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U.S. Investment in China's Capital Markets and Military-Industrial Complex

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It is my honor to provide testimony on China's financial opening process. This statement aims to provide an overview of and background information on the functioning of Chinese capital markets and China's foreign investment regime as well as global investments into China and the role of index providers in this process. The below comments seek to address the questions raised by the Committee. However, it is important to note that existing research (by others and myself) has not yet fully analyzed the most recent developments in this process and especially the recent US-China investment restrictions are not as thoroughly researched as other aspects of this topic. Some assessments are therefore not backed up by as much rigorous research as others. I am looking forward to answering any remaining questions.

1. How does the Chinese government steer foreign portfolio investment inflows to achieve national development objectives? How/why does it continue to restrict foreign investment?

To understand China's foreign investment regime, in a first step it is important to acknowledge that capital markets in China function quite differently from 'global' capital markets (i.e. capital markets as they exist in the US or Europe). While Chinese capital markets have been rapidly developing in recent years, they are embedded within China's socio-economic system of state capitalism (for lack of a better term). Chinese capital markets function according to a different institutional logic than 'liberal' global capital markets. In essence, this means that rather than the underlying principle being the achievement of efficient outcomes through enabling private profit creation and the free flow of capital, capital markets in China are designed to enable state control over market activities while market outcomes are directed towards national development policies.[1]

This does not mean that profit creation does not play a role in Chinese markets. Like any capital market, Chinese markets are populated by millions of profit-driven speculating investors. But while efficiency through profit creation and free markets is the primary underlying principle in liberal global markets, in China the state intervenes into capital markets in order to facilitate state objectives. The defining difference between liberal and state-capitalist logic is not the existence of capital markets per se but rather the principles that underlie market organization (profit creation vs state objectives) and the actors that dominate/shape these markets (private financial actors vs state institutions). Thereby, however, certain levers of state control remain intact as a state-capitalist institutional logic is engrained in financial market infrastructures – the socio-technical arrangements that enable the functioning of capital markets. These market

[1] For two detailed academic studies on this topic, see:
Johannes Petry (2020) Financialization with Chinese characteristics? Exchanges, control and capital markets in authoritarian capitalism, *Economy & Society*, 49 (2): 213-238 (https://doi.org/10.1080/03085147.2020.1718913);
Johannes Petry (2020) Same same, but different: Varieties of capital markets, Chinese state capitalism and the global financial order. *Competition & Change* (https://doi.org/10.1177%2F1024529420964723).

infrastructures are organized by China's state-owned (stock and futures) exchanges which establish constraints and incentives for market actors, whereby they shape how markets work and attempt to direct market outcomes towards specific state policies. While state guidance of capital markets is never absolute, what can be observed in China is that a way of thinking about, managing and governing capital markets has emerged that significantly differs from global markets.

This different logic of organizing capital markets also extends to how foreign portfolio investment enters China. From being virtually isolated 20 years ago, portfolio investment flows into China increased unprecedentedly in the last couple of years (figure 1). However, as one interviewee during my research stated with respect to this global integration, 'it's absolutely a love and hate story, they love the money, love the stability, hate giving up control… and hate it if foreign investors want to dominate the terms'.[2] On the one hand, global investors can help facilitate the professionalisation and institutionalisation of China's financial industry which has been an important government policy in China's market development. Having a strong domestic financial sector is crucial for China's aspirations to becoming a global financial powerhouse. Increasing portfolio investment through international investors also alleviates pressures stemming from capital outflows. Hence, a more internationally integrated and professional capital market is very much in China's national developmental interest. As they lack the know-how and expertise to completely develop this independently, global financial institutions have a role to play in this process. On the other hand, the authorities are wary of losing control over market development through an increasing influx of foreign money. For the Chinese authorities, it is important to have an independent financial sector without foreign influence, let alone dominance. This is especially important with respect to differences between what the regulators sometimes refer to as 'hot money' (short-term speculators such as hedge funds) and 'real money' (long-term investors such as pension funds).

The Chinese authorities do not want to see sophisticated foreign speculators coming into China and potentially disrupt the domestic market. Especially events such as Japan's financial liberalisation in the late-1980s or the Asian Financial Crisis in 1997 and the impact these events had on domestic economic systems, made an impression on Chinese regulators and they do not want such developments unfolding in China, especially as their markets are already quite volatile due to the strong presence of domestic retail investors. In contrast, long-term investors such as pension funds, endowments, insurance companies and especially passive investment are treated differently as they are perceived to stabilize the Chinese market, also countering the speculative activities of Chinese retail investors. Consequently, the institutional logic that informs capital market integration is markedly different in Chinese and global capital markets. Rather than simply opening up their market, the Chinese authorities try to create the right conditions to attract long-term rather than short-term global investors. They do so by creating financial infrastructures that enable this global integration to facilitate national development while strictly maintaining control. Rather than a 'Big Bang' style liberalization, China's capital market opening is managed in a way so that it enables foreign investor participation while simultaneously maintaining a distinctively state-capitalist logic of running capital markets.

This extends beyond a mere analysis of capital controls, and as noted above a more nuanced picture of China's financial opening emerges by looking at financial infrastructures. Here, it is helpful to point towards the following statement that an emerging markets strategist of a global exchange made during an interview:

> I have an analogy… […] If you look at capital controls as a wall, people have eliminated them in different ways… and you can remove the wall, full liberalisation, Big Bang, and that has a whole range of problems… you can remove it gradually… or you can do what

[2] Interview: CEO, asset manager (Hong Kong, 28 June 2017).

> the Chinese are doing and build holes through it. It's this pilot project approach, you build holes and then you think you can repair them if needed, and you leave the height of the wall more or less intact.[3]

In order not to disrupt the domestic economy, investment flows are controlled through the infrastructural arrangements of the financial integration process (the 'holes' in the wall). The financial infrastructures that link Chinese capital markets with global markets – such as the (R)QFII investor scheme or the Stock Connect are designed to facilitate national development while maintaining state control.

The first mechanisms that enabled such cross-border access were the Qualified Foreign Institutional Investor (QFII), Qualified Domestic Institutional Investor (QDII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programmes launched in 2003, 2006 and 2011, respectively. While QDII enabled designated Chinese investors to conduct financial transactions in global markets, QFII and RQFII investors could trade in Chinese capital markets. These schemes reflected the government policy of 'going out' and 'bringing in', thereby enabling the control of cross-border transactions for instance by quelling capital outflows after the 2015/2016 market crash. However, trading through these quotas was cumbersome and they were only issued to a few institutions.[4] In recent years, a much more comprehensive system of cross-border financial infrastructures has been created with the establishment of the Stock Connect between HKEx, SSE and SZSE in 2014 and 2016. Institutional investors viewed the Stock Connect as a more flexible access framework compared to the QFII and RQFII regimes, and consequently many large asset managers switched from (R)QFII to Connect funds.[5] However, the infrastructural arrangements of Stock Connect are also informed by state-capitalist logic.

On the one hand, following a state-capitalist logic the Connects also enable the tight control of markets. Because it is designed as 'closed loop', Stock Connect enables Chinese investors to diversify their portfolio and professionalize, while at the same time prohibiting capital outflows. This reversely applies to international investors. So, despite order routing and enabling transaction flows between the two markets, the Connect maintains Chinese capital controls. For the Connects, 'home-rules' also apply, and international investors must adhere to the characteristics of Chinese markets such as limited order types and data availability or t+1 (no intra-day trading).[6] Through the introduction of the so-called Northbound investor identification system in September 2018, the Chinese monitoring system to identify and track the behavior of individual investors was also applied to international investors investing through the Stock Connect.

On the other hand, Connect facilitates national development policies. For one, through increased cross-border market integration, Connect facilitates the Chinese governments' objective of educating and professionalizing Chinese investors. By early 2020, 8% of equity trading volume on HKEx was already conducted by mainland investors. Reversely, international investors can invest into China in a more seamless way than previously. As Bin Shi, Head of Equities at UBS Asset Management, noted: 'Hong Kong and China – these were two separate markets, the Stock Connect changed this! Much more so than QFII'.[7] International

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[3] Interview: emerging markets strategist, exchange (London, 11 January 2018).

[4] For a complete list of all issued quotas, see: https://www.safe.gov.cn/en/AdministrationInformation/index.html.

[5] Mark Stephenson, Index Equity Portfolio Manager for iShares MSCI China A UCITS ETF at BlackRock, MSCI/iShares 'Bring your A Game to Investing in China' Webinar (20 September 2018).

[6] For a detailed analysis, see:
Johannes Petry (2020) Financialization with Chinese characteristics? Exchanges, control and capital markets in authoritarian capitalism, *Economy & Society*, 49 (2): 213-238 (https://doi.org/10.1080/03085147.2020.1718913).

[7] 'Equities Market Development Including Stock Connect' Panel, 7th ASIFMA China Capital Markets Conference (Hong Kong, 14 June 2017).

institutional investors thereby also have a calming effect on China's volatile stock market, especially because Stock Connect attracts the right kind of – i.e. long-term – investors (as discussed below in the discussion of China's index inclusion).

Overall, Stock Connect has proven to be a successful model for the Chinese government because its cross-border infrastructural arrangements successfully balance the state-capitalist objectives of national development and control. In fact, all other mechanisms that integrate China with global markets and enable foreign investors' access are similarly designed to enable market control, intervention and monitoring while facilitating national development objectives (figure 2).

2. What benefits do Chinese companies hope to derive from the financial resources and knowledge they acquire from foreign investors?

While historically China's financial system was largely bank-based, in the last decade capital markets have become much more important for corporate governance and corporate finance. The original purpose of stock markets in China was facilitating the reform and restructuring of state-owned enterprises while maintaining a degree of state control over these companies.[8] Therefore, capital markets in China are not primarily designed to enable an open market for corporate control as in liberal markets that are focused on shareholder value orientation and enabling mergers and acquisitions (M&As). Funding is also not the primary purpose of capital markets, especially as many companies listed in China can rely on extensive funding through Chinese banks, while equity market financing is rather used to bolster and complement existing business activities. Capital markets are much more directed towards corporate reform with the aim of creating national champions.

Two specific national development policies are also linked with the increasing importance of stock markets for China's state capitalism. First, the 'Going Global Strategy' (or 'Go Out policy') first announced in 1999 took off after the global financial crisis as China became an exporter of capital and outward FDI began to surpass inward FDI with increasing overseas acquisitions, especially in Europe and the US. Second, for China to climb up the value chain from the cheap, low-quality and labour-intensive 'factory of the world' towards more capital- and technology-intensive production of high-value goods as envisioned by the 'Made in China 2025' strategy that was announced in 2015. To a significant part, these programmes rely on the continued reform, financing and governance of Chinese companies through capital markets as noted during the CCP's 18th National Congress in 2012.

In creating national champions, a degree of foreign investment is very helpful. But it is important to note that foreign investment is thereby capped at 30% of a companies' outstanding shares. So, while foreign investors are encouraged to invest into Chinese companies through infrastructures such as Connect as well as recent financial market reforms in 2020, this investment is not meant to translate into foreign investor dominance, let alone control, of Chinese companies. Rather, foreign investors have three tasks.

First, one aim is to help professionalise the Chinese market and, by extension, the Chinese financial industry. Especially with an increasing importance of capital markets for China's political economy, developing their own competitive financial sector has become very important for Chinese officials. Rather than be dependent on foreign financial institutions, such as US investment banks, there is a growing understanding that financial markets are a powerful,

[8] See: Yingyao Wang. The rise of the 'shareholding state': financialization of economic management in China, *Socio-Economic Review*, 13(3): 603-625 (https://doi.org/10.1093/ser/mwv016).

potentially harmful force but also a tool that is best owned and wielded independently. Since CITIC Securities' unsuccessful bid for Bear Stearns in 2008, it became clear that China's authorities were serious in their aspirations to create their own globally competitive investment banks – a 'Chinese Goldman Sachs'. Importantly, global financial institutions have thereby been both utilised by the Chinese authorities to facilitate this learning process but also kept at bay by not allowing them too much influence and market power. Second, as already noted, another aim is to stabilise the Chinese market which is dominated by domestic retail investors with very volatile trading behaviour. Especially through Connect, which is dominated by pension funds and passive investment, foreign investors act as patient capital (see section below). These two dimensions refer to any kind of foreign investment into Chinese capital markets. However, one needs to distinguish between 'normal' portfolio flows into China, for instance, as a result of index inclusions, and strategic investments into Chinese companies.

Third, as strategic investors, foreign financial institutions are linked more closely with Chinese companies themselves, as strategic investment is aimed to directly facilitate the development of their business activities. Until 2020, the most pursued approach had been for international banks, brokers, and asset managers to establish joint ventures with Chinese counterparties. This has been the preferred Chinese government option for onshore access. Similar to joint ventures in the manufacturing sector, the idea was to facilitate a 'legitimised transfer of intellectual property', as one interviewee called it.[9] For global financial institutions, the prospect of future access to China is an important driver of these often-lopsided arrangements, because 'they all know the huge potential that exists… so they make a lot of concessions and spend a lot of money'.[10] Even though it is much easier for international financial institutions to establish fully-owned operations in China since reforms in early 2020, they still require regulatory approval. Overall, strategic investments (not limited to joint ventures) have therefore been an important driver of the professionalisation of China's financial industry.

By gaining access to training opportunities, knowledge and technology transfer or international business networks for Chinese companies, the government utilizes strategic investments to further their national development of creating globally competitive national champions. This engagement with international counterparts mirrors China's overall industrial upgrading strategy where international cooperation is used to facilitate innovation and knowledge exchange, in turn facilitating national development in a state-capitalist logic.

3. How did the Chinese government engage investment index providers and foreign asset managers in this process? What do these negotiations tell us about the Chinese government's attitudes toward foreign investor participation?

Index providers such as MSCI, FTSE Russell and S&P DJI form a vital part of global financial markets, steering capital through including/excluding countries and companies from indices (see section below). In June 2017, MSCI decided to (gradually) include China A-shares into its emerging market index which serves as a benchmark for investments worth US$1.8 trillion, followed by FTSE Russell and S&P DJI in 2018. In early 2019, MSCI then announced to quadruple the weighting of Chinese A-shares to 20%. By March 2019, index inclusions had steered at least US$84 billion of passive and active investment into China's stock market, with resulting long-term inflows estimated at US$400 billion over the next decade.[11]

[9] Interview: business development, index provider (Hong Kong, 27 September 2018).
[10] Interview: APAC director, global exchange (Singapore, 7 December 2017).
[11] *South China Morning Post* 'US$400 billion expected to flow into Chinese stocks after MSCI inclusion: top fund manager' 15 May 2018.

Over the years, MSCI had been in close contact with Chinese regulators, advising on how to meet inclusion requirements. Some observers suggest that Chinese regulators made concessions to MSCI. The Chinese exchanges had for instance been actively improving the suspension system of Chinese companies, improving English information services and assisting Chinese companies in how to become eligible for index inclusion. Others, however, voiced concerns that the inclusion resulted from pressure by the Chinese government and MSCI's profit expectations through increased access to China. The *Wall Street Journal*, for instance, highlighted that Chinese asset managers suspended cooperation talks with MSCI and that the Chinese exchanges threatened to cancel MSCI's access to Chinese stock market data in case of a non-inclusion.[12] The truth probably lies somewhere between.

However, it is also important to take into account the increasing preference of global investors for Chinese investments. Although MSCI had pondered whether to include China since 2013, the main reason for repeated non-inclusions was restricted investor access to China's capital market. This changed with Stock Connect which was crucial for MSCI and other index providers' decisions to include Chinese A-shares into their indices. As Chin-Ping Chia, MSCI's Head of Asia-Pacific Equity Research, stated: '[Previously] the access scheme was based on the (R)QFII framework, and it was certainly challenging for some investors to get the license and invest… but the whole development of Connect was a very big game changer'.[13] International investors were much more willing to invest in China through Stock Connect, especially as China increasingly became too big to ignore in global capital markets, which was also revealed in index providers' consultations with their clients (i.e. international investors). While only 1,700 SPSA accounts to trade China via Stock Connect existed before MSCI's inclusion in June 2017, their number increased to over 9,700 by January 2020. Consequently, foreign ownership of Chinese stocks and bonds almost tripled since 2015 (figure 3).

Overall, none of the Chinese exchanges' activities to accommodate index inclusions went against state-capitalist logic: market access through Stock Connect enabled continued market control and improving companies' English language capabilities and tightening delisting rules only improved corporate governance, facilitating the development goal of company reforms. Essentially, index inclusions were a boon for China's integration into global markets as it brought China's financial integration even more in line with state-capitalist logic. As one Hong Kong-based asset manager noted during an interview, while 'Chinese regulators still don't like hedge funds, fast money, *MSCI inclusion attracts the right kind of foreign investors* – long-term, passive, they trade very little…'.[14] Through the index inclusions, such long-term investors were forced to invest into China. Similarly, Julien Martin, General Manager of Bond Connect, stated: 'I do consider the inclusion as sort of a trigger… […] from arbitrage and fast money going in, we finally see global asset managers to look at China, making their accounts ready, investing into China'.[15]

With its index inclusions, China had arrived in the upper echelons of global finance. However, this unprecedented inflow of foreign capital takes place according to rules set out by China's exchanges and follows a state-capitalist logic – facilitating the professionalisation and institutionalisation of Chinese markets (national development) while maintaining Chinese exchanges' monitoring and intervention system as well as reducing market volatility (control).

[12] *Wall Street Journal* 'How China Pressured MSCI to Add Its Market to Major Benchmark' 3 February 2019.
[13] MSCI/iShares 'Bring your A Game to Investing in China' Webinar (20 September 2018).
[14] Interview: product development, asset manager (Hong Kong, 3 July 2017).
[15] HKEx/Risk.net 'Chinese Bonds – Riding the Waves of Foreign Inflows' Webinar (28 November 2018).

4. What kind of regulation concerning the scope and limits of index provider authority with respect to individual companies is appropriate?

Index providers have increasingly become key actors in global financial markets. In order to discuss their regulation, one first has to look at their transformation and changing role in global capital allocation.[16] Historically, index providers were primarily providers of information. Indices were 'news items', helpful for investment decisions — but arguably not essential. Indices are numerical tools that enable comparative evaluations of groups of assets over time. The purpose of indices is to display the performance of specific (and often complex) economic entities such as national stock markets. Actively managed funds used these indices as baselines to compare their performance, but indices were not expected to direct financial markets. The hallmark of active investors was to be different from the index — the index was there to be beaten. Hence, index providers' decisions over the composition of their indices had relatively limited impact on financial flows as their exact composition was not yet crucial to investors, listed companies or countries (see figure 4). This changed fundamentally with the global financial crisis, which triggered two reinforcing trends: concentration of the index industry and the rise of passive investment. Together, these transformed index providers from merely supplying information to exerting power over asset allocation in capital markets globally.

First, the index industry concentrated — not least because banks sold non-core businesses to raise cash, as they tried to stay afloat during the global financial crisis. By 2017, the three major index providers S&P DJI, MSCI and FTSE Russell accounted for 27%, 26% and 25% of global revenues in the index industry, respectively. This market concentration led to a growing power position of the few index providers that had historically positioned themselves and their brands in financial markets. With profit margins averaging between 60-70%, they operate in a quasi-oligopolistic market structure. This is because their indices are not easily substitutable, due to unique brand recognition and network externalities, e.g. through liquid futures markets based on their indices. The S&P 500, for instance, represents US blue chips like no other index. It is also the most widely tracked index globally, and S&P 500 index futures are the most traded futures contract in the world (figure 5).

Second, and more importantly, the money mass-migration from active towards passive investments significantly increased the authority of index providers. They came to influence asset allocation in unprecedented ways, as more and more funds directly tracked the indices they own, construct and maintain. ETFs indexed to FTSE Russell indices more than doubled from US$315 billion in 2013 to US$765 billion in 2019. Meanwhile passive funds tracking MSCI indices increased more than sevenfold between 2008 and 2020, from $132 billion to more than $1 trillion. ETFs and index mutual funds that follow S&P DJI indices increased from $1.7 trillion in 2011 to staggering $6.3 trillion in 2019. This trend had continued since. Whereas in the past indices only loosely anchored fund holdings around a baseline, now they have an instant, 'mechanic' effect on the holdings of passive funds. As passive funds simply replicate an index, index providers' decisions to change index compositions lead to quasi-automatic asset reallocations. Index providers now effectively 'steer' capital flows.

In addition, index providers increasingly also have a steering effect over actively managed funds as benchmarking against indices has reached enormous proportions: US$14.8 trillion, US$16 trillion and US$11.5 trillion of assets (equities and bonds) were benchmarked against the indices of MSCI, FTSE Russell and S&P DJI in 2018/19, respectively. This is up from US$7 trillion (MSCI), US$7.1 trillion (S&P DJI) and US$7.1 trillion (FTSE & Russell) in 2013.

[16] We analyze this in detail in the following academic study:
Johannes Petry, Jan Fichtner & Eelke Heemskerk (2021) Steering capital: the growing private authority of index providers in the age of passive asset management, *Review of International Political Economy*, 28(1): 152-176 (https://doi.org/10.1080/09692290.2019.1699147).

Nowadays, index changes need to be reflected by actively managed funds which measure their performance against these indices. From a mere information tool, they have become crucial baselines to inform investment decisions. Thereby, the rise of passive management also increases the authority of index providers through active management. By steering evermore passive capital, index decisions mechanically move ever larger parts of the markets. This produces a 'pull effect' that actively managed funds need to follow. Next to these large benchmarks, index providers also create tens of thousands of customised indices for their clients that inform their investment strategies. Overall, with the ongoing shift towards passive asset management, index providers turned into powerful market actors. No longer mere benchmarks, their indices have become central building blocks in this new era of US financial markets. Which companies or countries are included into an index or excluded (i.e. receive investment in- or outflows) is based on criteria defined by index providers, thereby setting standards for corporate governance and investor access. In the past, the purpose of indices was to measure markets, now they move markets.

However, so far, no regulation governs index providers' investment decisions and index providers often deflect responsibility for investment decisions. This was for instance demonstrated by the efforts of a large group of international investors (170+ firms representing $9.7trillion of assets) to convince index providers to exclude manufacturers from controversial weapons such as cluster bombs, landmines or biological/chemical weapons from their benchmark indices. In their response, however, the index providers noted that their task was merely to create a representative picture of stock markets with their benchmarks whereas they offered other indices to take into account such investor preferences.[17] However, this neglects fact that the main benchmarks of index providers – be it the S&P500, FTSE100 or MSCI Emerging Markets – are tracked by a multiple of assets than their other index products, largely due to the above-described brand recognition and network externalities. Hence, if the benchmark does not change, changes of changing asset allocations are small.

Rather than merely representing a market with their benchmarks, nowadays index providers increasingly define what this market is and have a significant influence on investment decisions. These investment decisions, however, are reversely based on a methodology that aims to represent the market – and are not subject to any specific guidelines. Closer regulatory scrutiny should therefore be put on index providers and their changed role within capital markets. Whether to invest in companies linked to the Chinese military, companies such as Saudi Aramco, or controversial weapons is not merely a technical decision.[18] As a forthcoming paper in the Harvard Business Law Review argued, under the relevant statutory and regulatory regimes, index providers are investment advisors and should be regulated as such by the SEC.[19] This is especially important as this power to steer investments and set standards is concentrated in the hands of very few private firms which form an oligopoly that dominates the index industry with high barriers of entry which severely limit competition.

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[17] *Investors & Pensions Europe* 'Index providers respond to controversial weapons campaign' 14 February 2019.

[18] *Washington Post* 'Index funds might sound boring. But who decides which countries and companies to include?' 8 January 2020.

[19] Paul G. Mahoney & Adriana Robertson (forthcoming) Advisers by Another Name. *Harvard Business Law Review* (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3767087).
See: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3767087.

5. How do you assess the impact of current U.S. restrictions on investment in Chinese companies listed on the Mainland?

With respect to current US restrictions on investment in Chinese companies, the question is what these restrictions aim to achieve. There are three potential effects that the restrictions could have: on US investors; on banned Chinese companies; and on Chinese capital markets more broadly.

First is the effect on the asset allocation of US investors. Following the investment ban, index providers such as MSCI, FTSE Russell and S&P DJI have excluded select Chinese firms from their indices. In the case of MSCI, 10 Chinese companies were deleted from the index which in total represent 0.28% of the MSCI Emerging Market index.[20] Further, US investment banks have delisted hundreds of derivatives linked to these companies which reduced hedging possibilities of these stocks.[21] Therefore, the investment ban led to rapid immediate investment flows out of these individual stocks, e.g. the Chinese telecommunication firms listed in Hong Kong.[22] If the aim of current restrictions has been to prevent US financial institutions from investing into certain Chinese companies, then they have been very effective.

Second, is the effect on specific Chinese companies. Here, the effect has been more mixed, as other international investors substituted for US divestments. As a recent Reuters article highlighted, after a brief drop in share prices after US restrictions set in, European and Asian investors quickly snatched up discounted stocks of these Chinese companies, driving their prices up again.[23] At the time of writing, the effect of US investment restrictions on the share performance of banned Chinese companies has only been moderate. Of course these restrictions had an impact on these companies, also with respect to the reduced hedging possibilities noted above. But as previously noted, Chinese companies – especially when listed in mainland China – do not list because of funding needs. Therefore, the effects of investment outflows are measured compared to similar outflows in US markets. The effect on Chinese companies has been smaller, largely because of US unilateralism.

Third, is the effect on Chinese capital markets as a whole. As of 2020, Chinese companies account for 40.95% of the MSCI EM index as their weighting has more than doubled since 2014 (18.24%).[24] US investment restrictions have therefore hardly made an impact on the overall allocation of assets into Chinese companies. Only targeting a small number of companies does not reverse the massive funding shift into the Chinese economy. According to a recent study in the Financial Times, global investors poured more than $1trillion into Chinese capital markets in 2020 alone.[25] In particular US financial institutions have been rapidly expanding their China allocations in recent years. Hence, rather than actually restricting access to Chinese capital markets, the restrictions probably had a larger effect on the performance of US investors, which were not able to capitalize on the same gains as other international investors eager to invest into China. As long as Chinese capital markets continue to offer large returns and the Chinese economy remains the world's economic engine, international investors will continue to flock to Chinese capital markets.

If the aim was to restrict funding access for Chinese companies more broadly, another much more drastic solution would be widespread sanctions as in the case of Iran. But given the

[20] MSCI press release (https://www.msci.com/documents/10199/63363b6c-281f-798e-7f57-10728bb5b964=.

[21] *Wall Street Journal* 'Blacklisting of Chinese Stocks Prompts Banks to Delist Hundreds of Derivatives' 8 January 2021.

[22] *Bloomberg* 'MSCI Deletions Trigger Rush to Sell Chinese Telecom Stocks' 8 January 2021.

[23] *Reuters* 'Sanctions-hit Chinese firms surge as global buyers swoop in' 14 January 2021.

[24] See: *MSCI* 'The Rise of Emerging Markets and Asia'(https://www.msci.com/insights-gallery/emerging-markets).

[25] *Financial Times* 'Global investors place Rmb1tn bet on China breakthrough' 14 December 2020.

increasing interconnectedness of Chinese and US financial systems / economies, such actions would be non-advisable. Further, it is also important to remember that over the last decade, facilitating such access for US investors to China had in fact been an important policy goal of the United States. As noted above, global capital markets are built upon the principle of free markets, an idea that the US championed and facilitated in emerging markets across the globe, especially vis-á-vis China. Such actions would not only mark a reversal of decade-long US foreign economic policy but also increasingly undermine the principles that distinguish US capital markets from Chinese markets: a focus on free, accessible markets based on efficiency, rather than markets being politicized.

Threats by the Trump administration to delist Chinese companies following the Luckin Coffee scandal have, for instance, further bolstered China's state-capitalist markets as many overseas-listed Chinese companies are now pursuing (secondary) listings in Hong Kong and Shanghai. When SSE's STAR market was launched in June 2019 to 'bring home' Chinese tech companies, it was initially unsuccessful at that. It was only deteriorating Sino-American relations that pushed Chinese unicorns towards a Chinese listing and propelled STAR to become the world's 3rd largest IPO market in 2020. With more Chinese companies coming home, the Chinese exchanges' influence over Corporate China only increases, as a state-capitalist market logic now also encompasses Chinese companies previously listed in the US. As this example demonstrates, such unilateral US policies can easily backfire and can even strengthen Chinese capital markets.

6. What recommendations for legislative action would you make based on the topic of your testimony?

Index providers. Currently, no regulation guides index calculation which is aimed at representing specific stock markets. As argued above, it should be considered whether index providers ought to be regulated as investment advisors by the SEC. This applies both to their customised indices as well as their benchmarks. Whether with respect to investment into Chinese companies with military links or other areas (e.g. controversial weapons), the SEC should aim to create a regulatory framework for index providers and their business activities.

In the European Union, certain regulations such as the Benchmarking Regulation (BMR) that was created after the LIBOR-scandal as well as the Sustainable Finance Taxonomy to standardise ESG investment already seem to influence index creation (albeit the exact extent of this influence is not clear yet). If the US government were to assess tools to influence index provider activities, these two EU regulations might be good starting points.

US investment restrictions. Current restrictions are effective in preventing US financial firms from investing into China. It does not, however, significantly impact the activities of Chinese firms, let alone Chinese capital markets more broadly.

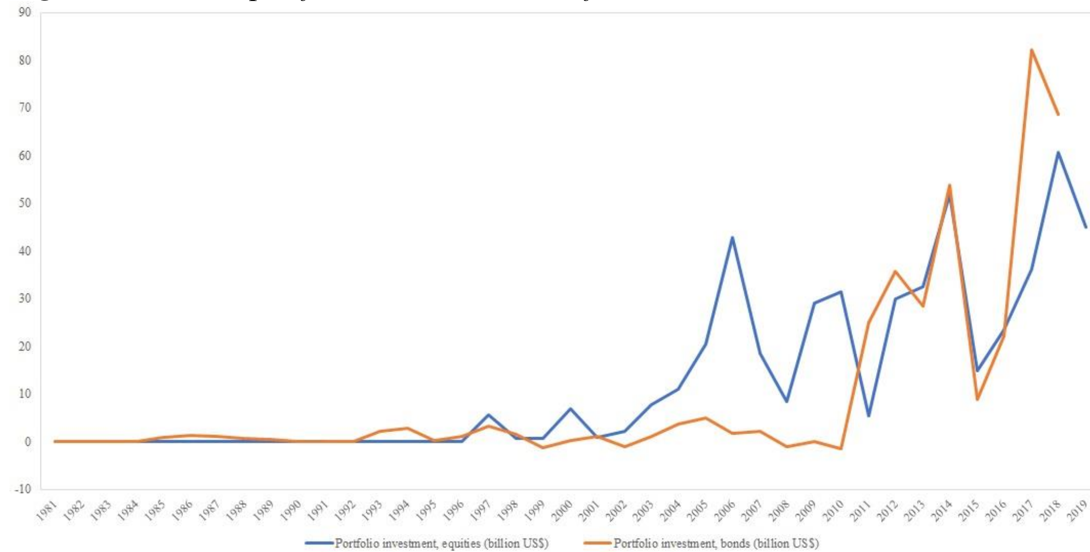
On the one hand, unilateral action can backfire. Threats to delist Chinese companies (after Luckin Coffee) have only bolstered the development of China's capital markets. Similarly, the unilateral investment ban has probably harmed US investors more than the delisted Chinese companies. On the other hand, I would strongly advise against more sweeping measures (e.g. sanctions). First, the Chinese and US financial systems are very strongly entangled and such measures would inevitably hurt both economies. Second, this would also undermine the principles that distinguish American from Chinese capital markets (efficiency / free flow of capital vs politicized / controlled markets).

In theory, restricting investments into specific companies is a smart economic policy tool. Rather than more sweeping measures that equally harm both the US and Chinese economies, ‘surgically’ removing particular companies from investment decisions minimizes financial collateral damage. However, in order to be effective, two criteria need to be met.

First, international cooperation is crucial. If not the majority of the international investment community is on board, restrictions mainly effect the US as the restricting country (US investors), not the restricted entities (Chinese companies). Hence, regulations should also involve European investors, maybe also institutional investors from Japan or Korea, in a multilateral effort. Unilateral action is not effective in this respect.

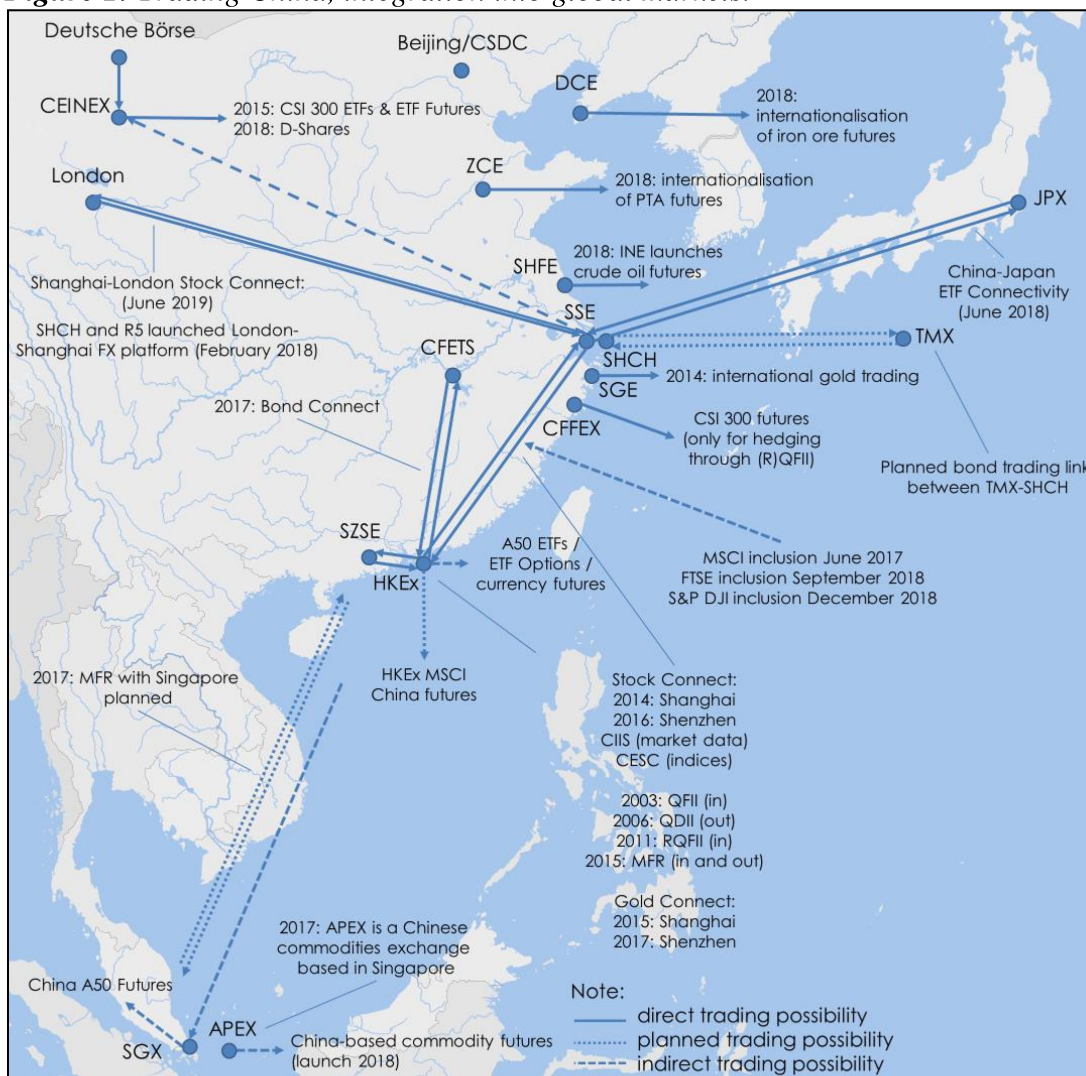
Second, the standards for such investment restrictions should be transparent and should be applied consistently across countries. If these restrictions are only created to harm Chinese companies/capital markets, the US risks violating the very principles that underpin liberal capital markets which they have championed for decades. Markets can be liberal but regulated according to certain normative considerations that are applied universally, but they quickly become illiberal and politicized when targeting one specific country. Rather than a short-sighted ban of Chinese companies based on narrow political considerations, the long-term effects of such restrictions on the US-led global economic order should also be considered.

Figure 1: *China's portfolio investment net inflows, 1981-2019.*



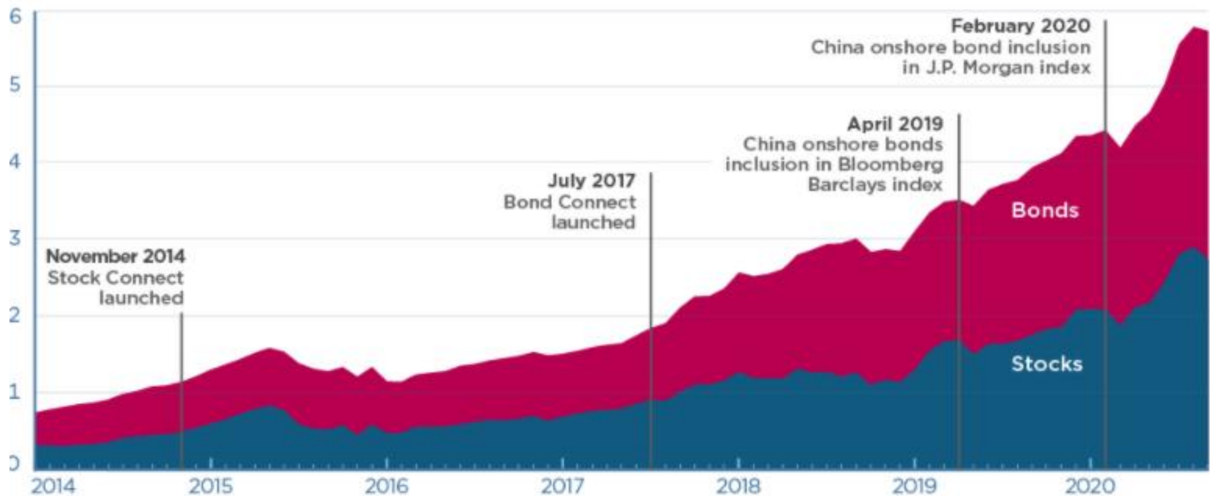
Source: https://journals.sagepub.com/doi/10.1177/1024529420964723.

Figure 2: *Trading China, integration into global markets.*



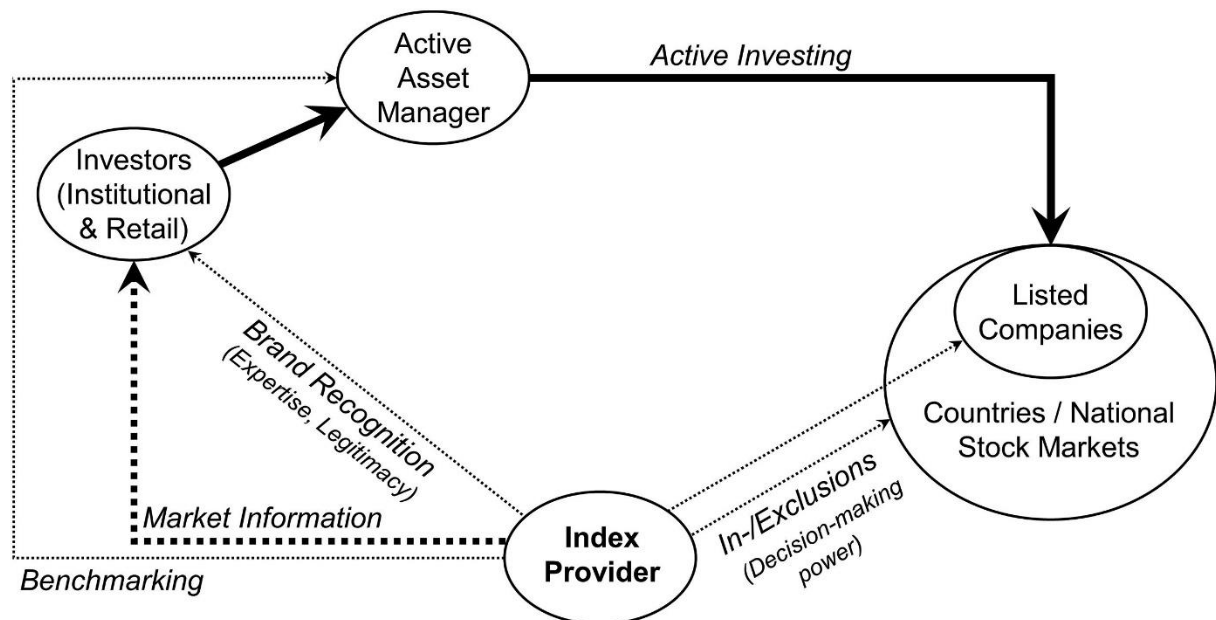
Source: https://journals.sagepub.com/doi/10.1177/1024529420964723.

***Figure** 3: Foreign onshore portfolio investment in China (in trillion RMB).*



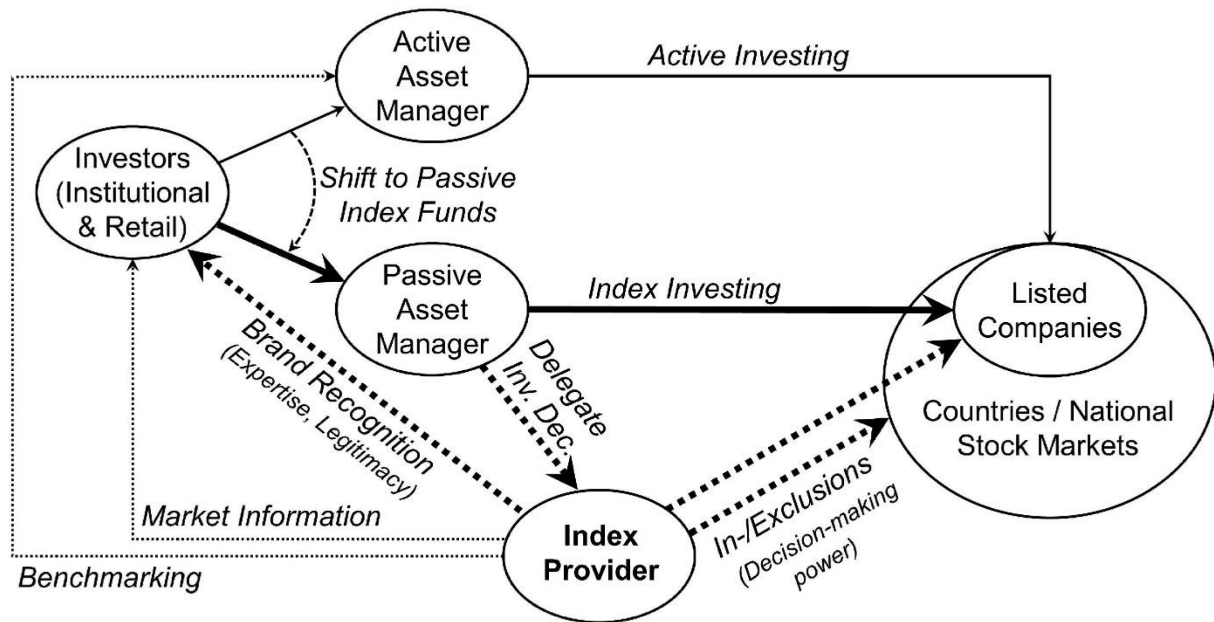
Source: [*https://www.piie.com/research/piie-charts/rising-foreign-investment-chinas-onshore-stocks-and-bonds-shows-accelerating*](https://www.piie.com/research/piie-charts/rising-foreign-investment-chinas-onshore-stocks-and-bonds-shows-accelerating).

***Figure 4:** The role of index providers before the shift to passive investing.*



Source: [*https://www.tandfonline.com/doi/full/10.1080/09692290.2019.1699147*](https://www.tandfonline.com/doi/full/10.1080/09692290.2019.1699147).

Figure 5: *The role of index providers after the shift to passive investing.*



Source: [*https://www.tandfonline.com/doi/full/10.1080/09692290.2019.1699147*](https://www.tandfonline.com/doi/full/10.1080/09692290.2019.1699147).