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U.S. Capital Markets and China: Issues for Congress

Financial ties between the United States and China have expanded significantly over the past few years. The government of the People's Republic of China (PRC or China) has created limited openings in China's debt and equity markets, while China's firms have sought access to U.S. capital, debt, and private equity markets. The Rhodium Group estimates that, as of December 2020, U.S. investors held $100 billion of Chinese debt and $1.1 trillion in Chinese equities, while Chinese investors held $1.4 trillion in U.S. debt and $720 billion in U.S. equities. This data may understate flows. The *Financial Times* estimates that, based on Bloomberg data, foreign investment in Chinese equities and bonds was $806 billion as of July 2021.

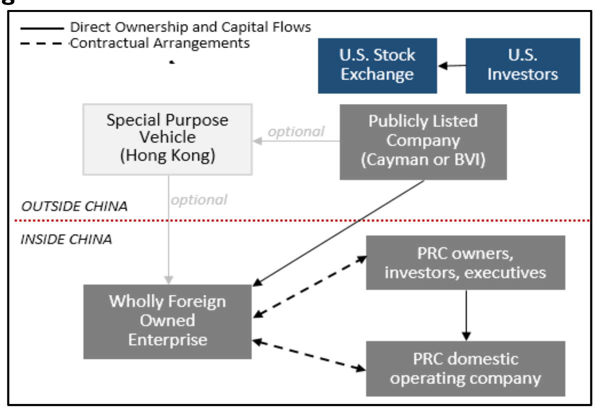
Some in Congress have raised concerns that U.S. investors may fund Chinese state and military-tied firms. Congress passed the Holding Foreign Companies Accountable Act (P.L. 116-222) to address its concerns about the lack of compliance by PRC firms with the U.S. Security and Exchange Commission's (SEC's) statutory audit requirements. Chinese firms appear to use complex structures that may obscure risks, state ties, and other corporate details, complicating the effectiveness of U.S. government oversight and U.S. investors' legal recourse.

China's Presence on U.S. Exchanges

U.S. exchanges offer China's firms access to deep capital markets and paths to earn hard currency, build brand recognition, and expand overseas. As of May 2021, there were 248 Chinese firms listed on the three major U.S. stock exchanges—up from 217 in December 2020—accounting for a market capitalization of $2.1 trillion, according to the U.S.-China Economic and Security Review Commission. Initial public offerings (IPOs) in the United States have been popular for Chinese firms in emerging industries, such as electric vehicles. PRC firms raised an estimated $12 billion to $19 billion on U.S. exchanges in 2020.

In many instances, the stocks and core assets of parent Chinese firms are not listed on U.S. exchanges. Many firms use American Depositary Receipts (ADRs), a structure that allows a U.S. financial institution to sponsor a secondary U.S. exchange listing of a foreign company. The overseas parent firm's stocks are listed in the United States through a contractual arrangement that bundles the company's stock certificates. Most listings of China's large state-owned enterprises (SOEs) are ADRs. These ADRs include a small number of the shares that SOEs list in China, and the China-listed shares represent only a small portion of the overall firm, potentially shielding the parent and its assets from the exercise of shareholder rights and financial or litigation risk. The U.S. legal entity for Chinese SOEs is often a shell company with few assets of its own. Even when a U.S. entity is directed and controlled by an SOE parent, it has proven difficult (but not impossible) to legally establish connectivity. Since 2014, the Aviation Industry Corporation of China (AVIC) has tried to deny direct ties to its U.S. affiliates and assert immunity under the Foreign Sovereign Immunities Act (P.L. 94-583) to thwart U.S. litigation despite China's World Trade Organization commitment that its state firms would operate on a commercial basis. The opacity of China's system can make it hard to secure evidence, prolong litigation, and impose significant costs on U.S. investors asserting their rights.

Figure 1. Outline of the VIE Structure



Source: CRS, with information from multiple sources.

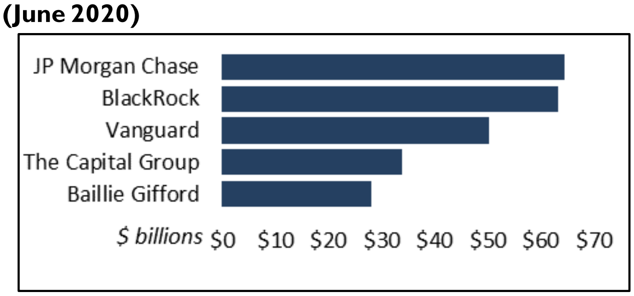
Note: Example of a typical variable interest entity (VIE) structure.

CRS estimates that two-thirds of all Chinese firms listed in the United States—including Alibaba, Baidu, and Tencent—use a variable interest entity (VIE) structure, often to address China's investment restrictions. A VIE structure involves the owners of a Chinese firm creating an offshore holding company to which foreign investors can purchase an equity claim. The holding company is tied to the "parent" through a series of contracts and revenue sharing agreements that mimic ownership arrangements but do not provide the same rights typically afforded to investors in U.S.-listed firms. The contracts underpinning the VIE allow the Chinese owner(s) to move funds across the business while creating a firewall between the listed entity and the core assets and licenses held by the Chinese owner (see **Figure 1**). VIE arrangements appear to have no definitive legal standing in China, which may leave U.S. investors without recourse. SEC 20-F disclosures by some firms acknowledge the risks of VIEs because they are incorporated offshore, conduct most operations in China, and have executives who reside outside the United States. Some Chinese VIEs have reduced U.S. shareholder value, including for large corporate investors, by shifting business licenses and issuing off-the-books bonds. In 2010, for example, Alibaba cut out Yahoo (a 43% stake investor) in its spinoff of the online payment firm Alipay to a separate VIE, controlled by its chairman Jack Ma. In February 2021, global investors reportedly also had no alternative exit strategy or legal rights for an estimated $10 billion invested in an offshore shell company after the Chinese government suspended Ant Financial's $34.5 billion IPO in Shanghai and Hong Kong. In 2021, the PRC government enhanced controls over technology firms, including new restrictions on Alibaba, shareholding and a board seat in ByteDance, and new data security reviews for firms listing offshore.

Disclosure and Auditing Requirements

While most Chinese firms are required to file an SEC 20-F annual report for foreign issuers, there are exemptions on specific disclosure requirements, particularly for ADRs. The SEC relies on China's reporting and disclosure rules, which are less extensive than U.S. requirements. Disclosure of shareholders and operations may present a conflict of interest for Chinese firms with government ties. The Chinese government prohibits the Public Company Accounting Oversight Board (PCAOB)—a nonprofit entity created by Congress to oversee audits of U.S.-listed firms—from inspecting the work of auditors based in China and Hong Kong. PCAOB's inability to confirm the financial health of U.S.-listed Chinese firms may expose U.S. investors in these firms to substantial risk. In June 2020, NASDAQ delisted Luckin Coffee after it was found to have fabricated sales. The Holding Foreign Companies Accountable Act (P.L. 116-222) requires firms to disclose state and military ties and a delisting from U.S. exchanges if the PCAOB cannot inspect a firm's auditors for three consecutive years.

Figure 2. Select U.S. Funds' China Stock Holdings (June 2020)



Sources: CRS, with data reported in Caixin, Citic Securities, and Bloomberg.

Mutual Funds and Indices that Include PRC Firms

Five major index fund providers include PRC bonds and A-shares of firms listed on China's exchanges; three major funds include Chinese government debt. U.S. pension funds have China exposure through these indices and direct holdings in Chinese firms. U.S. funds seek China exposure with an eye to potential higher returns, but some in Congress and the U.S. government are concerned about potential risks (see **Figure 2**). The Chinese government has approved a few U.S. financial firms to increase joint venture equity stakes and operate wholly owned funds. Among these firms is BlackRock, the largest money manager globally. It has $9.5 trillion under management as of July 2021 but does not publicly disclose its China assets. In May 2020, the U.S. government's Thrift Savings Plan board deferred implementing a decision to tie its international fund to an index that includes Chinese firms in response to pressure from Congress and the Trump Administration. In July 2020, the SEC issued an alert about U.S. exposure to China's financial markets. In August 2021, the SEC enhanced scrutiny of Chinese firms after China's restrictions on U.S.-listed firms wiped out an estimated $400 billion in value and China's ride-hailing firm DiDi Global Inc. failed to disclose regulatory risks before listing on the New York Stock Exchange.

Military-Tied Firms

In June 2021, the Biden Administration issued Executive Order (E.O.) 14032, which supersedes the Trump Administration's E.O. 13959, prohibiting U.S. persons (including financial services firms) from investing in Chinese firms identified as being tied to the military. The U.S. financial sector had challenged the scope of E.O. 13959, including corporate nomenclature and whether listed firms are tied to their China parent. Some Chinese firms challenged the earlier E.O. on due process and evidence issues. Morgan Stanley said it would launch parallel indices to retain stocks in question. As of June 2020, the U.S. Department of Defense (DOD) identified 44 PRC military firms operating in the United States under reporting requirements in the FY1999 National Defense Authorization Act (NDAA) (P.L. 105-261). The new executive order and the June 2021 DOD list do not include previously listed firms, such as China National Chemical Corporation, Xiaomi, Inc., and Advanced Micro-Fabrication Equipment. DOD's list is not exhaustive and is viewed by some experts as a first step in identifying Chinese firms of concern. In the FY2021 NDAA, Congress reauthorized and bolstered requirements for DOD to report on Chinese military firms.

Issues for Congress

To address its concerns, Congress might consider the potential costs and benefits of whether to do the following:

- Expand U.S. government identification of Chinese firms with state and military ties and related restrictions.
- Examine China's role in other areas—such as private equity and debt financing—to assess the costs and benefits of U.S. exposure and strategic implications.
- Consider due diligence and liability requirements for U.S. actors that represent Chinese firms; potentially seek for the SEC to further investigate and verify the accuracy and completeness of the information provided and to issue regular alerts on China investments.
- Strengthen disclosure requirements—including for investment risk and beneficial ownership—to account for state ties, opacity in China's system, complex corporate structures, and limited legal recourse. Consider requiring that all firms, including ADRs, to (1) file a 10K equivalent with full details about ownership, shareholding, and corporate ties; (2) issue quarterly reports and timely updates on major changes; and (3) provide separate unconsolidated financial statements for VIE contracts and controllers.
- Require Chinese firms to (1) establish a U.S. legal presence directly tied to its China parent; (2) hold ultimate beneficiaries in China legally accountable for listed firms; and (2) place a significant deposit with U.S. regulators in the event of litigation.

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