has also only recently curtailed the One Child Policy. Two unintended consequences—rapid aging and a dramatic gender imbalance—make growth harder to generate and see negative social consequences more likely to arise.

These problems, which are almost entirely neglected in public discourse, could engender grave social strife, including thwarted ambition among people no longer able to find formal employment, and anomie among those forced by real estate developments to leave their villages, raising rates of crime.

Faced with the very real possibility of calamity, the United States needs to double down on financial, legal, health, military, and governance exchanges that encourage China to build its less visible, soft infrastructure. Social collapse in China would be much worse for the United States than a strong China. The narrow economic consequences would include a collapse in the stock markets and of U.S. exports. It would mean that decades of capital investment by U.S. companies like Coca-Cola and General Motors would be unremunerative, as these companies face collapsing demand. More broadly, domestic turbulence and decay convey problems of crime, refugees, drugs, and more to other nations.

What Can Be Done

Broad frameworks for cooperation are important. At the ground level, specific measures need to be taken to protect U.S. businesses and investors from abuses endemic to the Chinese system. Many of these measures entail cooperation rather than avoidance and sanction.

The practical remedy for faked data, for example, on a corporate, industrial, and macro-economic level, is to grant American researchers unfettered access to conduct surveys, interview individuals, and review financial records of all sorts in a legal proceeding, including tax records, audit papers, invoices, and communications. A key impediment to such data collection is China's law forbidding independent surveys. Survey teams need

to be able to access respondents within a framework of privacy law but not one of data supervision.

- In the pursuit of some level of clarity and accountability, the Kennedy bill requiring delisting of companies whose auditors are not inspected by the Public Company Accounting Oversight Board is a good start but needs to have more teeth in implementation, starting with much faster effect, one year instead of three.
- The U.S. should also press China to rescind laws, regulations, and procedures that prevent evidence and testimony from being given in serious criminal cases.
- Technology advances that support the imminent proliferation of digital currencies, both fiat and crypto, and blockchain-enabled asset transfers, need to be carefully regulated by the U.S. The same is true of social media and platform-enabled securities promotion and fraud. Fraud by Chinese brokerages appears to be rampant. This distorts U.S. public markets and supports the use of such financial transfers in cross-border criminal financial activity.
- The institutions, Chinese and foreign, that support portfolio money flows are corruptible and capable of market manipulation to defraud legitimate investors. Regulations that institutionally separate brokerage from banking and bar smaller service institutions such as accountancies and PR firms from owning shares in companies they service could be effective.
- Chinese and American venture capital and private equity funds have a powerful incentive to fraudulently inflate the value of their portfolio companies. They should incur liability when there is a fraud case that covers their behavior in the period during which they were beneficially invested.
- Technology export restrictions have been surprisingly effective. New company-by-company restrictions work for a little while but need to have implementing rules similar to the TAM sanctions on selling to the military, whereby companies were made responsible for identifying the end user. The US government should recognize that we face unprecedented regulatory challenges in maintaining a stable financial system and fair capital markets. The challenges are unprecedented because of technology developments, expanding wealth, extensive financialization in the economies of several emerging regions, and, finally, very different concepts of business ethics and levels of accountability that now intrude upon US financial markets from areas once very remote, like China.

Focus on Enforcement

The U.S. and Chinese systems are fundamentally different. Changes to Chinese regulations will make little difference to market access or commercial practice as long as the Chinese government owns and manages the economy. What will make a difference is vigorous U.S. enforcement of existing rules. Possible measures include:

- Delisting Chinese companies that will not allow access to audit papers.

- Treating Huawei, ZTE, and other Chinese network gear as spyware. Just as you would not let a government click on a marketing link sent by email from a Chinese server, do not install gear from these companies in proximity to government installations.
- Further strengthening the oversight of the Committee on Foreign Investment in the United States. The tightening of the last few years has been very effective.
- Establishing clearer reporting standards for academics who cooperate with or receive funding from Chinese institutions.
- Dropping the “end user” assessment as a principal means of restricting exports. Data and access issues notwithstanding, the reality is that State actors can extract what they want from any commercial enterprise in China whenever they want, overtly or covertly. The U.S. needs people to continually comb through tech components and the IP stack to figure out what stuff is potentially dual-use vs commercial-only, and to make the call on our side.