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

For my written testimony I'll first provide opening remarks, and then address the questions provided sequentially.

As way of background, I've been managing portfolios in Emerging Markets, and specifically in China, since 2007. Over this time period, U.S. investors' access to China has changed dramatically, primarily as a result of the Stock Connect program, but also as a result of increased U.S. listings and greater integration of China into the global economy. China is both an important market for U.S. investors and for companies engaged in multinational sales and operations. China is increasingly a major component of investors' portfolios both through direct investment in Chinese companies' stock, and through the increased importance of China for domestic and international companies.

It seems the main question is what are the costs/benefits of restricting U.S. investments in Chinese companies? While there is clearly a cost for a U.S. investor in terms of loss of diversification, how large the loss is ultimately dependent on the size of the restricted list/companies. The cost/penalties imposed on Chinese companies as a result of these restrictions is less certain. The majority of equity investment in China, specifically for retail investors, comes through the trading of shares in the secondary market, where transactions take place between investors rather than through direct capital flows to the firm. Restricting U.S. investment could potentially increase the cost of capital for Chinese companies, but this will ultimately depend on how accessible and receptive alternative capital providers are to such companies.

If the intention is to reduce the potential significance of U.S. capital in foreign companies that pose a potential threat to national security, restricting U.S. investment will likely have minimal impact on the underlying behavior of these firms. However, there are alternative channels of influence, like enhanced disclosure requirements, that have the potential to impact firm behavior while imposing less of a diversification loss for U.S. investors. Many firms already disclose information on business activities and sources of revenue, in particular government revenues. Enhancing these disclosure requirements would provide investors with additional information to assess the potential risk and returns of their investments. Disclosure also has the additional benefit of providing more information to monitor potentially controversial activities.

I'll next turn to providing responses to the questions posed.

1. *How do you view the respective roles of the government and the market in ensuring U.S. investment does not fund Chinese companies which pose a threat to U.S. national security and values?*

The role of the government, regulators, and potentially exchanges should be to provide clear guidance as to what are permissible current and potential investments. There currently exist government restrictions on a variety of investments, and imposing additional restrictions is one of the many roles of regulators. The key feature for investors is the need for clear guidelines as to what constitutes a threat to national security and thus would be a restricted investment. We would benefit from clear guidance around issues such as the materiality thresholds for proposed rules. If, for example, a firm produces steel that is used in tanks and buildings, what proportion of a firm's steel production going to tanks would pose a national security threat?

The main fear from the investor perspective is that potential rules are enacted in an overly broad fashion impacting a variety of firms. The inclusion of the word "values" in the above question raises substantial concerns as "values" mean very different things to different people. I have substantial concerns with the U.S. government and regulators imposing restrictions based on "values." How would the government define values, and translate values into clear guidelines for investors?

Finally, I want to reiterate that from investors' perspective, consistency and transparency are the most critical features of any restrictions. If the U.S. government chooses to continue and/or add to these restrictions, we need clear rules and precise identification of restricted securities as well as clear guidelines as to how restrictions are determined.

2. *Some argue that investment in China's capital markets or those in other emerging economies provides an important source of portfolio diversification. How can U.S. policy preserve any such opportunities while also defending against the national security threats posed by some Chinese companies?*

   Diversification is one of the key reasons for investing beyond U.S. companies. Further restrictions on these activities will result in less diversification, and the ultimate cost will be determined by the size of the asset pool included in the restrictions. Any investment in non-U.S. domiciled firms comes with additional risk as regulations, disclosure, and investor protection vary by country. Investors need to be aware of these risks. Investors should always know what they own and specific risks involved in various investments. The key tool through which investors assess these risks is through disclosures. The role of the government and various market regulators is to ensure that investors have adequate disclosures to assess these risks. Rather than restricting investments, regulators could enhance the disclosure requirements for U.S. listed firms and work with global regulators to enhance disclosure requirements across the globe. Firms do respond to investors' disclosure requests. By working with regulators, firms, and investors there is the potential to enhance disclosure to better assess the potential national security risk of certain investments.

3. *As Beijing pursues financial opening, U.S. investor exposure to unique risks in China's capital markets rises. How desirable is the deeper integration of the U.S. and Chinese financial markets in light of these risks and considering heightened strategic competition between the United States and China?*

Both companies and investors have large interests in China. This is not only due to investments in China directly but also due to the interdependence of companies operating in the global economy. Chinese investors provide capital, sales, and supplies for U.S.-based firms and U.S. investors provide capital, sales, and supplies for Chinese firms. The openness of the Chinese market is crucial for both parties. Increased foreign investment in China reduces volatility by further diversifying the source of capital and shareholder base. Being able to invest in one of the largest and fastest growing economies provides unique opportunities for U.S. investors that is beneficial for both diversification and return generation. Deeper integration of U.S. and Chinese capital markets is highly desirable for all parties. Some of the benefits of the increased openness of the Chinese market are increased monitoring by foreign investors, better access to disclosures, and information about firms' activities. The initial phases of integration have resulted in increased information production and monitoring of Chinese firms by foreign investors and analysts improving the transparency of the Chinese market for all parties. As the product and capital markets have become more integrated, we have seen improvements in business practices and increased monitoring of issues such as the treatment of workers, environmental issues, and firm transparency; these are all ancillary benefits of increased integration.

4. *There are information asymmetries between developed capital markets and those in emerging markets, particularly China. How can retail investors who increasingly invest in passively managed funds navigate these asymmetries?*

While passive funds have various rules for inclusion in passive indexes, the majority of these rules revolve around size and liquidity. While these funds do include a variety of disclosures of the risk and returns of these investments, I would surmise that most investors do not read through these details. One potential solution would be to introduce some type of scoring or grading system of the business practices that are in question or introduce specific disclosure rules for passively managed funds to address the potential national security threat.

5. *How do you assess the impact of current U.S. restrictions on investment in Chinese companies listed on the Mainland? What else could the United States do differently to target investment that could potentially benefit Chinese defense firms or otherwise fund companies acting contrary to U.S. national security interests?*

We assess the impact based upon the current restricted lists and any subsequent update to the lists. In term of what else could the U.S. do? I will again stress the importance of disclosure. Enhanced disclosure around potentially controversial business activities and government revenues would be beneficial. From a process perspective, I would hope that the process by which these or potentially other restrictions are enacted is improved. Specifically, we would benefit from a more precise identification of the restricted names and potential related entities. The current restrictions list only the company name and some references make mention of related entities and instruments, but that is vague. I would hope that going forward the restricted list can be populated with additional identifiers beyond just company names, adding ticker symbols, ISIN, and other identifying information would be beneficial. In addition, it would be useful to provide guidance as to the specific type of business activities and criteria that go into the restricted list so investors can better assess the implications of potential future restrictions.

6. *The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. What recommendations for legislative action would you make based on the topic of your testimony?*

   Firms around the globe currently disclose various breakdowns of revenue, by product, by geography, and, in many cases, by customer type, including government contracting. One potential action along these lines would be to further enhance government sales disclosures by providing defense and non-defense related government contracts. If such disclosures were implemented, this information could then be used as an input for assessing the materiality of the potential national security threat. In addition to disclosing the dollar amount of government sales, the disclosures could include a narrative about the type of services/products the firm is providing to the government, which would provide additional information to investors.