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United States House of Representatives
Committee on Financial Services
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November 9, 2022

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: November 15, 2022, Investor Protection, Entrepreneurship, and Capital Markets Subcommittee Hearing entitled, "Investing in our Rivals: Examining U.S. Capital Flows to Foreign Rivals and Adversaries Around the World"

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, "Investing in our Rivals: Examining U.S. Capital Flows to Foreign Rivals and Adversaries Around the World" on Tuesday, November 15, 2022, at 2:00 PM E.T. in room 2128 of the Rayburn House Office Building and on Cisco Webex. There will be one panel with the following witnesses:

- **Courtney Alexander**, Senior Researcher, United Food & Commercial Workers International Union
- **Claire Chu**, National Security Fellow, Foundation for Defense of Democracies
- **Jeff Ferry**, Senior Economist, Coalition for a Prosperous America
- **Jeffrey A. Sonnenfeld**, Senior Associate Dean of Leadership Studies, Yale School of Management
- **Republican Witness**

Background

In recent decades, international tensions between the U.S. and China, as well as the U.S. and Russia, have risen steadily. Simultaneously, increasingly autocratic tendencies of the national governments of both China and Russia have produced considerable uncertainty within the business environments of both jurisdictions.[1,2] Together, these dynamics have produced a number of risks to investor protection, the American economy, and its national security or other interests.

As of the end of 2020, U.S. investors held $1.1 trillion in equity and $100 billion in debt securities issued by Chinese entities, but, for over a decade, the government of China had blocked the U.S. Public Company Accounting Oversight Board (PCAOB) from inspecting U.S.-related audit work and the practices of the PCAOB-registered firms in mainland China and Hong Kong, citing national security and state secrecy policies.[3,4] China was an outlier in this regard. As is detailed below, while PCAOB and China's regulators have reached an agreement to allow the PCAOB access, this agreement remains to be tested.

In the last year, regulators in China have taken significant steps to enforce existing and newly established domestic regulatory requirements for China-based companies—particularly in the technology sector—and have focused specifically on consumer data security and protection as well as

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[1] Harvard Law School Forum of Corporate Governance, *The Risky Business of Investing in Chinese Tech Firms*, (Feb. 4, 2019).
[2] U.S. Department of State, *2020 Investment Climate Statements: Russia*, (2020).
[3] US-China Investment Project, *US-China Financial Investment: Current Scope and Future Potential*, (Jan. 2021).
[4] PCAOB, *China-Related Access Challenges*, (Sept. 2021).

anti-monopoly efforts.[5] There is growing concern regarding the collateral impact this activity may have on U.S. investors in China-based firms that have issued securities or listed for trading in the U.S.

In addition to China, the flow of U.S. investment into Russia also poses investor protection and national security concerns, due to Russia's destabilizing actions throughout the world, particularly its illegal, unprovoked 2022 invasion of Ukraine.[6] Since the start of the invasion, the U.S. and its allies in the EU, UK, non-EU European countries, Switzerland, Canada, Australia, New Zealand, Japan, South Korea, Singapore, and Taiwan, among others, have announced sanctions, export controls, or both, in response to the Russian aggression, in addition to previously imposed sanctions against Russian individuals and entities.[7] Most of the new, allied sanctions actions are identical or similar to U.S. sanctions, the result of the Biden Administration's close coordination with its economic and security partners. Among these are sanctions that have directly limited the ability of U.S. investors to participate in Russian capital markets, including the tightening of restrictions on U.S. purchases of Russian government bonds.[8] The Biden Administration has strengthened sanctions to include prohibitions on new investment in the Russian energy sector and investment in any additional sector of the Russian economy, as determined by the Secretary of the Treasury.[9] There have also been increasingly broad restrictions on relationships with Russian individuals, entities, and government agencies involved with critical economic sectors such as financial services, energy, technology.[10]

Since the start of the war in Ukraine, many U.S. firms have also voluntarily curtailed their activity in Russia: as of November 7, 2022, over 300 U.S. companies have limited or completely withdrawn from business relationships in Russia and Belarus.[11] On March 24, 2022, Chairwoman Waters wrote to 31 of the prominent trade organizations representing thousands of U.S. financial, commercial, and technology companies, urging them to divest from Russia.[12]

Listed and Public Markets

According to data from Ernest & Young, 50 percent of foreign initial public offerings (IPOs) completed in the U.S. during the first half of 2021 were by companies based in China.[13] These offerings represented nearly 15 percent of total IPO proceeds raised in the U.S. during that period.[14] The IPO of the China-based online retail marketplace Alibaba (listed on September 18, 2014) on the New York Stock Exchange, which generated proceeds of nearly $22 billion, remains the second largest IPO in U.S. history.[15] As of September 30, 2022, there were a total of 262 China-based firms listed on U.S. stock exchanges, representing a combined market capitalization of $775 billion.[16] However, this marks a more than half-trillion dollar drop in the market capitalization of U.S.-listed China-based firms from June 30, 2022, owing primarily to several major national-level state-owned enterprises (SOEs) delisting in August 2022.[17]

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[5] CNBC, *China's regulatory crackdown has wiped billions off tech stocks — here are the risks ahead,* (Aug. 30, 2021). Didi's IPO price was $14.14, and it closed at $8.56 on Tuesday, Oct 19, 2021.
[6] T. Lister et. al., *Heres what we know about how Russia's invasion of Ukraine unfolded*, CNN (Feb. 24, 2022).
[7] Congressional Research Service, *Russia's Invasion of Ukraine: Overview of U.S. and International Sanctions and Other Responses*, (Updated Oct. 21, 2022) (IN11869).
[8] *Id.*
[9] Congressional Research Service, *New Financial and Trade Sanctions Against Russia*, (Mar. 17, 2022). (IFI12062).
[10] See, *Treasury actions in response to Ukraine*, (Accessed Nov. 9, 2022).
[11] Yale School of Management, *Over 1,000 Companies Have Curtailed Operations in Russia—But Some Remain*, (Nov. 7, 2022).
[12] See, *Chairwoman Maxine Waters letter to 31 trade organization*, (March 24, 2022).
[13] Ernst & Young Global Limited*, doing business as* "EY", *Q2 2021 IPO Report,* at 12, (Jul. 15, 2021).
[14] *Id.*
[15] Renaissance Capital, *All Time Largest U.S. IPOs,* (Jun. 2021).
[16] US-China Economic and Security Review Commission, *Chinese Companies Listed on Major U.S. Stock Exchanges*, (Sept. 30, 2022).
[17] *Id.*

In December of 2020, Congress passed the "Holding Foreign Companies Accountable Act," which requires that any U.S. exchange-listed foreign company be delisted if, for three consecutive years following the date of enactment, the PCAOB is unable to inspect the primary auditor of that company.[18] Recently, the PCAOB announced that it had signed a Statement of Protocol with the China Securities Regulatory Commission and the Ministry of Finance of the People's Republic of China, which is the first step toward allowing the PCAOB to inspect and investigate registered audit firms headquartered in mainland China and Hong Kong.[19] This agreement marks the first time the U.S. has received such detailed and specific commitments from China that they would allow PCAOB inspections and investigations meeting U.S. standards. However, despite agreeing to this framework, several more steps must be taken before PCAOB can inspect and investigate audit firms in China.[20] If the PCAOB is not allowed to do so, roughly 200 China-based issuers will face prohibitions on trading of their securities in the U.S. if they continue to use those audit firms.[21]

On February 28, 2022, the NASDAQ and New York Stock Exchanges (NYSE) moved to halt trading in the shares of the eight Russia-based and -controlled companies traded on U.S. stock exchanges as of the start of the war.[22] The NASDAQ-listed companies that have been halted are HeadHunter Group PLC (HHR.O), Ozon Holdings PLC (OZON.O), Qiwi PLC (QIWI.O), Yandex (YNDX.O), and Nexters Inc. (GDEV), which is based in Cyprus.[23] The three NYSE-listed companies that have been halted are Cian PLC (CIAN.N), Mechel PAO (MTL), and Mobile TeleSystems PAO (MBT).[24] While trading halts put in place by exchanges typically last less than an hour, the complex nature of the war in Ukraine has led the exchanges to maintain these halts indefinitely.[25] Further, on July 14, Mobile TeleSystems was notified by the NYSE that the Regulation office of the exchange had determined to pursue proceedings to delist shares of the company from the exchange.[26] Delisting of the Mobile TeleSystems shares from the NYSE, which were traded on the exchange in the form of American Depository Receipts (ADRs), became effective on August 8.[27] At least one large exchange has informed the Committee that should the exchange de-list these companies, their securities would become eligible to be traded in the over-the-counter (OTC) markets or among large dealers. Whereas, if the exchange maintains the trading halt, these securities cannot be quoted or traded in the OTC markets or among large dealers.

Exempt and Private Markets

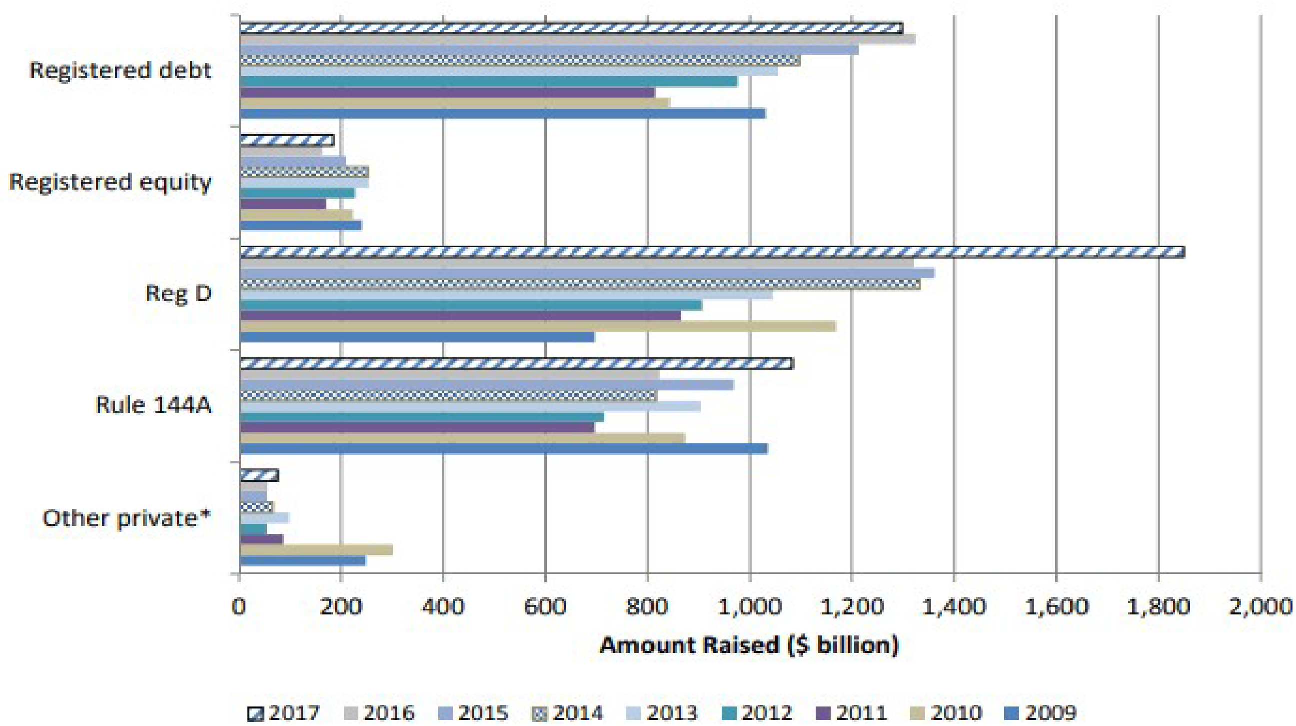
Foreign issuers aiming to raise capital from U.S. investors also have access to the "exempt offerings" regime, which—unlike publicly listed and SEC-registered securities—allows for issuers to sell their securities without registering with the SEC or providing regular and detailed disclosures. More than two-thirds of capital raised through the securities markets in the United States is conducted through these exempt offerings (Figure 1). In 2019 alone, over $2.7 trillion was raised through exempt offerings

[18] Government Printing Office, *Public Law 116-22*, (Dec. 18, 2020).
[19] PCAOB, *PCAOB Signs Agreement with Chinese Authorities, Taking First Step Toward Complete Access for PCAOB to Select, Inspect and Investigate in China* (Aug. 26. 2022).
[20] SEC, *Statement on Agreement Governing Inspections and Investigations of Audit Firms Based in China and Hong Kong* (Aug. 26. 2022).
[21] *Id*.
[22] NasdaqTrader.com, *Current Trading Halts*, (Nov. 8, 2022).
[23] *Id.*
[24] *Id.*
[25] FINRA, *Trading Halts, Delays and Suspensions*.
[26] SEC, *Mobile TeleSystems Public Joint Stock Company Form 6-K*, (July, 2022).
[27] SEC, *Mobile TeleSystems Public Joint Stock Company Form 6-K*, (August, 2022).

in the U.S.[28] Foreign issuers "accounted for approximately 22% of the total amount reported sold during 2017."[29]

Regulation D and Rule 144A are the most frequently used exemptions to issue and sell unregistered securities. Data on unregistered offerings by China-based or China-related issuers (*e.g.,* issuers that are based outside China but raise capital for firms based in China) is limited, but some of these companies currently do raise capital through exempt offerings. Should currently U.S.-listed China-based companies be de-listed or go private, they may migrate to the exempt offerings space.

Figure 1. Aggregate capital raised in 2009-2017 by offering method ($billions)



* Other private includes Regulation S offerings, Section 4(a)(2) offerings, Regulation Crowdfunding offerings, and Regulation A offerings.

Opaque Foreign Investments in U.S. Capital Markets

While the focus of the hearing is the challenges related to U.S. investors' exposure to companies in rival or adversarial countries, inbound investments—through capital markets' vehicles—have also highlighted the need for transparency. For example, the Financial Accountability & Corporate Transparency (FACT) Coalition has recently raised concerns that U.S. regulators' lack of visibility into foreign investors' unfettered and unchecked access to our private markets, and the financial stability risks it could pose.[30] Specifically, in a recent comment letter to the Commission, the FACT Coalition highlighted the fear that federal financial regulators have little way of knowing how reliant U.S. private

[28] SEC, *Statement on Amendments to the Exempt Offering Framework*, (Nov. 2, 2020).
[29] SEC, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, at 2 (August 2018).
[30] FACT Coalition, *Letter to SEC Regarding Form PF Amendments to Reporting Requirements for All Filers and Large Hedge Fund Advisers*, (Oct. 12, 2022).

markets are on foreign investors as a source of capital.[31] Given the geopolitical tensions between the U.S. and countries like China and Russia, it appears investments from these jurisdictions could represent a fragile source of capital for U.S. private markets, and therefore a source of potential instability.[32]

In addition to issues related to financial stability, some policymakers have raised concerns that Russian entities and individuals, particularly Russian oligarchs subject to U.S. sanctions, may seek to continue to invest in the U.S. through unregistered investment vehicles, including venture capital funds, hedge funds, and private equity funds.[33] Unlike other U.S. financial institutions, these investment vehicles, and the investment advisors who manage them, are not currently required to disclose information identifying their investors to the Treasury Department.[34] While all of these funds, with assets of $150 million or more, are required to disclose details of their investments to the SEC on a quarterly basis through Form PF, these disclosures also do not require funds to provide the Commission with the identity of fund investors.[35] Following the Russian invasion of Ukraine, some have petitioned the SEC to modify Form PF to "identify on Form PF the beneficial owners of the private funds being advised, including any politically exposed persons; and (c) disclose on Form PF, for each private fund being advised, the percentage of fund investors and fund equity from specific countries, providing the data on a country-by-country basis to facilitate risk analysis."[36]

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[31] *Id.*
[32] *Id.*
[33] Office of Senator Elizabeth Warren, *Letter to Secretary Yellen and Chair Gensler*, (March 29, 2022).
[34] Wall Street Journal, *Treasury to Study How Russians Could Use Hedge Funds, Private Equity to Evade Sanctions*, (May 25, 2022).
[35] SEC, *SEC Proposes to Enhance Private Fund Reporting*, (Aug. 10, 2022).

[36] The Fact Coalition, *Form PF Comments Submitted to the SEC*, (March 21, 2022).

Appendix

Legislation

- **H.R. 6285, "Accelerating Holding Foreign Companies Accountable Act" (Sherman).** Would shorten the time period in the Holding Foreign Companies Accountable Act from three years to two years for foreign companies to comply with PCAOB audits or face delisting from U.S. stock exchanges.

- **H.R. ____, "Foreign Adversary Corporate Transparency (FACT) Act" (Sherman).** This discussion draft would require Russia and China-based issuers of securities which fulfill certain exemptions from registration with the Securities and Exchange Commission (SEC) to submit basic information to the SEC regarding the issuer.

- **H.R. ____, "Private Fund Investor Disclosure Act."** This discussion draft would direct the SEC to issue regulations to require all private fund advisers subject to Form PF filing requirements to include in those filings, beneficial owners of the fund identified on a country-by-country basis and the origin of invested funds on a country-by-country basis.

- **H.R.____,** This discussion draft would require the disclosure of certain information by issuers of exempt offerings above a certain threshold and would also require the SEC to report to Congress summarized information relating exempt offering issuances by entities that are domiciled in People's Republic of China or entities that predominantly invest in entities domiciled therein.

- **H.R.____, "Private Securities Transparency and Reform Act."** This discussion draft would require issuers offering securities under Rule 506(b) or 506(c) to file a Form D with the SEC before either (1) the first sale of securities, or (2) the commencement of general solicitation. Further, the bill would require issuers to file a closing amendment within 90 days after the offering is completed with certain information, including the total size of the offering, the number of investors participating, and fee amounts. In addition, the SEC would be required to study brokers who primarily deal in exempt offerings, as well as the relationship between private, quasi-private, and public securities offerings.

- **H.R. ____, "Index Fund Investor Protection Act" (Sherman).** This discussion draft would prohibit certain low-cost investment products, such as mutual funds and exchange-traded funds, as well as the Thrift Savings Fund from holding the securities of issuers from foreign jurisdictions in which the PCAOB is unable to conduct inspections of PCAOB-registered auditors. It would also require the Treasury Department to establish a list of Russia-related securities which U.S. investment companies would be prohibited from holding.