



**Written Testimony Before the U.S.-China Economic and Security Review Commission
Hearing Entitled
“U.S. Investment in China’s Capital Markets and Military Industrial Complex”
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Chairman Bartholomew, Vice Chairman Cleveland, and members of the U.S.-China Economic and Security Review Commission (Commission): Thank you for the opportunity to provide written testimony for the Commission’s March 19th hearing entitled “U.S. Investment in China’s Capital Markets and Military Industrial Complex.” This timely hearing will examine several issues critical to America’s national security and the protection of mom-and-pop investors and retirement savers in the United States.

For years, the American Securities Association (ASA)¹ has been the only financial trade association advocating to end the Chinese Communist Party’s fraud on our capital markets and the harm it has caused America’s working families. We are proud to have partnered with members on both sides of the aisle on the *Holding Foreign Companies Accountable Act*, a bill which was recently enacted into law after passing both chambers of Congress unanimously. We look forward to continuing to partner with policymakers in a bipartisan manner to further safeguard America’s national and economic security interests.

Introduction

History suggests that the free flow of global capital leads to more sustainable investment, helps lift people out of poverty, and brings transparency that enhances the rule of law. The free flow of capital across borders also serves to strengthen relations among nations, which furthers international peace and stability. That said, it is fair to ask whether an authoritarian regime that aggressively and coercively undermines the norms of the open international system adhered to by free societies should continue to reap the economic and financial benefits of accessing it.

As China’s great power competition with America intensifies, financial markets have become a frontline battleground. The Chinese Communist Party has used deceptive statecraft to methodically exploit the U.S. capital markets. This has helped fund China’s rise while exacting

¹ The ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA’s mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This mission advances financial independence, stimulates job creation, and increases prosperity. The ASA has a geographically diverse membership of almost one hundred members that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.





heavy costs on American investors, the U.S. economy, and the integrity of the U.S. capital markets. This outcome has been a win-win for the Chinese Communist Party.

Thus, the paramount question before this Commission is: Should the Chinese Communist Party continue to access the U.S. capital markets to fund a military, cyber, and geopolitical strategy that undermines the economic and national security of the United States and establishes China as the world's preeminent power?²

Chinese Bond Funds and Indexes

Registered investment funds that hold Chinese government bonds or track an index that includes them facilitate a transfer of savings from America's working families, military service members, pensioners, and retirees directly to the Chinese Communist Party. Since modern day China is run as a "Party-State" and funds that flow to the CCP cannot be separated from Chinese industry, one can only assume that this money goes to underwrite everything the Chinese Communist Party touches.³ This includes factories that use forced labor,⁴ re-education camps for the Uyghurs,⁵ the destruction of the environment,⁶ the rise of its military,⁷ and a cyber-army that relentlessly attacks the U.S. and other nations of the free world.⁸

The Commission should examine whether registered investment funds (i.e. mutual funds and exchange traded fund) that own these bonds or track an index that includes them should be available for sale in U.S. markets. As part of that analysis, the Commission should consider that two separate presidential administrations --one Democrat and one Republican-- in control of the U.S. government believe the Chinese Communist Party is committing 'crimes against humanity' and 'genocide' against its own people.⁹

² <https://www.whitehouse.gov/wp-content/uploads/2021/03/NSC-1v2.pdf>. *Interim National Security Strategic Guidance*, March 2021, pg 8. "China has rapidly become more assertive. It is the only competitor potentially capable of combining its economic, diplomatic, military, and technological power to mount a sustained challenge to a stable and open international system."

³ <https://www.asiatimesfinancial.com/ccp-announces-plan-to-take-control-of-chinas-private-sector> "President issues 'important instructions' to all regions to boost party control over private enterprise and rejuvenate the nation; all firms will need employees from the party to boost law abidance and moral standard".

⁴ <https://thehill.com/blogs/congress-blog/homeland-security/522443-countering-chinas-forced-labor-practices>;

⁵ <https://www.bbc.com/news/world-asia-china-51697800>; <https://www.reuters.com/article/us-hikvision-usa-uyghur/u-s-might-blacklist-chinas-hikvision-over-uyghur-crackdown-source-idUSKCN1SS28U>.

⁶ *China's Engine of Environmental Collapse*, Richard Smith, Pluto Press, 2020.

⁷ <https://www.cnn.com/2020/10/29/asia/us-election-us-military-indo-pacific-intl-hnk-ml/index.html>

⁸ <https://www.enbc.com/2020/07/07/fbi-chief-slams-chinese-cyberattacks-against-us-hudson-institute.html>;

<https://www.justice.gov/opa/pr/chinese-military-personnel-charged-computer-fraud-economic-espionage-and-wire-fraud-hacking>.

⁹ <https://www.c-span.org/video/?509661-1/state-department-briefing&live> Biden State Department Spokesman Ned Price: "The PRC also has committed crimes against humanity in Xinjiang against the Uyghurs, who, of course, are predominantly Muslim, and members of other ethnic and religious minority groups, and that includes imprisonment, torture, enforced sterilization, and persecution."; <https://www.msn.com/en-au/news/other/pompeo-chinas-uyghur-policy-perpetrating-genocide-and-crimes-against-humanity/ar-BB1cTU6k>.





Given the importance many institutional investors place on environmental and social issues, one would expect them to begin to divest their portfolios of any security associated with an authoritarian regime.¹⁰ Until that occurs, the Commission should investigate whether the Chinese Communist Party's access to the U.S. capital markets through these bond funds poses direct economic and national security threats to the United States.

Chinese Companies Registered in U.S. Markets

The ASA has been a canary in the coal mine alerting lawmakers, regulators, and investors about the risk of allowing opaque Chinese companies to be listed on U.S. stock exchanges or included in index funds.¹¹ Investors have no insight into whether these companies are growing, profitable, or losing money because the Chinese Communist Party regularly asserts a national security privilege to prevent routine audits from taking place.¹² This intentionally keeps investors in the dark and subjects them to a risk of fraud that is very real.¹³

From reverse mergers and stock indexes to single-stock listings, this fraud has been deliberate and pervasive.¹⁴ Despite warnings from the U.S. Securities and Exchange Commission and the Public Company Accounting Oversight Board that Chinese companies involve a “substantially greater risk that disclosures will be incomplete or misleading and, in the event of investor harm, substantially less access to recourse,”¹⁵ many of these firms are still listed on U.S. exchanges and remain a threat to Main Street investors.¹⁶ Until more de-listings occur,¹⁷ America's mom-and-pop investors, labor unions, pension funds, and retirement plans will continue to be exposed to fraudulent Chinese companies.¹⁸

This Commission should examine the pattern of fraud associated with Chinese companies dating back 2011 to determine whether it is a normal part of investment risk or a calculated tactic used to implement China's larger geopolitical strategy. Many believe it is the latter.¹⁹

¹⁰ <https://www.institutionalinvestor.com/article/b1qs5j405m2qtf/How-the-World-s-Largest-Asset-Managers-Are-Finally-Taking-ESG-Seriously>; *Interim National Security Strategic Guidance*, pg 20. “In many areas, China's leaders seek unfair advantages, behave aggressively and coercively, and undermine the rules and values at the heart of an open and stable international system.”

¹¹ <https://www.americansecurities.org/post/asa-sends-letter-to-sec-highlighting-risks-to-investors-from-chinese-companies>

¹² <https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>; <https://foreignpolicy.com/2019/02/07/we-cant-tell-if-chinese-firms-work-for-the-party/>; <https://www.wsj.com/articles/sec-revives-fight-over-inability-to-inspect-chinese-auditors-of-alibaba-baidu-1544229843>.

¹³ <https://www.forbes.com/sites/walterpavlo/2011/04/08/fraud-in-chinese-reverse-mergers-on-american-exchanges-and-were-surprised/?sh=29a878924f47>.

¹⁴ <https://abcnews.go.com/Blotter/us-investors-lose-billions-alleged-chinese-stock-schemes/story?id=18164787>; <https://www.ft.com/content/78b0d934-6b27-11e9-80c7-60ee53e6681d>.

¹⁵ <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting>.

¹⁶ <https://www.nasdaq.com/articles/nyse-begins-move-to-delist-chinese-state-oil-producer-cnooc-2021-02-26>.

¹⁷ In December 2020, the President signed into law the Holding Foreign Companies Accountable Act, a bipartisan bill that was strongly supported by the ASA. The legislation would grant companies up to three years to allow their auditors to be inspected by the PCAOB, as required by the 2002 Sarbanes-Oxley Act. If companies failed to allow for such inspections within that period, then they would be de-listed from U.S. Exchanges.

¹⁸ <https://www.cnbc.com/2020/04/02/luckin-coffee-stock-plummets-after-investigation-finds-coo-fabricated-sales.html>.

¹⁹ <https://www.forbes.com/sites/peterpham/2018/02/12/whats-chinas-secret-source-of-funding/?sh=61d625a8254b>.





The Passive Index Loophole

A regulatory loophole exists which allows passive index funds and index providers to direct American investor dollars into mainland Chinese companies by including them in international or emerging market indices. Inclusion in an index can lead to billions of dollars being steered into opaque Chinese businesses.²⁰

Investors often have no idea that by investing in an index fund, they are sending their savings to Chinese companies that avoid basic disclosure, financial reporting, and governance standards or are controlled by the Chinese Communist Party.²¹ Many of these Chinese companies, especially those listed on mainland Chinese exchanges, have turned out to be frauds.²² Investors have no real understanding of how the governance of a Chinese company functions but one thing is clear: when the Chinese Communist Party wants to interfere in the company's business to force change, it does.²³

As if ignoring these risks is not bad enough, index providers also include companies placed on the U.S. government Entity List and OFAC Sanctions List in their indexes. A company is generally placed on these lists if it is "acting contrary to the national security or foreign policy interests of the United States" or is a "threat to the national security, foreign policy or economy of the U.S." A reasonable person might ask 'how could an American investor invest in a company on an exchange or through an index if it is a violation of American law to do business with that company?' We hope the Commission recognizes the absurdity of this reality and would support a broad policy recommendation to prohibit any such company from trading in the U.S. capital markets.

In November 2020, President Trump did just that by issuing Executive Order 13959, "Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies." This Order de-listed and de-indexed 31 firms trading in U.S. markets that are owned or controlled by the Chinese military. The Biden Administration has affirmed this Order, which establishes it as a template for how to prevent the Chinese Communist Party from coercing U.S. investors into sending their savings to fund China's military and economic rise. The SEC should go further and strip these companies of their registration so they cannot bypass

²⁰ <https://oxfordbusinessgroup.com/overview/indexed-growth-inclusion-global-indices-often-results-greater-flow-funds-capital-markets-it-just-one>.

²¹ <https://pcaobus.org/oversight/international/denied-access-to-inspections>; The PCAOB noted that it is unable to inspect the auditors of over 200 companies listed on exchanges in the United States or to determine who really controls them.

²² <https://www.reuters.com/article/us-china-stocks-regulation-analysis/chinese-firms-missing-6-billion-tests-regulators-resolve-idUSKCN1SN00T>; <https://www.scmp.com/business/companies/article/3024084/why-kangmei-pharmaceutical-found-have-committed-one-chinas>; <https://finance.yahoo.com/news/one-theme-popping-among-chinese-154155487.html>.

²³ <https://www.cnn.com/2020/12/24/tech/alibaba-china-antitrust-investigation/index.html>;
<https://www.asiatimesfinancial.com/cp-announces-plan-to-take-control-of-chinas-private-sector>.





the listing process and raise capital from unsuspecting American investors through the opaque 'over-the-counter' private market.

Index related issues require enhanced scrutiny because unregulated index providers can be subject to significant conflicts of interest when selecting index components.²⁴ The Commission should review the role index providers play in bringing Chinese companies to the American market and how their interactions with the Chinese Communist Party impact index inclusion or expansion decisions.

Recommendations

To end China's fraud on our markets, this Commission should recommend that Congress require the SEC to (1) terminate the 2013 Memorandum of Understanding;²⁵ (2) deregister every Chinese company that doesn't meet the same company-specific governance, disclosure, audit, and financial reporting standards as U.S. companies; (3) force index funds to remove and exchanges to delist any Chinese company that is on the OFAC sanctions list, the U.S. Department of Defense list of Communist Chinese military companies, or the U.S. Department of Commerce 'entity list'; (4) close the passive index loophole which allows index funds to steer American investor savings into opaque and financially questionable Chinese companies listed on mainland Chinese exchanges; and (5) clearly and publicly outline the legal redress or lack thereof that American investors can seek if they are harmed by registered Chinese companies.

We also suggest that policymakers implement the unanimously passed *Holding Foreign Companies Accountable Act* as written. Neither Congress nor the SEC should deviate from the three-year de-listing timeframe, as there is little discretion left to regulators to amend the provisions of the legislation.

The Commission should examine claims that American investors will simply buy Chinese companies in other markets if they are prohibited from buying them in the U.S.²⁶ Those making such claims conveniently forget that institutional investors at every level have a fiduciary obligation to those who entrust them with their savings.²⁷ This obligation requires institutional investors to conduct diligence on any company in which they invest. In China, thorough due diligence is impossible because the Chinese Communist Party won't allow it.²⁸ The Commission should weigh the cost of Chinese companies moving their listings from the U.S. to Hong Kong against the benefit of protecting American investors and the integrity of U.S. markets.

²⁴ <https://www.wsj.com/articles/how-china-pressured-msci-to-add-its-market-to-major-benchmark-11549195201>.

²⁵ https://www.shearman.com/-/media/Files/NewsInsights/Publications/2013/06/PCAOB-Announces-Agreement-With-China-On-Producti_/Files/View-full-memo-PCAOB-Announces-Agreement-With-Ch_/FileAttachment/PCAOB-Announces-Agreement-With-China-on-Producti_.pdf.

²⁶ <https://www.wsj.com/articles/china-has-one-powerful-friend-left-in-the-u-s-wall-street-11606924454>.

²⁷ <https://www.americansecurities.org/post/asa-letter-to-wsj-real-audits-for-chinese-firms-listed-in-the-u-s>.

²⁸ <https://foreignpolicy.com/2019/02/07/we-cant-tell-if-chinese-firms-work-for-the-party/>.





It may also benefit the Commission to examine the types of legal, political, or reputational risks a U.S. company doing business with the Chinese Communist Party specifically, or in China generally, poses to its investors. At a minimum, it would be useful for American investors to understand the scope and potential cost of any legal liability that could arise from a U.S.-listed company doing business in China under U.S. law, international law, or otherwise.²⁹

Conclusion

Twenty years ago, the consensus theory was that as China grew wealthier, it would become a responsible international stakeholder. Unfortunately, that theory never materialized. Today, Communist China's seeks to become the world's dominant superpower. To realize that goal, the Chinese Communist Party needs access to Western capital. Those who still believe in the consensus theory, are willing to facilitate that access because they can profit from it. They will continue to put their own financial interests over the economic and national security interests of the United States until it is no longer legal or profitable to do so.

Loopholes and exemptions have allowed the savings of American investors to fund Chinese companies that are outright frauds, arms of the Chinese Communist Party, or engaging in activities that are hostile to American interests for far too long.³⁰

A strong bipartisan consensus in Washington has emerged that wants to end the Chinese Communist Party's exploitation of America's capital markets and her investors. This Commission can play an important role in recommending the policy changes necessary for Congress and the Administration to help move that consensus along.

I look forward to assisting this Commission in any way that will make the investment climate safer for American investors and promote the economic and national security of our country.

Sincerely,

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²⁹ <https://www.justsecurity.org/74388/genocide-against-the-uyghurs-legal-grounds-for-the-united-states-bipartisan-genocide-determination/>; <https://www.washingtonexaminer.com/news/state-department-china-committing-uyghur-genocide-wont-say-if-ongoing>; <https://cja.org/what-we-do/litigation/legal-strategy/the-alien-tort-statute/>.

³⁰ <https://healthymarkets.org/archives/2101>; <https://www.americansecurities.org/post/why-are-american-investors-funding-chinese-fraud>.

