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Testimony Before the U.S.- China Economic and Security Review Commission

Chinese Investment in the United States: Impacts and Issues for Policymakers

Greetings,

I would ask the Commission to guess in what country the following scenario occurs.

An investor is told they must sell a company's stock. The stock is down more than 50% since the IPO three years ago and at a record low. The Chairman and Insiders, unseen since the IPO, control the company and offer to pay a 16% premium.

The investor will lose 42% on their investment. Meanwhile, since IPO the company has grown its cash balance by 400%, and its total assets by 800%. (Appendix, Figures 1, 2)

The investor believes the buyout offer is too low, feels ripped off, and wants to challenge the company's lowball squeeze out. However, it's proving to be impossible, because:

- The Stock Exchange won't review it because of the company's extralegal status.
- The company's Chairman and "independent" directors ignore investor grievances.
- The courts don't recognize the investor because they have no legal standing.
- Regulators simply shrug. There's no time for abuse that's technically not illegal.

The investor publishes a letter in the media protesting this lowball squeeze out. Soon, the investor is threatened with a defamation lawsuit by a company director, who also is a foreign government official. The legal bill starts at US$100,000 in a foreign court.

The investor is intimidated into suffering in silence against this powerful company. Adding insult to injury, there is news the company is planning a future IPO in another stock market at a mark up of 4x-5x the value the company will pay the investor for full control. (Figure 3)

In what country is this happening? Considering the lack of legal protection and individual rights, it resembles an authoritarian government with an unregulated stock market, right?

Wrong. It is happening in America. Our stock markets are havens for poor corporate governance exported to U.S. investors. Even worse, the U.S. unwittingly incentivizes foreign issuers to become predators.

How did we get here? U.S. laws allow foreign private issuers (FPIs) to raise capital in our financial markets primarily obligated not to U.S. laws, but instead their home laws.

In the globalization of America's stock markets, the first wave was from Canada, the U.K. and Europe, and then Israel. Today it's Chinese companies incorporated in offshore jurisdictions. The next wave may be from India, Russia, or Africa. What is more relevant than where these FPIs are from is closing this regulatory gap allowing FPIs to raise capital in American financial markets without accountability to American investors.

I ask the Commission and our Congress, "Do we permit foreign bank branches or offices to operate under their home laws in the U.S.? Or foreign investment companies and funds?" Of course not. It's nonsense to forfeit U.S. jurisdiction over the protection of Americans' money in our own country. Yet FPIs set up shop in America's financial markets by the hundreds to sell securities, collect billions of dollars from U.S. investors, and if challenged for misconduct, enjoy diplomatic immunity. It is time for us to come to our senses.

It is important to state we are not China-bashing. Heng Ren invests exclusively in companies operating in China for a reason - we are optimistic about the future of Chinese companies, entrepreneurs, and investors. We find most companies we invest in to be ethical and law abiding. However, as in any country there are unethical businesspeople. Increasingly, when we see such FPIs hurt American investors, they are shielded from accountability by crafty legal barriers, starting with their extralegal status.

Small wonder this legal loophole is bustling. The biggest growth in FPIs since 2000 has been companies incorporated in offshore jurisdictions (Figure 4). Hundreds of issuers hungry for the investment capital are nourished in the world's wealthiest financial markets – and as a bonus are largely freed of the burdens of U.S. laws and regulations.

The cost of this legal loophole for U.S. financial markets is increasing. Lower corporate governance standards take root in U.S. financial markets and erode confidence in the integrity of our financial markets, as in the case of lowball squeeze outs (Figure 6). Disadvantaged U.S. investors find little legal and regulatory support while they witness known violators of the Foreign Corrupt Practices Act trade openly on U.S. stock exchanges. Chinese investors, with high expectations of legal rights and protections here, are stunned to find they have no recourse.

I don't believe this is the outcome U.S. investors expected when purchasing stocks trading on the platforms of the NASDAQ and the New York Stock Exchange (NYSE). Increasingly purchasers discover they are not shareholders but mere holders of "depositary receipts" with no legal standing in our own courts. (Figures 7, 8)

In these times when businessmen are calling for less regulation, and citizens to lower the costs of globalization's weaknesses, Heng Ren offers the Commission six recommendations readily available for a solution:

1. If foreign companies raise capital in the U.S., the issuer, their officers, and directors, must be legally accountable in the U.S.

If harmonization of laws is too heavy a lift, despite its simple rationale, then provide checks and balances, in particular during buyouts:

2. The Securities and Exchange Commission (SEC) should monitor the activities of an FPI during a buyout.

3. The SEC should actively solicit the largest non-management shareholders for an opinion on the fairness of the buyout offer.

4. Special committees evaluating buyouts of FPIs need to be composed solely of valuation experts appointed by the exchanges and paid for by the companies.

5. A majority of minority shareholders should be required to approve a management buyout transaction by an FPI. This should be part of the listing requirements of the NYSE and NASDAQ.

If checks and balances fail to be implemented, then give investors a chance with truth in advertising:

6. An FPI's stock ticker should include an explicit warning label similar to the U.S. Surgeon General's warning on smoking.

In conclusion, I want to state I believe in globalization. The aim to globalize our stock markets to reflect a global economy is admirable. I have witnessed and enjoyed its benefits. But the regulatory and legal gaps outlined show flaws that are endured by investors in U.S. financial markets at an increasingly heavy cost. Let's correct it.

Thank you.

Heng Ren Partners

Appendix

Testimony of Peter Halesworth, Heng Ren Partners LLC

Before the U.S.-China Economic and Security Review Commission (USCC)

Hearing on "Chinese Investment in the United States:

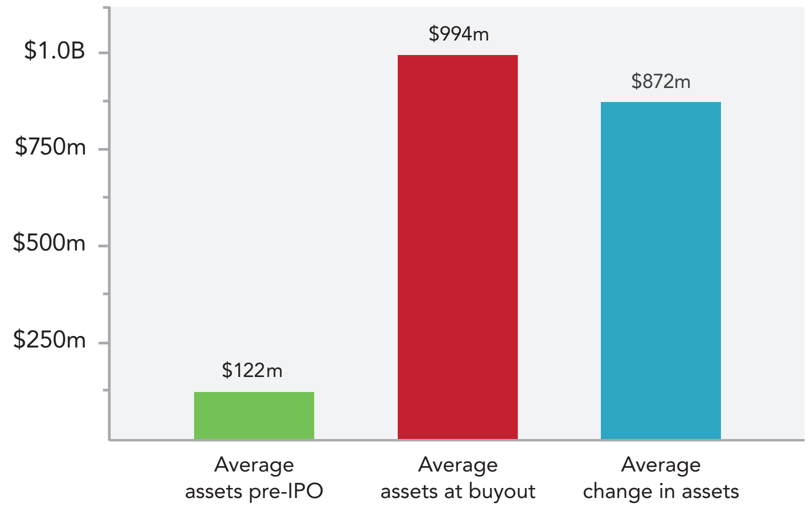
Impacts and Issues for Policymakers"

January 26, 2017

Washington, D.C.

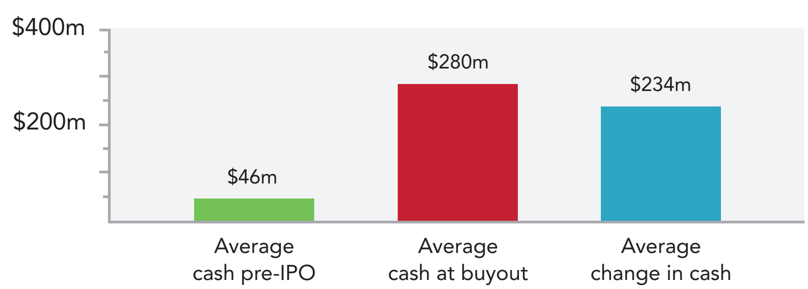
Fig. 1 – Chinese management buyouts leave U.S. much wealthier

Assets increase



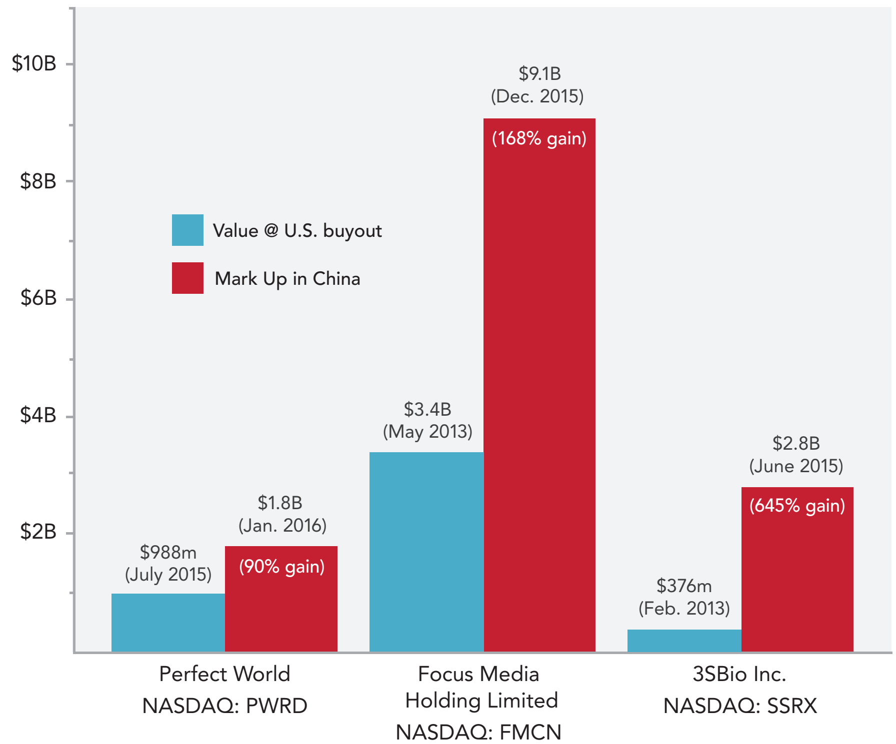
Source: U.S. SEC filings

Fig. 2 – Cash increase



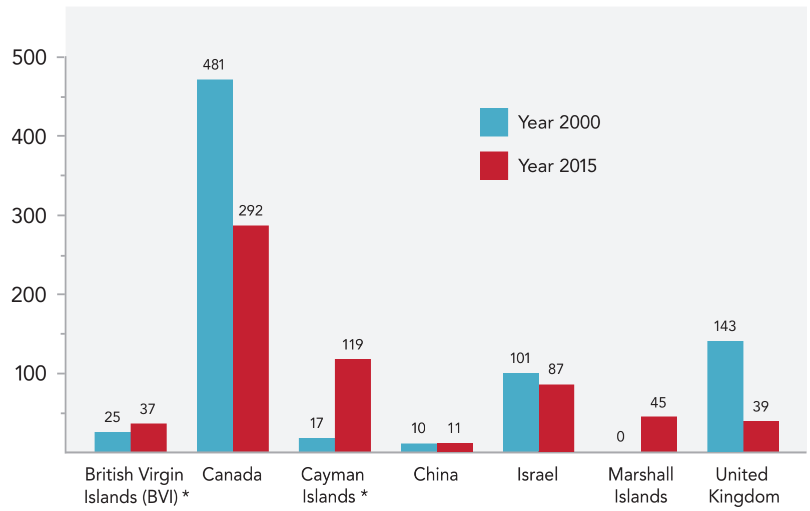
Source: U.S. SEC filings

Fig. 3 – Chinese buyouts reap huge windfalls



Source: *Bloomberg*

Fig. 4 – Changes in Foreign Private Issuers (FPIs) by Country of Incorporation 2000-2015

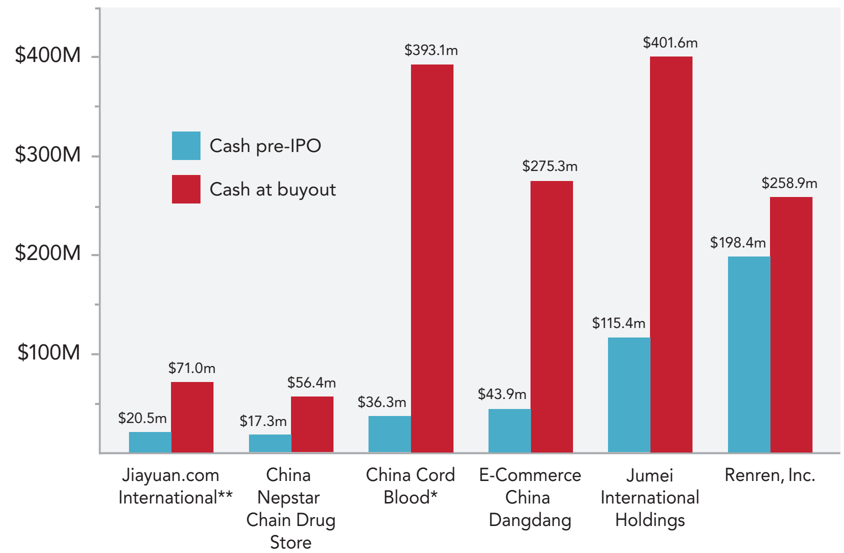


Country of Incorporation	Year 2000	Year 2015
British Virgin Islands (BVI) *	25	37
Canada	481	292
Cayman Islands *	17	119
China	10	11
Israel	101	87
Marshall Islands	0	45
United Kingdom	143	39

** British Overseas Territory*

Source: SEC

Fig. 5 – Raising U.S. cash, and growing the cash pile



** N.A. – Non-IPO offering. Cash at time of most recent transaction.*

*** N.A. – Original management bid of $5.37 revised to $7.20, then beaten by competing bid of $7.56 – still 35.6% below Heng Ren's fair value estimate.*

Source: *Bloomberg and U.S. SEC filings*

Fig. 6 – Squeezing out investors at low prices below IPO

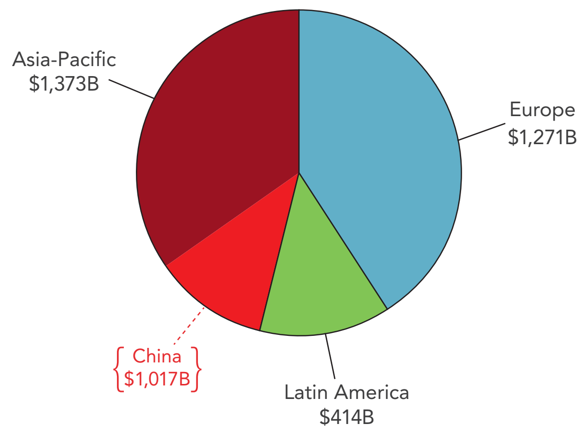
Name	Ticker	Exchange	Cash pre-IPO ($ m)	Cash at Buyout ($ m)	Buyout Below IPO? (% Below IPO)	Bid Premium Below U.S. Avg? (% Prem.)	IPO Year
Jiayuan.com International**	DATE	Nasdaq	20.5	71.0	Yes, -35%	No, 55%	2011
China Nepstar Chain Drug Store	NPD	NYSE	17.3	56.4	Yes, -84%	Yes, 14%	2007
China Cord Blood*	CO	NYSE	36.3	393.1	N.A.	Yes, -11%	2009
E-Commerce China Dangdang	DANG	NYSE	43.9	275.3	Yes, -51%	Yes, 20%	2010
Jumei International Holdings	JMEI	NYSE	115.4	401.6	Yes, -68%	Yes, 20%	2014
Renren Inc.	RENN	NYSE	198.4	258.9	Yes, -70%	Yes, 2.2%	2011

** N.A. – Non-IPO offering. Cash at time of most recent transaction.*

*** Original management bid of $5.37 revised to $7.20, then beaten by competing bid of $7.56 – still 35.6% below Heng Ren's fair value estimate.*

Sources: *Bloomberg* and U.S. SEC filings

Fig. 7 – Total value traded of ADRs, by region



Source: *BNY Mellon Depository Receipt Market Review 2016*

Fig. 8 – Total stock value traded by country (2015)*

Global Rank	Country	Total (U.S. $ billion)
1	United States	41,398
2	China	39,326
3	Japan	5,571
4	ADRs in U.S. **	3,059
5	U.K. #	2,167
6	Hong Kong	2,068
7	South Korea	1,843
8	Germany	1,444
9	France #	1,116
10	Canada	1,096
11	Chinese ADRs in U.S.	1,017
12	Spain	978
13	Switzerland	955
14	India	772
15	Australia	751

* *Source: The World Bank Group*
The value of shares traded is the total number of shares traded, both domestic and foreign, multiplied by their respective matching prices. Figures are single counted (only one side of the trade is considered). Value of trade of all stock exchanges in the respective country.

** *Source:* BNY Mellon Depositary Receipt Market Review 2015

\# *Estimates*