INVESTING IN OUR RIVALS: EXAMINING U.S. CAPITAL FLOWS TO FOREIGN RIVALS AND ADVERSARIES AROUND THE WORLD

HYBRID HEARING

BEFORE THE

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CONTENTS

WITNESSES

TUESDAY, NOVEMBER 15, 2022

APPENDIX

INVESTING IN OUR RIVALS: EXAMINING U.S. CAPITAL FLOWS TO FOREIGN RIVALS AND ADVERSARIES AROUND THE WORLD

Tuesday, November 15, 2022

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Brad Sherman [chairman of the subcommittee] presiding.

Members present: Representatives Sherman, Scott, Himes, Foster, Vargas, Gottheimer, Casten; Mooney, and Gonzalez of Ohio.

Ex officio present: Representative Waters.

Chairman SHERMAN. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of the subcommittee are authorized to participate in today's hearing.

Today's hearing is entitled, "Investing In Our Rivals: Examining U.S. Capital Flows to Foreign Rivals and Adversaries Around the World."

And I do want to apologize for the fact that this hearing is taking place while the Republicans are holding their leadership elections. We scheduled this hearing, and then, apparently in determining when to have their leadership elections, Mr. McCarthy didn't think that this was the most important thing to avoid scheduling against. Still, obviously, this would be a better hearing if we had the full participation of the current minority party. Although, Mr. Gonzalez will represent his party well.

I will now recognize myself for 4 minutes for an opening statement, and then I will turn to Mr. Gonzalez.

Over a year ago, we had a hearing on China, Inc. This hearing builds on that. Americans are investing in Russia to some degree, not much now, and substantially in China.

There are 262 Chinese companies listed in the United States, and of course, Americans are free to invest in Hong Kong and Shanghai, including our index funds.

Eight Russian firms were suspended from trading in the United States. Some $83 billion of American capital has been invested in Russia.

This raises three types of issues: macroeconomic; investor protection; and national security. As to macroeconomic, capital is very good for a capitalist system. We send $1.2 trillion of capital to China. Some would say, why don't we just stop? Well, China provides $2.1 trillion to the U.S. economy.

But not all capital is equal. Equity capital does more. Risk capital does more to build a capitalist economy. We send $1.1 trillion in equity capital to China. They send only $700 billion of equity capital to the United States.

Don't take my word for it that equity capital is more important. That esteemed institution, the U.S. Congress, has decided to spend $200 billion every year on our capital gains allowance to encourage equity investment.

But for some reason, we not only subsidize Americans who invest in America, but we provide that same capital gains allowance to those investing in the Chinese economy. I just want to point out, that is not on us; another committee is responsible for that.

First, on investor protection, we have the Public Company Accounting Oversight Board (PCAOB) in Hong Kong now. Congress passed the bill I sponsored in the House, the Holding Foreign Companies Accountable Act. China has agreed in principle, and now work is going on in Hong Kong to see whether they will actually implement that important legislation. We will know more at the end of the year.

Second, on investor protection, we have the variable interest entity (VIE) structure. You think you are buying Alibaba stock, but you are not. You are buying Alibaba Cayman Islands, which then has a contractual relationship with a shell company in China, which then has a contractual relationship with Alibaba.

We have to see what risk that poses for investors and particularly wonder whether index funds should be investing—when they say they are investing in the biggest companies in the world, Alibaba Cayman Islands is not one of the biggest companies in the world.

And to say that with little investigation, capital should be deployed through this VIE structure is questionable, and it is also questionable whether index funds should go outside the United States, invest in the Shanghai or Hong Kong exchange perhaps, in Chinese companies that have deliberately avoided the PCAOB by delisting from the United States.

And we then turn to the national security issues. When Americans invest in Chinese companies, that creates a lobbying interest here in the United States to support the success of those companies, and ultimately, China. In addition, it can create an incentive to transfer technologies to those Chinese companies which are the subject of U.S. investment.

We should know which Chinese companies are raising money here by changing our rules to say that when there is a private placement, even if they don't choose to use Regulation D or one of the other safe harbors, that there is some registration in the major deals.

Not only the SEC, but under certain circumstances, other U.S. Government agencies can look at private files and see what is coming in. Likewise, we ought to see when a hedge fund or a private equity fund already is required to file a foreign PF with the SEC, and we should know whether they are getting substantial amounts of Chinese capital or Russian capital.

With that, I will turn to Mr. Gonzalez for an opening statement.

Mr. GONZALEZ OF OHIO. Thank you, Chairman Sherman. I will be very brief. First, I would like to submit for the record the opening statement of Representative Bill Huizenga, the ranking member of this subcommittee.

Chairman SHERMAN. Without objection, it is so ordered.

Mr. GONZALEZ OF OHIO. Thank you.

To pick up on what Mr. Sherman was saying about our leadership elections, to our witnesses and those watching on C-SPAN, please do not take the absence of Republican Members today as disinterest on the Republican side. We have been just as engaged and aggressive, I think, when it comes to what are the right policy measures that we should be taking vis-a-vis China, Russia, and our adversaries, what role the capital markets play, and what policies we should advocate for. We simply have our leadership elections today, and there is certainly nothing that I can do about that.

Some would say, as one person who didn't run for reelection, I might actually be the smartest Member of Congress in this room today. I am not saying that; some people might say it. But with that, I will yield back. Thank you.

Chairman SHERMAN. Thank you. I now yield 1 minute to the distinguished Chair of the full Financial Services Committee, Chairwoman Waters.

Chairwoman WATERS. Thank you very much for this hearing. Each year, billions of dollars of capital from the United States is invested into companies owned by, controlled by, or affiliated with China and Russia, undermining our national security.

After Putin invaded Ukraine, I wrote to groups representing U.S. businesses and investment funds to question whether they would divest from Russia. Unfortunately, dozens still have not.

Protecting our national interests is not a partisan issue. We worked together to reauthorize and reform the Committee on Foreign Investment in the United States (CFIUS) in 2018, the Export-Import Bank in 2020, and on several measures to isolate Russia and China earlier this year.

I hope this hearing will help us identify further ways to ensure that our national security is bolstered by the strength of our private markets. I yield back.

Chairman SHERMAN. Thank you.

We have a great panel of witnesses here today. It is not just me saying that. The Republicans were entitled to have a witness, but they looked at how beautiful the panel was that we created and decided they had nothing to add, and I couldn't agree with them more.

I do think we have outstanding witnesses. First, we have Courtney Alexander, senior research analyst at the United Food and Commercial Workers International Union, who has focused on the flow of capital to China, and particularly Americans investing in facial recognition and other technologies that might help allow the Chinese government to impose a police state on its own citizens.

Second, we have Claire Chu, a senior China analyst at the Janes Group, who is focused on the rights and lack of rights that investors have in the VIE structure, and index funds ignoring that and investing indirectly in China.

Third, we are going to hear from Jeff Ferry, the chief economist at the Coalition for a Prosperous America, who is focused on decoupling from China and on the possibility of tariffs.

And finally, to introduce our last witness, I recognize Mr. Himes.

Mr. HIMES. Thank you, Mr. Chairman, and it is a delight to welcome a fellow citizen of the nutmeg State. From Connecticut, we have the senior associate dean for leadership studies at the Yale School of Management, Jeffrey Sonnenfeld.

He has had a tremendous academic career, including time at the Emory Business School, but I seize this moment to do a brief introduction because in addition to his academic work, he has, in the last several months, been an extremely aggressive leader on pushing corporate America, in his guise as a professor of leadership, to reflect on the values that corporate America and corporations around the world demonstrate if they make the decision to continue to work in the nation of Russia, and to continue to be part of the economic engine which drives the authoritarian brutality that we see in Ukraine.

We are deeply grateful to Dr. Sonnenfeld for doing that, and we are deeply grateful for his work in the State of Connecticut in helping us with our economic issues, and it is a delight to welcome him here today.

Thank you, Mr. Chairman.

Chairman SHERMAN. Thank you, Mr. Himes.

Witnesses are reminded that their oral testimony will be limited to 5 minutes. You should be able to see a timer that will indicate how much time you have left. I would ask that you be mindful of the timer so that we can be respectful of both the witnesses' and the committee members' time.

And without objection, your full written statements will be made a part of the record.

Ms. Alexander, you are recognized for 5 minutes.

STATEMENT OF COURTNEY ALEXANDER, SENIOR RESEARCH ANALYST, UNITED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION

Ms. ALEXANDER. Thank you, Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee. My name is Courtney Alexander, and I work for the United Food and Commercial Workers International Union.

I am here to address my recent work analyzing the outflow of capital from U.S. private equity firms to China. That capital includes public employee pension money invested by private equity firms in a country of national security concern.

My testimony details a case study which we believe illustrates the need for public disclosure by private equity firms of their investments in countries of concern.

In 2017, KKR Asian Fund III founded a Chinese artificial intelligence company called Cue Group. KKR owned and controlled Cue until late 2021. Cue was described by KKR as, "the first one-stop digital marketing company for the Chinese market."

KKR's digital marketing company went on to jointly develop surveillance technology with an arm of the Ministry of Public Security, the organization that oversees China's vast surveillance systems.

In 2020, Cue had jointly developed technology with the Video National Engineering Laboratory Zhuhai Innovation Center, a government lab run by the First Research Institute of the Ministry of Public Security.

Zhuhai Lab and the First Research Institute play key roles in China's surveillance state, and the First Research Institute works with Chinese entities sanctioned by our government for facilitating human rights abuses or participating in the Chinese military-industrial complex.

CUE's jointly-developed product was called the CUE Real-time AI Facial and Body Temperature Detector, integrating facial recognition, thermal detection, and identity data. It was used for pandemic surveillance, reading body temperatures, tracking 14-day migration of individuals, and identifying companions.

CUE's technology also had potential non-pandemic uses for recognizing, "blacklisted persons," and "to prevent incidents involving mass gatherings."

Additionally, Zhuhai Zhongdun Star Technology Company, which KKR identified as an indirect KKR subsidiary, was a strategic signatory of the government's Zhuhai Lab. Zhuhai Zhongdun Star had participated in the, "Safe Campus" surveillance project. This past February, The Wire China profiled KKR's investment in Cue and Cue's collaboration with the public security lab.

KKR and Cue denied the collaboration to The Wire, however, "The Zhuhai lab confirmed in an email to The Wire that it had at one time collaborated with Cue on one of its wholly-owned subsidiaries."

The Zhuhai Innovation Center was formed by the National Engineering Laboratory for Intelligent Video Analysis and Application called NELIVA. NELIVA's laboratory director is Qiu Baoli. Qiu was previously the deputy director of the Public Security Bureau of the Xinjiang Construction Corps, which was sanctioned for human rights violations.

NELIVA's ruling council also includes entities sanctioned by the U.S., including Hikvision, Huawei, and the Institute of Automation of the Chinese Academy of Sciences.

First Research Institute, which runs the Zhuhai Lab, designed what it called SkyNet in Xinjiang, which it co-built with the Public Security Department of Xinjiang, an entity sanctioned for its role in human rights violations. To be clear, we do not have information that Cue's surveillance technology was used in Xinjiang, or to violate human rights.

In response to our research, KKR told me the firm conducts very careful screening on issues of privacy, surveillance, and geopolitics, and that former General David Petraeus leads a team at KKR Global Institute to help assess every KKR investment for such risks.

This process concerns us. KKR's purported risk review may have missed Cue's own promotion of its collaboration with a lab run by China's surveillance apparatus, even though KKR executives served on the board, or possibly KKR's review may have identified Cue's connections to China's surveillance lab and still knowingly kept its investment and board seats.

Whatever the case, we find it hard to trust that private equity can sufficiently police itself when it invests in China.

Cue's surveillance and advertising business paid its investors well. Late last year, KKR sold a potential interest in Cue to Baring Private Equity Asia in a deal valuing KKR's stake at 3 times its investment.

Money talks, surveillance pays, and the American public needs tools to protect our country's interests.

That is even more true when you consider that KKR Asian Fund II investors include public employee pension funds, like the Washington State Investment Board, the Florida State Board of Administration, the Oregon Treasury, and the Texas Permanent School Fund.

When we asked public pension funds to divest Cue, some said they could not exit an individual investment because they were limited partners, and one fund said it relies on the Federal Government to flag investments of national security concern.

Therefore, we urge you to give public pension funds, investors, regulators, and American citizens the tools to hold private equity accountable to our own national security and human rights interests, by mandating public disclosure of all subsidiaries and investments in countries of national security concern.

Last, the Cue story was uncovered through public data from other countries. Germany, Singapore, and China all require more public disclosure from companies than we do. So when their firms argue that investments are proprietary, ask them why Americans don't deserve the same information they give to China and Singapore.

Thank you very much for holding this hearing today.

[The prepared statement of Ms. Alexander can be found on page 32 of the appendix.]

Chairman SHERMAN. Thank you, Ms. Alexander.

Ms. Chu, you are now recognized for 5 minutes.

STATEMENT OF CLAIRE CHU, SENIOR CHINA ANALYST, JANES GROUP

Ms. CHU. Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, thank you for the opportunity to appear here today. I am the senior China analyst at Janes, an open-source intelligence firm where I specialize in the national security implications of China's global economic activity.

In particular, I research how the Chinese government manipulates private-sector interests and commercial relationships in order to achieve strategic policy goals.

I have been asked to speak on U.S. capital flows to China in light of Russia's invasion of Ukraine. I will also provide recommendations for ways in which the United States can refine its economic and financial toolkit in order to respond to the unique risks posed by U.S. investor exposure to Chinese and Russian companies, and conversely, posed by adversarial nations' access to U.S. capital.

The concept of economic statecraft is not new, but it has evolved. The playing field has expanded beyond trade sanctions and tariffs to include options like financial sanctions and capital flow restrictions. Not everyone is on board just yet.

The national security community has started to recognize the international financial system as a potential warfighting domain, although the Pentagon can be reticent to encroach on Wall Street's territory, and financial institutions aren't interested in what they consider to be the politicization of private markets, and find it difficult to reconcile national security objectives with their fiduciary responsibilities.

Following Russia's invasion of Ukraine earlier this year, we saw how quickly the U.S. Government was able to mobilize at not only the Federal, but also the State and local levels, as well as in sync with allies to isolate Russia from global financial markets.

Financial actors, including stock exchanges and global index providers, also took swift action. Although at some level, this was not an ethical response as much as it was a financial choice, because Russia's stock had become uninvestable.

The unprecedented and expansive nature of the sanctions imposed on Moscow has raised the specter of the U.S. taking a similar approach with Beijing if red lines were to be crossed.

The scale of U.S. economic and financial exposure to China is significantly greater than it is to Russia, and observers have wondered whether China's weight in a global economy insulates it from Western sanctions. Yes, China has a larger economy than Russia, and as Russia's stock market was valued at 780 [inaudible]. However, China had a cumulative $11 trillion in its mainland forces.

And yet, the United States' stock market is the largest in the world, representing nearly half of global equity, about $51 trillion, nearly 4 times the next largest market, China.

I would posit that the United States could use financial sanctions more effectively than almost any other country in the world.

Capital flows can have a more immediate impact than trade flows. Capital markets are one of the United States' greatest strengths, and we should be analyzing how to harness financial markets, institutions, and instruments in the service of foreign policy and national security.

U.S. investor exposure to publicly traded Chinese companies has expanded dramatically over the past few years, with the inclusion of mainland Chinese A-shares in global stock indices and various investment products.

Institutional investors like public pension funds and university endowments have all taken different approaches to investing in China. Although nearly all have some level of exposure, owing to the use of passive investment strategies which allow fund managers to delegate investment decisions to index providers that wield virtually unregulated authority over U.S. capital flows to China.

U.S. investors are consequently exposed to a wide range of Chinese companies engaged in activities contrary to the national security and foreign policy interests of the United States.

Many are already sanctioned by the United States, but not subject to any investment restrictions or divestment mandates and are able to continue raising capital in the U.S. markets.

Private funds, which represent a significant portion of institutional portfolios, function as unregistered investment vehicles that are not required to verify or disclose investors' identities or sources of funds.

This presents an ideal environment where the U.S. Treasury cannot enforce sanctions, where Russian oligarchs like to park their wealth, and where Chinese state-owned firms are able to gain non-transparent access to sensitive U.S. businesses and technologies.

The United States should consider establishing an interagency committee or a task force to coordinate the Federal Government's activities in response to various global economic and financial challenges, whether that be to capital markets access, foreign procurement, or critical mineral security.

There should also be more clear engagement with Silicon Valley and Wall Street stakeholders in order to create opportunities for cooperation, and to effectively communicate policy guidance.

U.S. regulatory authorities need to accelerate plans to expand oversight and increase disclosure requirements for index providers and private market actors, as well as enact China- and Russia-specific due diligence practices in order to identify and mitigate this evolving category of risks to investors in the United States.

Thank you. I look forward to your questions.

[The prepared statement of Ms. Chu can be found on page 42 of the appendix.]

Chairman SHERMAN. Thank you, Ms. Chu. And I am glad our witnesses are sticking to the 5-minute limit.

Mr. Ferry, you are now recognized for 5 minutes.

STATEMENT OF JEFF FERRY, CHIEF ECONOMIST, COALITION FOR A PROSPEROUS AMERICA (CPA)

Mr. FERRY. Thank you. The Coalition for a Prosperous America (CPA) thanks the subcommittee for holding this hearing to explore the risk posed to American investors by nations that are adversarial and hostile to U.S. interests, most notably Russia and the People's Republic of China. CPA is a bipartisan, nonprofit organization representing exclusively domestic manufacturers, producers, and workers across many sectors of the U.S. economy.

I am Jeff Ferry, the chief economist at CPA. In addition to my work as an economist, I have also worked in a U.S. optical networking company competing with Chinese companies, and as a hedge fund analyst for a $100-million technology hedge fund.

Especially alarming to CPA and our members are the risks posed to U.S. investors by Chinese Communist Party (CCP)-linked companies that are actively exploiting our free and open capital markets. In 2020, U.S. holdings of Chinese securities neared $1.2 trillion, which is about 5 times the holdings of any other country. The exposure of U.S. investments in Chinese securities has never been greater, and it will continue to grow.

My testimony will focus primarily on the problem of U.S. investor exposure to Chinese securities, the risks this poses to U.S. economic and national security, and potential solutions that should be considered.

My oral testimony focuses on three main components: A-shares and passive investment; the Federal Government's own Thrift Savings Plan, which many of the people in this room are invested in; and the need for closing gaps in U.S. sanctions policy via sanctions harmonization.

Further details and policy solutions may be found in my written testimony.

First, A-shares and passive investments. Congress, the media, and regulators have recently focused on the risks posed to U.S. investors from Chinese companies directly listed on U.S. stock exchanges. While CPA welcomes this focus and encourages further action, it does not address the bulk of bad-actor Chinese companies that are present in American passive investment products.

Their presence is in the form of over 4,200 A-share and H-share companies found throughout a multitude of financial vehicles such as exchange-traded funds and index mutual funds that have received little or no regulatory scrutiny or fiduciary due diligence.

Tens of millions of Americans are unwittingly exposed to these A-shares in their investment portfolios and retirement investment accounts. U.S. investors are inadvertently subsidizing Chinese companies involved in activities that are contrary to the national security, economic security, and foreign policy interests of the United States.

We are also subsidizing the economic growth of our own top global adversary.

For those who are unaware, A-shares are securities listed on mainland Chinese exchanges and only accessible to American and foreign investors via inclusion in indexes in associated index funds.

It is similar for H-shares, which are listed in Hong Kong. These companies are predominantly noncompliant with U.S. security laws and financial reporting norms, and in some cases, they have even been sanctioned by the U.S. Government for egregious human rights and national security abuses.

The financial industry will not lead. Congress must do so. To ensure against further American investment flowing to Chinese companies that pose investor protection, national security, and human rights concerns, Congress should take action to increase transparency and accountability for passive investing and more. I outline key recommendations in my written testimony submitted today.

Next, the Federal Government's Thrift Savings Plan (TSP). The Thrift Savings Plan is the largest defined contribution pension system in the country, with more than $730 billion in assets.

In June of this year, the TSP's administrators enabled TSP participants to invest up to 25 percent of their savings in more than 5,000 mutual funds via a new platform called the Mutual Fund Window. CPA research found that 5 of the largest investment funds in the Window had an average weight of 22 percent towards Chinese companies, and all 5 funds held companies listed on the U.S. Department of the Treasury's list of Chinese Military-Industrial Complex Companies, the Department of Commerce's Entity

List, the Department of Commerce's Unverified List, and the Defense Department's Chinese Military Companies List.

We would like to see all of these lists harmonized to enable American investors to know and to avoid investing in Chinese companies that are involved in Chinese civil military fusion and other activities harmful to the United States.

I will just wrap up, as I am out of time.

In conclusion, the U.S. Government should take the necessary steps to ensure that passive investment and government pensions are safe and secure from adversarial, authoritarian regimes like China. They should do so because it is in the best interest of the U.S., from both a national security and an economic security perspective.

The financial industry will not fix these problems which are existential, national, and economic security risks to America. The risks are increasing daily. Congress must pass laws that the financial industry must comply with in the national interest. Thank you very much.

[The prepared statement of Mr. Ferry can be found on page 60 of the appendix.]

Chairman SHERMAN. Thank you, Mr. Ferry.

Mr. Sonnenfeld, you are now recognized for 5 minutes.

STATEMENT OF JEFFREY A. SONNENFELD, SENIOR ASSOCIATE DEAN FOR LEADERSHIP STUDIES, YALE SCHOOL OF MANAGEMENT

Mr. SONNENFELD. Thank you very much. I just wanted to thank you, Chairman Sherman, for the invitation, Ranking Member Huizenga in absentia, and of course, Congressman Gonzalez, for representing Ranking Member Huizenga and your party today.

Distinguished members of the subcommittee, I am honored by this opportunity to testify. I want to particularly thank Chairwoman Waters for her catalytic role in raising some critical issues that we are all wrestling with this afternoon across this panel and, in absentia, Ranking Member McHenry for his own great interest in this topic.

And, Congressman Himes, I am quite honored by that wonderful introduction. I think we probably will not be sitting near each other, though, at the Harvard-Yale game this coming weekend, unfortunately.

I should also just mention quickly that I am very honored to be here with this distinguished panel of fellow presenters. I agree largely with the positions that they share and admire everything about them.

But I must admit I am very envious of their punctuality, and I am worried that I am the only schoolteacher here, so I will be watching the clock.

I should also mention being in this beautiful room—if there is nothing else that gets taken away from the material that I want to present today, it should be how important it is that this topic be represented in this room, in this city, at this time, because it represents a confluence of leadership across sectors, that neither sector has the monopoly on working successfully in diplomacy, and that the private sector has something important to contribute here, and the public sector does as well.

When we talk about economic blockades, sadly, it often falls down into these corporate withdrawals, how successful are they, or taking a look at government sanctions. It only works when they work in concert, and I am so happy we have the chance to take a look at how the sectors can work together instead of throw stones at each other.

I am Jeff Sonnenfeld, senior associate dean for leadership studies, Lester Crown Professor of Management Practice at Yale School of Management, and founder and chief executive of the Chief Executive Leadership Institute, which is a division of Yale University, which is the world's first school for incumbent CEOs.

Well before the World Economic Forum of Davos or CEO-targeted events elsewhere, we sort of created that space as a purely educational forum. It is noncommercial, nonadvocacy, and nonpartisan. We have, as a matter of fact, political leaders from all sides of the aisle. Many Members of Congress, some with us today, have been in our forums. Four U.S. Presidents, from President Biden to President Trump, have been regular participants joining with our corporate leaders.

I have been working in this field of corporate responsibility for 45 years. My first book was entitled, "Corporate Views of the Public Interest," published in 1981. It is not a bestseller. And I have published about 200 scholarly articles and 7 books in this field, advised thousands of CEOs on corporate social impact issues, and I regularly appear in the media on these topics.

But today, we are talking about the historic exits of 1,000-plus multinational companies from Russia right after Russia invaded Ukraine on, of course, February 24th of this year. And we believe we had some influence in helping to spark an exodus, if not a stampede, of companies from there.

We identified the original 12 who exited, and the work that I have done previously having to do with voting rights or environmental issues or gender parity or racial representation or immigration reform, the companies that moved first on Russia were not generally the first movers on other social justice issues.

I was surprised by who they were. It was Big Tech, Big Oil, and professional services. If we have time later, we could talk about that anomaly.

When I went to talk to the CEOs of each of these companies, what they were most concerned about wasn't the recognition of being a bold first-mover, but a lot in the media were giving attention to the pretenders that were making polite noises but actually weren't doing much in terms of pulling out of Russia.

So I went public in the media, frankly on CNBC and in Fortune Magazine. We put the names out of the authentic companies that pulled out versus the pretenders, and that was akin to Justice Louis Brandeis' admonition of how sunlight is the best antiseptic.

That helped catalyze mass movements of hundreds of companies, and we wound up grading them on a system from A to F, not just because we are a schoolhouse, but because we wanted to get around some of the public relations smokescreen that often prevails as to who was truly pulling out. And we can talk about that later if there is time.

One of the biggest takeaways we got was that win the companies that pulled out, the shareholders did not suffer. These weren't woke CEOs. There was no question about somehow with some stakeholders at the advantage of other shareholders, is, in fact, companies that pulled out did better than those who stayed.

In terms of that impact, it was enormous. It is a huge impact on Russia's economy.

As I am going into extra innings right now, let me just wind down by saying that in working with 45 volunteers with great mastery in the languages of the countries we were studying, we wound up being the first to puncture Putin's propaganda that fooled many in this town. Virtually everybody in my field, in academia, macroeconomists of every school, and the International Monetary Fund, believes Putin's propaganda, that these corporate exits didn't matter.

They had an enormous impact, and we are the first to reveal that Russia's economy was not resurgent but imploding. And if we have time later, I can talk to you about how, in fact, it did matter, and how doing good is not antithetical to doing well. Thank you.

[The prepared statement of Mr. Sonnenfeld can be found on page 70 of the appendix.]

Chairman SHERMAN. Thank you. I will now recognize, for 5 minutes of questioning, the distinguished Chair of the Full Committee, Chairwoman Waters.

Chairwoman WATERS. Thank you very much. I would first like to say to Mr. Ferry, the chief economist at the Coalition for a Prosperous America, I certainly thank you for your testimony. You were absolutely descriptive of the harm and the solutions.

And I am sitting here a bit unnerved by the fact that we have not moved more aggressively in dealing with the issues of our adversaries that we allow to invest and to seek investments here in our country.

I don't know whether or not you went through all of the solutions. If you did not, I would like you to continue, if you have more at this time that you would like to share with us about solutions.

Mr. FERRY. Thank you, Madam Chairwoman, for your comments. There is more in my written testimony. I think what I would highlight here are a couple of things.

One, on sanctions harmonization, the Department of Commerce's Entity List includes over 1,100 Chinese companies which are engaged in activities that are either a threat to our national security or through taking advantage of oppression in the Uyghur region, Xinjiang, a threat to basic human rights.

On the other hand, the Treasury's list contains a couple dozen companies, it is a tiny list, and we need to harmonize these sanctions so all arms of the government are operating together and taking a resolute, comprehensive position against investing in our adversaries, which we are not doing today.

I would also add that I think these sorts of sanctions and Federal guidelines ought to extend not just to publicly listed companies in either North America or China, but also private investment vehicles, including private equity and venture capital.

I will give you one example. The Biden Administration has taken commendable action to restrict the export of semiconductors and semiconductor technology to China. The entities list has many semiconductor activities on it. President Trump took good action to restrict semiconductors going to Huawei.

However, when I looked at the financial records last year, the Chinese semiconductor industry invested $8 billion in semiconductor investment, 6 times the amount of money that this country invested, which was about $1.3 billion.

A significant portion of that $8 billion of funds going into China came from U.S. venture capital firms in California. It is a ridiculous situation that venture funds, including some funds that invested in my former company, are sitting in Menlo Park, California, investing in Chinese high-tech companies, and in whatever area of high-tech they are in, it will ultimately benefit the Chinese military.

We need, first of all, more transparency to have visibility to these things. Second, we need sanctions and guidelines from the Federal Government. Thank you.

Chairwoman WATERS. Wow. Thank you so very much, and, of course, I thank our Chair of this subcommittee. This is very timely, and as I indicated early on when I made my 1-minute presentation, the letter that I sent out to all of these companies has not been responded to.

This hearing absolutely focuses on what we need to do and what we must do. The harmonization that you referred to is absolutely necessary for us to move forward, and so I thank you for being here today.

And I thank all of our panelists for being here today, and I thank our Chair of the subcommittee for leading on this issue. I yield back the balance of my time.

Chairman SHERMAN. Thank you. I will now recognize Mr. Gonzalez.

Mr. GONZALEZ OF OHIO. Thank you, Mr. Chairman. And thank you to our witnesses for your testimonies and your time.

Ms. Alexander, I want to start my questions with you. Your union certainly has pension assets, right? Are any of those assets invested in Chinese VIEs, or in any of the index funds that are invested in some of the companies that Mr. Ferry was referencing, to your knowledge?

Ms. ALEXANDER. Thank you for your question. I think much of the private equity investments in Chinese companies are through some kind of structure that either is VIEs, or mirrors VIEs on the private side. I think it is a very important question, and disclosure is a way to get at what those investments are.

Mr. GONZALEZ OF OHIO. But are your pension assets invested in any of those companies, directly or indirectly, to your knowledge?

Ms. ALEXANDER. I don't know the full extent of our pension investments. I think we have tried not to be invested directly in funds that invest in China.

Mr. GONZALEZ OF OHIO. I don't mean to put you on the spot, but I have had conversations with other folks who manage money, either pension assets, insurance companies, what have you, and I have asked that question, and it is an uncomfortable question, because the answer is almost certainly yes.

And by the way, it is yes for the ones that I have asked, I assume it is yes for you all, and I think that there is a real question here, which is, what should we do about that?

Frankly, on our side of the aisle, there are sort of two opinions. One is, our capital markets are the most open, deepest, and most liquid markets in the world, and that is an enormous advantage for our country. We should do everything we can to protect that, and so you don't want to muck around too much with foreign policy things.

I tend to feel like if you were to poll-test most Americans and say, hey, how do you feel about your pension assets being invested in companies that are designed to destroy your country, they would probably say, no thank you, to that.

And so, I guess my encouragement would be in absence of law, to encourage your union, those managing those assets to be more thoughtful in that regard.

Ms. Chu, I want to switch to you. It's good to see you again. It is, I think, your second time here since I have been a member. Last Congress, or maybe it was earlier this year, Mr. Sherman and I—I lose track of time, he loses track of his phone—had the Holding Foreign Companies Accountable Act, in which the SEC struck a deal with the Chinese government to allow for the auditing to take place in Hong Kong essentially.

I can't speak for Mr. Sherman, but my goal with that legislation was to force Chinese companies to play by the exact same rules on the auditing front that every other country and every other company in our public markets has to play by.

With that as a backdrop, how confident are you in the SEC's agreement? How confident are you that the Holding Foreign Companies Accountable Act will be implemented consistent with the intention I just laid out?

Ms. CHU. Thank you. It is good to see you again, too, and it is great to be here, and realizing that we are covering a similar topic this year as to last year. Last year, the hearing focused a bit more on, I think, end down investment. This year we are talking more about outflows, but it is still an important topic, and I am just really grateful to be a part of it as this conversation is accelerating and more stakeholders are becoming involved.

One of the U.S.'s greatest strengths is its commitment to high-quality, reliable disclosures, and financial reports that protect investors, that protect stakeholders, and protect market participants. China doesn't have that.

What China has instead is capricious domestic policymaking that induces a very volatile market situation, as well as nontransparent corporate structures that make it difficult to ascertain, as Congressman Sherman had mentioned, what the true nature of the underlying assets of security are.

And as a result, there should be China-specific due diligence. Regardless of the results of the PCAOB audits, there should be China-specific processes in place that evaluate Chinese securities on their own merit, which at present are not equivalent to those U.S. securities.

Mr. GONZALEZ OF OHIO. I only have 10 seconds. I would love to know more specifically about what you have in mind. With that, I will yield back.

Chairman SHERMAN. Thank you. At this point, I will recognize Mr. Scott for his questions. I do have questions, don't worry, but Mr. Scott will come first.

Mr. SCOTT. No problem. Thank you very much.

First of all, let me just say, I agree first with Chairlady Waters. This is an extraordinarily important hearing, and because of this fact, China is now the second-largest economic system in the world, next to ours.

And although we have some very starkly different foreign policy and political differences with China, as the whole world knows, this one fact is true: China cannot be ignored as a global power in the global economy. And China's growth and substantial share of the global economy means that we have to carefully consider China's role in our own financial system at the top of the line, the United States. Investment companies and pension funds have a fiduciary duty, best interest, to their investors. They have to act prudently in order to minimize the risk of large losses.

Ms. Chu, let me ask you this question. It is sort of a three-point question, but it all comes together. Are investments in Chinese companies inherently more risky, and does China's OPEC regulatory regime make them more risky? And finally, would reducing investments in Chinese-owned companies improve pension plans' performance and stability? Ms. Chu?

Ms. CHU. Thank you. Chinese companies trading, whether domestically or listed on overseas exchanges, are inherently more risky for a number of reasons, some of which my fellow panelists have spoken on, but one of the reasons being variable interest entities (VIEs). Variable interest entities are a way in which Chinese companies can circumvent certain domestic laws but also enter U.S. markets using different jurisdictions. And the way that the conversation has played out over the past couple of months, the U.S. has been wondering whether China was planning to actually clamp down on the use of VIEs.

They are technically legal in China, and so there is this question, is this going to be a problem, or is the problem going to resolve itself?

But last December, the Chinese equivalent of our SEC released a rule saying that VIEs are actually okay. There are certain policies in place, but business as usual.

And this type of event goes to show how much of Chinese financial policymaking is, again, capricious and unpredictable. A lot of times, it is led by domestic priorities rather than market reasons, and there is a lot that goes into China's policymaking that is not necessarily profit-driven. And because of that, Chinese companies and Chinese securities are inherently more risky.

And really quickly, to your last point about pension funds, I will say that the Tennessee Consolidated Retirement System (TCRS), might be the only pension fund in the United States that has little to no exposure to China or Russia, and that is because they invest in country-specific ETFs and have used a democracy weighting system.

And they still outperform many other pension funds. So, it is possible. It just matters whether or not an administrator is willing to take that stand and also willing to make that shift for all of the constituents.

Mr. SCOTT. Excellent. And I agree with you too, and I think your remarks were right on target.

And now, Mr. Ferry, let me go to you. In your written testimony, you agree that there are substantial China-specific material risks to our investors relating to national security. How is this a threat to our national security? That, I believe, is on the top of the minds of all of us.

Mr. FERRY. Thank you, Congressman. Yes, there absolutely are risks to our national security from some of the Chinese companies that are funded by American investors. As I said, the civil-military crossover is widespread. It spreads across many industries.

I could give you an example of the China State Shipbuilding Corporation (CSSC), a Chinese shipbuilding company which is building military ships. China, as you may know, has the world's largest navy. The United States is now number two—you don't often hear that about the military sector, where the United States is number two, but the Navy is an area where it is.

CSSC takes in investment funds through these indexes and international exchange-traded funds, and CSSC is building ships, it is building ports, and it is building other naval equipment to enable the Chinese navy to grow. And we are helping to fund that, and I think that is a situation that should change.

Mr. SCOTT. And, Mr. Chairman, I would ask for just a couple more seconds because I want to ask you, Mr. Ferry, because I think the whole nation wants to know, with all of this missile activity, with what China is doing in the arena—

Chairman SHERMAN. Mr. Scott, you are already a minute over, so I will ask that the answer be for the record. We will decide later whether we are doing a second round, but unless the witness feels they can answer in just 10 or 15 seconds—

Mr. FERRY. Can you summarize your question? The missile activity over Taiwan is absolutely a threat.

Mr. SCOTT. I am just saying that is what is busting on the news everywhere. I think it is appropriate for us to get some kind of answer from all of you.

Chairman SHERMAN. Thank you, Mr. Scott. Your time has unfortunately expired.

Mr. SCOTT. Sorry.

Chairman SHERMAN. I will now recognize myself for 5 minutes. There are a few comments I want to make first. First, it is this Congress and this committee that put the pressure on, passed the law that is getting the PCAOB access to the audit work papers.

Right now, they are in Hong Kong to see whether this agreement is actually going to be implemented, and if it is not, then our law will require that many of these Chinese companies need to be delisted.

The second is, and I think Ms. Chu pointed this out, that the VIE structure is designed to evade Chinese laws, or avoid Chinese laws, however you phrase it, but it puts our investors in a position where they think they are buying Alibaba, a big Chinese company, and instead, they have no shareholder rights, except in Alibaba Cayman Islands, which raises the issue of whether we should allow a company to sell stock in our country calling themselves Alibaba, when they are really Alibaba Cayman Islands, not the same thing as the big Chinese company.

And we have to look and see whether it is appropriate for low-cost funds and index funds to be investing in companies that either have fled American markets to avoid the PCAOB, or employed a VIE structure, because when you have no money to investigate what you are investing in, you are just doing it on the basis of an index. And those are risks to which you probably shouldn't subject American investors.

And in particular, Alibaba is one of the biggest companies in the world. If you want to invest in the big countries of the world, invest in Alibaba. But Alibaba Cayman Islands is not one of the biggest companies in the world, and so you don't actually meet the qualifications for the index.

Ms. Chu, I would like you to comment on the idea of whether these low-cost, paint-by-the-numbers index funds should be allowed to invest in VIEs that are not operating companies, but rather a company in the Cayman Islands, that has a relationship with a company in China, that then has a relationship with Alibaba or another big Chinese company.

Ms. CHU. Thank you. And, no, I don't think that this should be an option for U.S. investors, least of all because of investor protections, but also because of the possibility that some of these companies are engaged in activities that are contrary to U.S. national interests, without the knowledge of, again, the investor.

The problem with index funds is that they are beholden to profit. The index funds, and the index providers specifically, operate using a set of technical and financial criteria, so criteria like market cap or liquidity or size, when they evaluate which companies or securities to add into an index or which ones to remove.

For example, Russian securities were all removed from MSCI, FTSE Russell, S&P, Dow Jones, all of these indexes in early March of this year. But they weren't removed because of ethical concerns or because of U.S. sanctions. They were removed because they were virtually worthless.

And there are already policies—

Chairman SHERMAN. I do want to move on with my question.

Professor Sonnenfeld, should index funds be investing in companies that were listed on American exchanges and then delisted themselves, or were delisted, because they wouldn't allow access of the PCAOB to their audit work papers?

Mr. SONNENFELD. I share the spirit and the content of my fellow panelists. I do think that there should be greater transparency, and that even sophisticated investors are representing a lot of individual innocent people's money—

Chairman SHERMAN. I am going to try to sneak in one more question. In November of 2020, the SEC required that in public offerings, you have to disclose the unique risks that investors face investing in China, the VIE structure, the rule of law questions.

Should we also require that these same risk factors be disclosed? And this is required by one of the pieces of legislation under consideration today, that these same risk factors be disclosed to those investing in private placements.

Mr. SONNENFELD. Yes, I think they should be. I will say in the case of Alibaba Cayman, I actually read the 500-page registration papers, not in preparation for this, but when it happened, I thought that the volume was misleading itself.

It, in fact, allowed for Jack Ma, the then-CEO, to be emperor for life with the exception that only the Chinese government could remove him. He had founder shares that nobody in the U.S., that I know of, who invested in the company realized he had, but it was just buried in so much stuff.

Sometimes, I will say, Mr. Chairman, we have disclosure, and it is still not transparent. It was buried in the fine print.

Chairman SHERMAN. Thank you. My time has expired, and I will now turn to the gentleman from Connecticut, Mr. Himes, who is also the Chair of our Subcommittee on National Security, International Development and Monetary Policy, a new subcommittee that also deals with some of the national security issues that we are confronting here today in this subcommittee. Mr. Himes?

Mr. HIMES. Thank you, Mr. Sherman, and I am glad that the titles don't get charged against my time here. And thank you to the witnesses who are with us today.

I have a question that I am going to direct, not to Professor Sonnenfeld, but to Ms. Chu and Mr. Ferry, and it is a China capital markets-related question. It is not controversial to me that China shouldn't have any advantage over other international issuers with respect to disclosure in PCAOB, but we are spending a lot of time talking about China and Russia, two very different countries with very, very different situations from a capital markets standpoint.

We have almost no capital market interaction with Russia. We have very little trade with Russia. That was true when Russia was the Soviet Union.

We have deep, deep, deep ties financially with China, $125 billion a year, roughly, of foreign-directed investment into China, with $38 billion coming this way. China owns $1 trillion of United States Treasury debt.

The situation is one akin to the ones that the Germans find themselves in with respect to Russian energy, of deep entanglement.

What I am not hearing in today's testimony and I will just ask you—I do have one question for Professor Sonnenfeld related to Russia, so I will ask for quick answers—what should be our strategy with respect to these financial and capital markets entanglements with China? Should we be looking for less, with what that might imply for growth? Should we be looking for more, because entanglement will also create commercial interests against the possibility of kinetic antagonism?

Just give me your thoughts on what our overarching principle should be with respect to financial and capital markets entanglement with China?

Ms. CHU. Thank you. Quickly, I want to touch on your last point, which is the concept of peace through trade, democracy through trade. I think it is a concept that a lot of Administrations in the past have held up, and we have seen was perhaps not as effective as we might have hoped.

And with the case of China, yes, perhaps trade and further entanglement will endear diplomatic relations. At the same time, trade goes both ways. So while the U.S. may be able to export values such as freedom of speech, or civil liberties, to attempt to export these to China, China is also and has also exported concepts like censorship, for example, authoritarian values to other countries.

Mr. HIMES. Mr. Ferry?

Mr. FERRY. Congressman, I believe we ought to decouple this economy from China, not immediately, but over time, and I believe that will benefit the U.S. economy.

You say there are commercial gains on both sides. Right now, we are importing from China $600 billion worth of goods each year and exporting around $150 billion worth of goods. If we can reduce that level of imports and redirect that demand towards American production, you will see the American economy grow, and you will see employment, good-paying jobs grow in this country.

On the capital market side, I think the same thing will follow. We do not need them to buy $1 trillion worth of our Treasury debt. And they are buying it partly in order to keep the dollar high so they can continue to keep Chinese people employed, because the one thing President Xi fears more than anything else is a revolt and a revolution of the Chinese people against the oppressive system he has put in place.

Instead, our capital should be funding investment in U.S. industries and in investing in friendly nations. There are the iPath nations, India, there are plenty of friendly nations that we could invest in as a matter of foreign direct investment, to grow their economies, to grow trade in a balanced fashion, and regrow our own economy.

As far as capital markets go, I always fall back on the quote of Paul Volcker, who was Chair of the Fed many years ago, and I believe the best Chair the Federal Reserve has ever had. He said, "Every time I have a meeting with financial professionals, they tell me that free, open capital markets are making the U.S. economy more efficient, and I ask them for an example, and in 30 years, they have never been able to give me one example."

Mr. HIMES. Mr. Ferry, I have a quick question to you. The Congress, on a bipartisan basis, rejected the Trans-Pacific Partnership (TPP) trade deal. Very, very quickly, should the Congress reopen the discussion of something that looks like the TPP? This is for Mr. Ferry, then I am going to Professor Sonnenfeld.

Mr. FERRY. I absolutely do not believe that free trade agreements benefit the United States.

Mr. HIMES. Okay. Thank you.

Professor Sonnenfeld, the sanctions that have been applied to Russia, big holds obviously associated with Chinese purchases of Russian energy, et cetera, and in the 20 seconds I have remaining, what more should the West collectively, the United States in particular, be doing to isolate the Russian economy?

Mr. SONNENFELD. The energy deals aren't so bad, that China and India can't buy the Russian gas the way Putin said, even though most of the world was fooled by that, but most Russian gas goes through pipelines. It is natural gas. It is in the form of vapors, and he doesn't have pipelines into Asia. The liquid natural gas that we can sell them and are selling them—we now supply the EU with more gas than they ever bought from Russia. Russia has fallen, just as the war broke out, from 46 percent down to 9 percent of gas on oil. It is not such a big problem either because they are such tough bargainers in India and in China, that they are extracting a $36-barrel discount, on top of the fact that Russia is the least-efficient producer in OPEC. It costs the Saudis $22 a barrel. [inaudible] They are not making money. But there are things they can do.

Chairman SHERMAN. Thank you. The time of the gentleman—

Mr. HIMES. I thank the chairman for his leniency.

Chairman SHERMAN. I now recognize the gentleman from Illinois, Mr. Foster, who is also the Chair of our Task Force on Artificial Intelligence, for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman. This is for Mr. Ferry and Professor Sonnenfeld. There are two general classes of disclosures for cross-border investment flows. There are disclosures to regulators and disclosures to the public. Can you say something about the relative merits of either one in terms of accomplishing what we want to accomplish here, Professor Sonnenfeld?

Mr. SONNENFELD. I don't think there should be differences. I think disclosures to the public and disclosures to the regulators should be one and the same. We don't need to look very far from FTX to see some awfully sophisticated people who got fooled and have lost a lot of money when they thought they understood what they didn't. We need to have, I think, a more equal playing ground on disclosures across sectors.

Mr. FOSTER. Mr. Ferry?

Mr. FERRY. I would echo what—I agree 100 percent with my what my Yale colleague expressed, and I guess what I would add is that I spent an earlier part of my life reading 10-Qs and 10-Ks. Disclosures to the public are a great benefit to investors. And I would just say if you think of Bernie Madoff and the way in which he evaded disclosure to the public and got billions of dollars of funds, China is full of literally hundreds of people who are just like that, using nontransparency to attract millions and billions of dollars. And I would hate for that to be American money.

Mr. FOSTER. What sort of efficiency hit would the global economy take from a just radical transparency requirement for all cross-border investment flows? You have to know the beneficial owner on each end and you have to know where the money is actually going. There is an obvious paperwork cost of that, which I guess could be roughly quantified, but aside from that, what would be the downside of that?

Mr. FERRY. That is—

Mr. FOSTER. Anyone who wants to say, even if you don't agree with it, what would be the arguments you anticipate against a radical transparency regime?

Mr. FERRY. Efficiency in quotes always benefits when you strip away regulations. If in the Democratic Republic of the Congo, there are 10-year-olds mining cobalt, boys and girls, would you call it more efficient because the cobalt is cheaper than if we mined it in a country that respected laws and regulations? So, I think efficiency is an overused and overrated word.

Mr. FOSTER. Ms. Chu, you mentioned something called democracy waiting, which I found fascinating. How exactly does that work? Do you just trace back where all of the investment flow is starting and originating, and then find some way of saying, okay, this much is coming from that country, it has a democracy waiting of .5?

Is there a general mechanism here, where you could set up not only democracy waiting, but national security waiting or religious freedom waiting or abortion rights waiting, or whatever you want, with enough transparency of where the money was coming and going?

Ms. CHU. Thank you. In the case of TCRS, I can't remember exactly what their process is. I think they use some sort of annual report that comes out on democracy around the world. Although there are so many great nonprofits and there are watchdog groups that put out reports, and I think annual research about democracy, freedom of speech, freedom of religion and all of these other topics, environmental, so ESG plus essentially, that one could use to formulate their own methodology, their own waiting matrix.

Mr. FOSTER. Okay. But the other part of the problem is actually seeing the flow. Waiting to assign this mine in this country from how good and accurate it is, and then there is the tracing of the flow.

Is the rest of the thing a potentially solvable problem, and then let third parties estimate how to apply those waits to the final product that someone may want to base their investment decision on?

Ms. CHU. In this case, I think the strategy involves using preexisting exchange-traded funds that are attracting country-specific indexes. And there isn't additional waiting or analyses on the part of the fund administrator. With that said, I do know that there are funds out there—there is one that uses something they call freedom waiting, which are proprietary methods that I am sure could be expanded upon by other index providers, larger ones as well, that I think are of value and I am hopeful will catch on.

Mr. FOSTER. Ms. Alexander, can you say anything about the differences in different countries and how useful they are in tracking down all of these issues?

What are the limits of what the U.S. can do unilaterally versus are there gaping holes where some countries just are not helping out with the transparency we need here?

Ms. ALEXANDER. Thank you for your question. I think there is a lot more information that is publicly available in other countries that we don't have a habit of disclosing in this country. And I do think disclosure and transparency is a way of holding capital accountable for what it ends up getting invested in, the patterns or the structures of transparency on who owns companies, what the investments are in different countries is pretty complex, but—

Chairman SHERMAN. I am going to have to interrupt at this point. The time of the gentleman has expired.

I'll move onto Mr. Vargas, who is there on our screen, and is recognized for 5 minutes.

Mr. VARGAS. Thank you very much, Mr. Chairman. And I thank the ranking member, of course, and all of our witnesses today.

Mr. Sonnenfeld, you were saying that there were gaps in our sanctions on Russia, and then you started to say that we could do something about it. Then, you were truncated about that point, and you didn't tell us what those were. Why don't you go ahead and tell us what those were?

Mr. SONNENFELD. Thank you, Mr. Vargas. I did want to more completely answer Congressman Himes, and I thank you, Congressman Vargas, for giving [inaudible] Oligarchs that it could have been better addressed than the families of oligarchs and top public officials, and there are some sanctions groups that have some great legislation on this, from the McFaul group out of Stanford, and from the Kyiv School of Economics, but in particular, the major U.S. airlines are suffering badly right now, and it is an area that hasn't gotten much attention.

American passengers are filling the flights of American departing planes that are flying on Qatar Air, on Etihad, on Emirates Air, on—not just Middle Eastern carriers, Air Serbia, Air India that are making the most-profitable U.S. airline routes, the most-profitable paired routes so unprofitable that they are canceling them, flying from San Francisco to New Delhi, flying from Newark to New Delhi, JFK to New Delhi or to the Philippines, Dallas to Seoul, these are flights that are being canceled now by American, by United, and by others that used to be the most-profitable.

And who's filling them? Americans. Why? Because they are flying out of U.S. departure airports. They are flying over Russia. Our airlines can't and shouldn't do that, but we are allowing the non-U.S. carriers flying out of the U.S. that nobody questions this, that is—we are also paying, by the way, millions of dollars of overage fees that go to Russia because of the way air traffic rules work. We pay the money to fly over them that Americans are basically paying for that, and we are hurting our own airlines. So, thank you, sir. That is a major issue.

And the third one has to do with parts. There is something going on that has not been publicly discussed until this moment. Boeing is living by sanctions against using Russian titanium. In fact, they had a major joint venture in Russia. They discontinued it. I am sorry to say that I believe British Airways has gone in and taken over what had been Boeing's interest there. And we have other parts leakages issues, so that Aeroflot, an F7 domestic carrier, had basically stopped in March. They are back up in the air right now because somebody is getting aviation parts that are being smuggled in and leaked in. I just think that some in Europe aren't living by the same rules as some in the U.S. when it comes to aviation. And we have foreign carriers leaving U.S. airports that aren't being held to the same standards as U.S. carriers.

Mr. VARGAS. Okay. I do want to follow up with one question, You published a formal analysis of the stock price performance of publicly traded companies, which had announced formal plans to suspend commercial activity in Russia compared to their peers, which continued to do business there following the Russian invasion of Ukraine.

In your findings, you observed that firms pulling out experienced a 4-percent market capitalization increase, whereas firms that continued to operate in Russia saw an average of a 5.5-percent decline.

Is that still the case today, do you know?

Mr. SONNENFELD. Yes. We have a team studying that right now, Congressman. Thank you very much for asking about that.

If you would take a look independent of the country where it is domiciled, independent of the size of the company, independent of the industry, you could look at an industry sector like energy. It is not all, "a rising tide raises all boats." Energy total suffers where BP and others are soaring. Exxon and Shell, they each wrote down billions of dollars, but they wound up having a 13 to 20 percent surge in their stock price, having reduced financial risk, operational risk, and reputational risk.

So, they paid off. And in every industry, you find the same thing, whether it is retail and consumer goods or pharmaceuticals, the companies that stayed there are doing worse than the companies that pulled out. Even the public and private companies, we have looked at pricing, the debt offerings of private companies—it is a higher risk I will say.

Mr. VARGAS. My time is about up. I just wanted to point out that corporate social responsibility, in some cases, really does pay off. I appreciate it.

I wish you the worst of luck on Saturday. I hope Yale gets crushed.

Mr. SONNENFELD. Thank you, sir. It is an away game. We are worried.

Mr. VARGAS. I will be there with my daughter. So, I am looking forward to it.

Chairman SHERMAN. Thank you. The time of the gentleman has expired, although I agree with him on the game, and I now recognize the gentleman from Illinois, Mr. Casten, the Vice Chair of this subcommittee.

Mr. CASTEN. My contribution of comity on this panel is going to a small Division 3 college that cannot compete in any sports against the rest of you.

Thank you, Mr. Chairman. And thank you to our witnesses.

Ms. Chu, I want to follow up with you, and just follow up on the exchange you had with Mr. Gonzalez. He had chatted with you about the Holding Foreign Companies Accountable Act, in which, if the PCAOB is not allowed to review these auditors, these companies are going to be delisted within 3 years of enactment, which is about a year from now.

Just really quickly, given how much time you have spent in this space, are you optimistic as we sit here today that we are going to come to some agreement with the Chinese regulators to get through that, or are these 200-some listed firms going to be delisted by the end of the year? What is your view of where this sits right now?

Ms. CHU. Thank you. I think it is possible to come to an agreement, but enforcement is a whole other issue. And in addition, disclosure is a problem, true disclosure, and also the fact that Chinese companies have found so many loopholes, whether through regulations or through corporate structures to navigate U.S. regulations on this front. I think it is possible that it will pass, and I am hopeful, because that sets a wonderful precedent. But I don't think that means the challenge is over.

Mr. CASTEN. Just from a capital markets perspective, give me the outer bounds here. If these 200-ish companies are delisted, what kind of volumes are we talking about on U.S. capital markets, in terms of dollars? Any sense of what that is?

Ms. CHU. I think I have to defer to Mr. Ferry on this.

Mr. CASTEN. Mr. Ferry?

Mr. FERRY. I'm sorry. That is a good question. I don't have at my fingertips the volume of trading or the volume of capital involved in these 200 companies. I do agree with Ms. Chu's point of view that an agreement is possible. Enforcement of the agreement is going to be very difficult, given where the Chinese economy is with deep, deep problems with debt. Their interest is in keeping our investors' pockets open to help prop up their economy.

Mr. CASTEN. Okay. I am not trying to get precise numbers, but I am asking because we have also seen the rise in this exempt offerings market, which, of course, would be totally outside of these rules, and not subject to SEC compliance.

And Ms. Chu, Mr. Ferry, any of you who have any other thoughts on this, are you satisfied if indeed this Act were to go into force, if indeed whatever this quantum of money is, does that actually get pulled out, or should we be concerned that we are just going to create a venue for this money to move over to the exempt offerings market, because I think the latest number I was able to find was $2.7 trillion, just in 2019, raised on those markets, which I think would be totally outside of this agreement; is that right?

Mr. FERRY. I think so, but I haven't studied that issue in detail. And if your point is that the money will find a way to be domiciled in the Cayman Islands and still invested in China, all of these leakages are possible because capital is fungible, but we have to go step by step and protect our investors each step of the way, and then plug the holes just like the proverbial woman and the Dutch dike.

Mr. CASTEN. Any suggestions on what Congress might do to plug those holes?

Mr. FERRY. The first thing is to enforce the Holding Foreign Companies Accountable Act. And the next thing is to move to sanctions harmonization to require all arms of the Federal Government to harmonize, preferably with the Department of Commerce's Entity List, which lists 1,100 Chinese companies as companies in which U.S. investors should not invest.

Mr. CASTEN. With the time I have left, I want to move to Professor Sonnenfeld, and just to pick up on Mr. Vargas' question a little bit, this observation in your research that there is a declining market cap for companies that have stayed in Russia, obviously, they reversed the other way.

I think—and if I am putting words in your mouth, correct me—you are saying that it is our sanctions regime that has, to some degree, contributed to that?

Mr. SONNENFELD. It is completely independent, but consistent with the sanctions regime, when we have seen disappointments in economic blockades in Cuba or North Korea or Iran, it is because, in fact, we didn't have the sectors working together. But these are independent decisions that have not been, for the most part, in finance and some other areas that were driven by sanctions. But for the most part, these were individual decisions.

As we saw with Libya, Chile, Yugoslavia, Ceausescu in Romania, and Erich Honecker in East Germany, we saw a profound takedown of tyrants happen because of private-sector decisions that matched the public-sector decisions. That is what makes blockades work. But in South Africa, for example, there were sanctions passed by our government—I think by a 77–22 vote that Senator McConnell actually led the override of President Reagan's veto on it. Still, that wasn't enough. It took 200 companies to voluntarily pull out. That was the high watermark then, and that was independent of the sanctions; Coke, IBM, and GM led that. And now, we have never seen anything like this in world history, to have 1,200 companies voluntarily pull out, either through enlightened self-interest, ethics or whatever reason, it was—

Chairman SHERMAN. The time of the gentleman has expired. I thank for your answer.

I would like to thank our witnesses for their testimony. And I thank Mr. Gonzalez for representing his party well here.

The Chair notes that some Members may have additional questions for these witnesses, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned.

[Whereupon, at 3:24 p.m., the hearing was adjourned.]

APPENDIX

November 15, 2022

OPENING STATEMENT OF REP. BILL HUIZENGA

House Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

"Investing in our Rivals: Examining U.S. Capital Flows to Foreign Rivals and Adversaries Around the World"

November 15, 2022

Thank you, Chairman Sherman, and thank you to the witnesses for your testimony this afternoon.

Today's hearing is entitled; "Investing in our Rivals: Examining U.S. Capital Flows to Foreign Rivals and Adversaries Around the World." At first glance, some might be wondering why this subcommittee is having a hearing on national security. While the topic is worthy of our attention, hijacking securities law to push a foreign policy agenda can be counterproductive and sends the wrong message.

Additionally, as has become customary under current leadership, this hearing contains numerous bills that the minority is seeing for the first time- with no coordination or effort made to consult with Republicans.

However, I will take a moment to acknowledge the Chairman's "Accelerating Holding Foreign Companies Accountable Act", a bi-partisan bill that unfortunately was more suited to be discussed at a previously announced and then postponed subcommittee hearing on accounting standards.

If the Chair would like to discuss public accounting firms, I would encourage him to invite both the Chair of the Public Company Accounting Oversite Board (PCAOB) and the SEC's Chief Accountant- both suggestions that Ranking Member McHenry and I made to Democrats back in September.

To be sure, committee Republicans support policies that make our capital markets the most competitive and attractive place to do business in the world. There should be no doubt- foreign companies participating in our capital markets must play by our rules.

While countries like China and Russia are busy making foreign investors question their ability to govern responsibly, the U.S. should be reaffirming our commitment to a financial system that is open and thoughtful. U.S. securities regulators should not chase a foreign policy agenda, but rather redouble their efforts to ensure that all companies listing in US public markets adhere to US securities laws.

Mr. Chairman, given this will likely be our last hearing before the end of the 117th Congress, I thought I'd use my remaining time to provide some thoughts on the last two years.

As the former Chairman of this subcommittee, I've been troubled by the lack of progress we have made towards supporting investors and entrepreneurs through capital formation. Capital formation is vital to our markets. Ten years ago, the Jobs Act was a major step forward, but we should be doing more to support small businesses and entrepreneurs in this country. I look forward to working on many of these bi-partisan issues in the next Congress.

And lastly, congressional oversight of the Securities and Exchange Commission on this subcommittee has been abysmal. In the last two years, by my count, we've had one, count it one hearing with a director level appointee at the SEC. We must do better holding these unelected bureaucrats accountable.

As for Chair Gensler, what more can be said? The committee has sent numerous requests to Chairwoman Waters asking for a hearing with the Chair, as well as with the full commission. These requests have been ignored. And if that wasn't bad enough, this past September, the Senate Banking Committee held an SEC hearing with Mr. Gensler, while this committee passed on its constitutional duty to conduct oversight.

If I've said it once, I've said it a thousand times, the SEC has embarked on one of the most aggressive and dangerous rulemaking agendas in our lifetime. Making matters worse, in October, the agency reported a "technical glitch", calling into question the integrity of an already questionable rulemaking process. Coupled with an alarming inspector general report, that reported staff shortages and inadequate subject matter expertise, I hope my friends across the aisle will join Republicans in holding them accountable.

With that Mr. Chairman, I yield back.

Testimony of Courtney Alexander
United Food and Commercial Workers International Union
before
House Financial Services Subcommittee on
Investor Protection, Entrepreneurship and Capital Markets
November 15, 2022

Good afternoon, Chairman Sherman, Ranking Member Huizinga, and members of the subcommittee. Thank you for the opportunity to testify today. My name is Courtney Alexander, and I am a senior research analyst with the United Food and Commercial Workers International Union. I have 35 years of experience working for labor unions analyzing corporate ownership and financial structures, with a focus on the rise of private equity in the service industry and the impact of financial engineering on American workers. What I am here to address today is my recent work analyzing the outflow of capital from United States-based private equity firms to the People's Republic of China. That capital includes public employee pension assets invested by private equity firms in a country of national security concern. I will present a case study which we believe illustrates the need for public disclosure by private equity firms of their investments in countries of concern.

In the last few years, scrutiny into U.S. investment in China has been building. Examples include:

1. Your passage of the Holding Foreign Companies Accountable Act, requiring listed companies to permit inspections of their audits, a longstanding obstacle for investors in Chinese companies listed in the U.S.
2. The resulting September 2022 Statement of Protocol between the Public Company Accounting Oversight Board (PCAOB), the China Securities Regulatory Commission (CSRC) and China's Ministry of Finance setting a framework for access to such audits, to be tested in the coming year.[1]
3. Presidential Executive Order 14032 which bans U.S. transactions in certain *publicly* traded securities that finance companies in the Chinese Military Industrial Complex and Chinese surveillance technology;
4. House and Senate bills and hearings outlining the case for an outbound review process – sometimes called a reverse CFIUS - for investment in industries important to national security, in countries of concern.

Much of the engagement around investments in Chinese companies is guided by what is visible in publicly traded companies. What is less visible, but no less important, is the trove of investments made by U.S. private equity funds in Chinese companies.

[1] https://www.sec.gov/news/statement/gensler-audit-firms-china-hong-kong-20220826

Let me present a case study of one such investment based on our research.

Between 2007 and 2018, U.S. based KKR & Co. invested $3.3 billion in companies and entrepreneurs in Greater China.[2] In late 2017, KKR Asian Fund III, an investment vehicle run by KKR, founded a Chinese artificial intelligence and big data company called Cue Group. The company, formally called Shanghai Cue Information Technology Co., Ltd. **上海开域信息科技有限公司**, was formed by combining four digital advertising, communications and big data analytics companies under the leadership of Mr. Shi Kan, a Chinese technology entrepreneur.[3] At launch, Cue was described by KKR as "…the first one-stop digital marketing company for the Chinese market."[4]

Until November 1, 2021, KKR owned a majority of Cue and KKR executives comprised a majority of Cue's Board.

KKR's "digital marketing company" went on to jointly develop surveillance technology with an arm of the Ministry of Public Security, the government organ that oversees China's vast internal surveillance apparatus.

In 2020, Cue had jointly developed technology for a surveillance product with the Video National Engineering Laboratory Zhuhai Innovation Center 视频国家工程实验室（珠海）创新中 ("Zhuhai Innovation Center"), a government lab run by the First Research Institute of the Ministry of Public Security **公安部第一研究所**, according to an April 2, 2020 press release posted on Cue's website during 2021.[5]

The Zhuhai Innovation Center and the First Research Institute play integral roles in the Ministry of Public Security's surveillance apparatus, and the First Research Institute works with Chinese entities that are sanctioned by the U.S. government for facilitating human rights abuses or playing a role in the Chinese military-industrial complex. I will come back to this point after describing Cue's technology.

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[2] https://www.businesswire.com/news/home/20180320006664/en/KKR-Launches-China%E2%80%99s-First-One-Stop-Digital-Marketing-Company-Cue-Co. "KKR has been investing in China through its pan-regional private equity funds since 2007, deploying more than US$3.3 billion to support leading companies and entrepreneurs in Greater China through its private equity platform."

[3] https://www.businesswire.com/news/home/20180320006664/en/KKR-Launches-China%E2%80%99s-First-One-Stop-Digital-Marketing-Company-Cue-Co.

[4] https://www.businesswire.com/news/home/20180320006664/en/KKR-Launches-China%E2%80%99s-First-One-Stop-Digital-Marketing-Company-Cue-Co.

[5] https://cue.group/news/index.html 2020 年04 月02 日, accessed 7/3/21, professional translation. Web posting was removed following publication of The Wire China report. "'CUE All-in-One Machine', which has two core capabilities of AI smart contact-free temperature measurement and 14-day migration trajectory tracking, was an epidemic prevention product jointly and urgently researched and developed by CUE Group, Zhuhai Zhongdun Star Technology Co., Ltd and Video National Engineering Laboratory (Zhuhai) Innovation Center."

The jointly-developed product was called the "CUE Real-time AI Facial & Body Temperature Detector" or All-in-One machine, and it integrated facial recognition, thermal detection and identity data. It was used for pandemic surveillance in public places, reading temperatures of passersby, tracking 14-day migration of individuals, and identifying "companions." According to Cue's 2021 website postings, Cue's technology also had potential non-pandemic uses for recognizing "blacklisted persons" and to "prevent incidents involving mass gatherings".[6]

In August 2020, Cue posted on its website that this technology was used in train and bus stations, shopping malls, government agencies, schools and businesses.[7] More recently, on June 7, 2022, while KKR was a minority owner of Cue, Cue posted on its website about a similar, updated epidemic prevention product called Cue Digital Sentinel, which screens passersby for temperature, identity verification and health code accuracy, using artificial intelligence and big data. Cue stated: "'Digital Sentinel' is connected to the big data platform, which can check the authenticity of the health code and achieve real verification."[8]

Pandemic surveillance has not been a benign government function in China, with mandated quarantines, mass lockdowns and restricted travel based on health codes.[9] Voice of America, New York Times, and CNN have also reported on the use of other pandemic surveillance tools to restrict travel of protestors.[10]

Additionally, Mr. Shi's personal company Zhuhai Zhongdun Star Technology Co, Ltd. 珠海中盾之星科技有限公司 was a "strategic signatory" of the Zhuhai Innovation Center, and Mr. Shi attended the 2019 grand opening of the government laboratory as a representative of the lab's

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[6] https://cue.group/news/index.html 2020 年04 月02 日, accessed 7/3/21, professional translation. Web posting was removed following publication of The Wire China report. "'CUE All-in-One Machine', which has two core capabilities of AI smart contact-free temperature measurement and 14-day migration trajectory tracking, was an epidemic prevention product jointly and urgently researched and developed by CUE Group, Zhuhai Zhongdun Star Technology Co., Ltd and Video National Engineering Laboratory (Zhuhai) Innovation Center."
"For example, in terms of daily passenger flow statistics, (it) can collect and analyze passenger flow, record visitors' information, send warnings about abnormal passenger flow, prevent incidents involving mass gathering…. support blacklist warning, when recognize specific blacklisted person(s), (it) will send out real-time warnings."

[7] https://cue.group/news/index.html 2020 年08 月04 日, accessed 7/8/21, professional translation. Website has been removed. "During the epidemic, 'CUE Real-time AI Facial & Body Temperature Detector' served government agencies, businesses, communities, schools, restaurants, shopping malls, train stations, bus stations and other places all over the world, provided safety protection for tens of millions of people during their daily activities."

[8] https://cue.group/#/newsdetails?id=articleDetial_9abbe02cc4868d83 , post dated 6/7/2022, accessed 8/30/2022, Google translate. Website has been removed.

[9] https://www.bloomberg.com/news/features/2022-08-02/china-s-covid-zero-strategy-could-last-years-under-xi

[10] https://www.nytimes.com/2022/01/30/world/asia/covid-restrictions-china-lockdown.html?searchResultPosition=1
https://www.voanews.com/a/reports-chinese-authorities-using-covid-tracking-app-to-thwart-protesters-/6619689.html
https://www.cnn.com/2022/06/15/china/china-zhengzhou-bank-fraud-health-code-protest-intl-hnk/index.html

strategic partners, according to an October 28, 2019 ChinaDaily.com article.[11] According to that article, Zhuhai Zhongdun Star Technology had participated in the government's "Safe Campus" surveillance project starting in 2018.[12]

According to a 2020 Xinhuanet.com article, "CUE Group CEO Shi Kan said that CUE Group's business area covers digital marketing, but in essence, its core DNA comes from big data and artificial intelligence technology. CUE Group is essentially a digital technology company. At present, the artificial intelligence business has become an important part of the group's continuous efforts."[13]

Importantly, KKR listed Cue and Zhuhai Zhongdun Star Technology as "indirect subsidiaries" of KKR in a German regulatory filing dated February 20, 2020.[14] Further documenting the entangled nature of Cue and Mr. Shi's personal companies, the National Enterprise Credit Information System of China documented a 2020 pledge of equity by Mr. Shi's holding company for Zhuhai Zhongdun, to Cue.[15]

On February 20, 2022 *The Wire China* published an article entitled "The Surveillance Stake", profiling KKR's investment in Cue and Cue's collaboration with the government lab. KKR and Cue denied the collaboration to *The Wire*, however "…the Zhuhai lab confirmed in an email to The Wire that it had at one time collaborated with Cue and one of its wholly-owned subsidiaries."[16] I have submitted that publication with my written testimony.

Why does a collaboration with the Zhuhai Innovation Center matter?

The Zhuhai Innovation Center was formed in 2019 by the National Engineering Laboratory for Intelligent Video Analysis and Application, called NELIVA, and the Jinwan District government in

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[11] https://tech.chinadaily.com.cn/a/201910/28/WS5db690e7a31099ab995e8371.html dated 10/28/2019, professional translation: "Zhuhai Zhongdun Star Technology Co., Ltd., as a strategic signatory of Video National Engineering Laboratory (Zhuhai) Innovation Center, had already officially participated in the "Safe Campus" project in 2018, assisted in the implementation of research subjects at the Video National Laboratory, provided technical services and support, promoted the operation of the subject project, carried out the application of scientific research results."

[12] https://tech.chinadaily.com.cn/a/201910/28/WS5db690e7a31099ab995e8371.html dated 10/28/2019, professional translation: "Zhuhai Zhongdun Star Technology Co., Ltd., as a strategic signatory of Video National Engineering Laboratory (Zhuhai) Innovation Center, had already officially participated in the "Safe Campus" project in 2018, assisted in the implementation of research subjects at the Video National Laboratory, provided technical services and support, promoted the operation of the subject project, carried out the application of scientific research results."

[13] http://www.xinhuanet.com/info/2020-10/28/c_139470907.htm Professional translation with the letters DNA in the Chinese original. 10/28/2020.

[14] https://www.bafin.de/SharedDocs/Downloads/DE/Angebotsunterlage/axel_springer_se_delisting.html p. 260

[15] National Enterprise Credit Information Publicity System of China, corporate record for Shanghai Shuchuan Data Technology Co., Ltd., 99% shareholder of Zhuhai Zhongdun Star Technology, accessed 11/23/2021

[16] Northrop, Katrina. The Surveillance Stake, *The Wire China* dated February 20, 2022, p.2 https://www.thewirechina.com/2022/02/20/the-surveillance-stake/

Zhuhai.[17] The Laboratory Director of NELIVA is Qiu Baoli, the Director and Deputy Secretary of the Party Committee of the First Research Institute of the Ministry of Public Security.[18] Qiu was previously Deputy Director of the Public Security Bureau of the Xinjiang Construction Corps.[19] The Xinjiang Production and Construction Corps was sanctioned by the U.S. Department of Treasury in 2020 for serious human rights violations.[20]

The national lab NELIVA partners with Chinese companies and entities that are sanctioned in some form by the United States government. In 2021, NELIVA's website described the pedigree of what it calls its "co-construction units":

> "The First Research Institute of the Ministry of Public Security is a leader in video technology. The Automation of the Chinese Academy of Sciences is at the international leading level in the field of image and biometrics. Vimicro is at the leading level in the design of "China Core" chips. Hikvision is a leading company in the surveillance industry. Huawei has a leading position in the communications field and has strong independent innovation capabilities. Sun Yat-sen University has a leading technology in intelligent transportation research. The Key Laboratory of the Ministry of Public Security of Video is a practical application base for public security."[21]

Executives of Hikvision and Huawei serve as Directors of the NELIVA's ruling Council,[22] and both entities are on the Chinese Military Industrial Complex list sanctioned under President Biden's Executive Order 14032.[23] The Institute of Automation of the Chinese Academy of Sciences ("CASIA") is on the Commerce Department's Entity List[24], and according to a December 2021 report by the Hoover Institution, "In addition to its research and partnerships supporting surveillance and public security, CASIA has partnered with the [People's Liberation Army] PLA; all of the 'Seven Sons of National Defense' (国防七子) universities, which support defense programs as their primary mission; five of China's state-owned defense conglomerates; and a

[17] http://nelivaiczh.com.cn/ (website removed after publication of The Wire China article). About Us – Introduction of Video National Engineering Laboratory (Zhuhai) Innovation Center. Professional translation. "To answer the call from the government to "Shift focus downwards to serve the ordinary people; ensure leaning downwards to serve common workers", on July 1, 2019, the Video National Engineering Laboratory and Zhuhai Jinwan Government jointly formed the Video National Engineering Laboratory (Zhuhai) Innovation Center."
[18] http://www.neliva.com.cn/Index/lists/catid/11.html accessed 11/7/22 Google translate
[19] http://www.neliva.com.cn/Index/lists/catid/11.html accessed 11/7/22 Google translate
[20] https://home.treasury.gov/news/press-releases/sm1073 7/31/2020 "Treasury Sanctions Chinese Entity and Officials Pursuant to Global Magnitsky Human Rights Executive Order"
[21] http://www.neliva.com.cn/Index/lists/catid/10.html accessed 11/9/22
[22] http://www.neliva.com.cn/Index/lists/catid/11.html accessed 11/7/22
[23] https://home.treasury.gov/policy-issues/financial-sanctions/consolidated-sanctions-list/ns-cmic-list, accessed 11/7/22
[24] https://www.bis.doc.gov/index.php/documents/regulations-docs/2326-supplement-no-4-to-part-744-entity-list-4/file accessed 11/4/22

division of China's nuclear weapons complex."[25] Lastly, Sun Yat-sen University is on the Commerce Department's Unverified List[26].

According to a June 1, 2015 Beijing News story posted on the official Cyberspace Administration of China's website, "The First Research Institute of the Ministry of Public Security has been known as the 'National Team of Cyber Security'".[27]

Furthermore, First Research Institute is the organ that designed and implemented what it called Skynet in Xinjiang working with the Public Security Department of Xinjiang Uygur Autonomous Region, an entity on the Treasury Department's Specially Designated Nationals And Blocked Persons List for its role in human rights violations.[28] The First Research Institute announced Skynet in Xinjiang in a January 21, 2015 article posted on the Cyberspace Administration of China's website with the headline: "First Research Institute of the Ministry of Public Security Set Up Four Platforms; Build Anti-Terrorism Anti-Violence 'SkyNet'", stating:

> "The timely handling of the Shule incident indeed was benefited from the 'Four Major Platforms' of the Xinjiang Public Security's Informatization, which the First Research Institute of the Ministry of Public Security and Public Security Department of Xinjiang Uygur Autonomous Region built over a period of three years – Video Information Integration Application Platform, Police Geographic Information Application Platform, National Security Information Application Platform and Internet Service Platform."[29]

To be clear, we do not have information that Cue's surveillance technology was used in Xinjiang or for human rights violations. Nonetheless, the collaboration is concerning, according to Jeffrey Stoff, a former U.S. government official who worked on technology protection and was quoted in *The Wire China* article:

> "'KKR is directly associating with parts of the state that develop surveillance that is responsible for human rights abuses. Even if the particular technology that [KKR] is investing in is deployed for the notionally benign use of temperature detection and Covid detection, it can be easily diverted to reprehensible applications. That needs to be assumed.'"[30]

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[25] Jeffrey Stoff and Glenn Tiffert, Hoover Institution, "Eyes Wide Open: Ethical Risks in Research Collaboration with China", December 2021, p. 5 https://www.scribd.com/document/545616632/Eyes-Wide-Open-Ethical-Risks-in-Research-Collaboration-with-China#download

[26] https://www.bis.doc.gov/index.php/documents/regulations-docs/2713-supplement-no-6-to-part-744-unverified-list/file accessed 11/4/22

[27] http://www.cac.gov.cn/2015-06/01/c 1115476484.htm , dated 6/1/2015, Cyberspace Administration of China website, source Beijing News, professional translation.

[28] https://www.treasury.gov/ofac/downloads/sdnlist.pdf, accessed 11/4/22

[29] http://www.cac.gov.cn/2015-01/21/c 1114068012.htm , dated 1/21/2015, Cyberspace Administration of China website, source Science and Technology Daily, professional translation.

[30] Northrop, Katrina. The Surveillance Stake, *The Wire China* dated February 20, 2022, p. 8 https://www.thewirechina.com/2022/02/20/the-surveillance-stake/

For its part, the Zhuhai Innovation Center's website described two of its public security goals as follows: "build a three-dimensional 'Jinwan Model' for social prevention and control, establish a model for social governance in the Guangdong - Hong Kong - Macao Greater Bay Area."[31] Its research directions included: "conduct research on the safety, stable transmission and application of the installation of moving video surveillance system in the sky, on the ground and under the water".[32] In 2021, its website said it was working with many industries on research subjects "…including comprehensive management of public security, three-dimensional prevention and control for large-scale activities, intelligent communities, safe campus, intelligence safety, AI detection, emergency mass defense and mass control."[33]

The Zhuhai Innovation Center was formed in 2019 across the bay from Hong Kong, before China's imposition of the 2021 National Security Law in that city, the advent of which sparked wide-spread democracy protests in 2019 and 2020. We do not have information that the Zhuhai Innovation Center played a role in police surveillance or suppression of protests in Hong Kong. According to South China Morning Post, China's Ministry of Public Security stated in 2020 that the Ministry would "fully guide and support the Hong Kong -police force in curbing violence and chaos, restoring the order…"[34] Changes in Hong Kong governance have prompted an Advisory to American businesses from the US Departments of State, Treasury, Commerce and Homeland Security regarding electronic surveillance and data collection in the province, among other warnings.[35]

Until February 20, 2022, when *The Wire China* profiled KKR's investment in Cue, Cue's website also contained a video and posting about a prototype of a Cue-branded autonomous vehicle utilizing artificial intelligence and described as "… suitable for public security, fire protection, military, engineering and other fields."[36]

After being approached by *The Wire China*, Cue proceeded to cover-up its collaboration with the Zhuhai Innovation Center and public security products by removing website postings referencing the Zhuhai lab, the use of facial recognition and temperature detection, videos

[31] http://nelivaiczh.com.cn/plus/view.php?aid=14 , Zhuhai Innovation Center website, Inauguration announcement, dated 3/17/2020, accessed 6/1/2021, professional translation. Website no longer accessible.
[32] http://nelivaiczh.com.cn/plus/view.php?aid=14 , Zhuhai Innovation Center website, Inauguration announcement, dated 3/17/2020, accessed 6/1/2021, professional translation. Website no longer accessible.
[33] http://nelivaiczh.com.cn/ Zhuhai Innovation Center website, About Us. Accessed 8/19/2021, professional translation. Website no longer accessible.
[34] https://www.scmp.com/news/hong-kong/law-and-crime/article/3086783/chinas-public-security-ministry-vows-fully-guide-hong South China Morning Post, 5/30/2020
[35] https://www.state.gov/risks-and-considerations-for-businesses-operating-in-hong-kong/
[36] Google translation of posting at https://cue.group/#/newsdetails?id=2021_013 . Posting was removed after The Wire China published "The Surveillance Stake" on 2/20/22. "The product is independently developed and integrates a variety of artificial intelligence technologies, and is suitable for public security, fire protection, military, engineering and other fields."

depicting its AI Facial and Temperature Detector and autonomous vehicle prototype. More recently, Cue has replaced its website outside China with a one-page description removing descriptions of its technology.[37] We can no longer access Cue's Chinese website, if there is one.

In response to our research, KKR told myself and colleagues that the firm tries to ensure that it does not invest in "surveillance capitalism", that it conducts "very careful screening with respect to every investment we make on issues of both privacy, surveillance, as well as geopolitics" and that former Gen. David Petraeus leads a team at the KKR Global Institute to help KKR assess every investment for such risks as a matter of policy.[38]

This investment process is concerning to us. For example, KKR's purported risk review may have missed Cue's own promotion of its collaboration with a lab run by China's surveillance apparatus, even though KKR executives served on Cue's Board of Directors. Or possibly KKR's review may have identified Cue's connections to China's surveillance apparatus and still knowingly invested in it. In whatever case, we find it hard to trust that private equity can sufficiently police itself when it invests in China and other countries of concern.

Cue's surveillance and advertising business paid its investors well. In November 2021, KKR sold a partial interest in Cue to Baring Private Equity Asia, a Hong Kong-based private equity company. KKR Asian Fund III entities received a $235 million dividend following this partial sale and valued their remaining stake in Cue at $215 million at year end 2021.[39] That $450 million valuation for its stake in Cue is more than three and a half times KKR Asian Fund III's original investment of $126 million, made four years earlier.[40]

Money talks, surveillance pays, and the American public needs tools to protect our country's interests. That is even more true when you consider who the investors are in KKR's Cue investment.

KKR Asian Fund III investors include public employee pension funds, like Washington State Investment Board, Florida State Board of Administration, Oregon Treasury, Texas Permanent School Fund and others across the country. We believe it is fundamentally wrong for public employees' retirement to fund any collaboration with China's repressive surveillance state. When we asked public employee pension funds to divest of Cue based on The Wire China's confirmation of Cue's government collaboration, some of the public pension funds said they were limited partners and could not exit individual investments, and one fund said it relies on the federal government to flag investments of national security concern.

[37] https://cue.group/en/ accessed 11/9/22
[38] Notes, conversation 6/21/22
[39] Singapore Corporate Registry, Sino Ad Ultimate Holdings Pte. Ltd. Financial Statements for 2021, p. 23.
[40] Singapore Corporate Registry, Sino Ad Ultimate Holdings Pte. Ltd. Financial Statements for 2021, p. 11.

Therefore, we urge you to give public pension funds, our regulators and American citizens the tools to hold private equity accountable to our own national security and human rights interests by mandating public disclosure of all subsidiaries and investments in countries of national security concern.

One last point about public disclosure: the information used to uncover the Cue story was all public information, required by other countries in which KKR does business. KKR filed a list of indirect subsidiaries in Germany because it was required to. Chinese companies are required to disclose all shareholders in publicly available filings. Singapore and Hong Kong companies must file ownership information. These countries require more public disclosure from companies than we do in the United States, and still they are very profitable countries for private equity investments. So, when KKR and other private equity firms argue their investments are proprietary or secret, ask them why Americans don't deserve the same information they give to China and Singapore.

Thank you for the opportunity to address you on this matter.

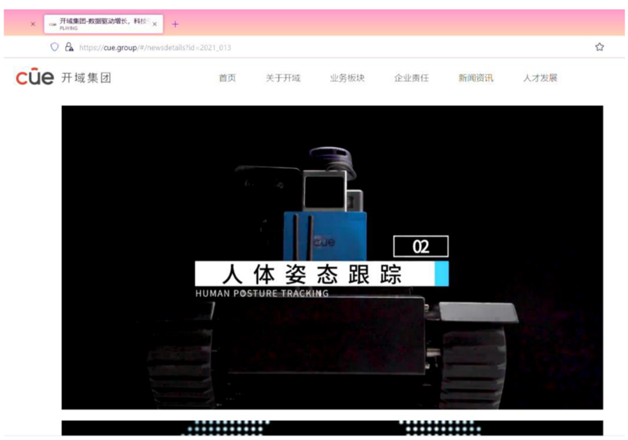
Appendix - Images

CUE Real-Time AI Facial & Body Temperature Detector video on Cue's website, stills captured 5/28/2021

Caption translation:

Analysis of 14-day migration trajectory of passenger flow
Early warning for place of risk origin
Real-time surveillance of passenger flow, early warnings for high-density mass gathering

Cue Autonomous Vehicle Prototype, from Cue video on LinkedIn, captured 2/20/2022



Testimony before the U.S. House Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

Investing in our Rivals:
Examining U.S. Capital Flows to Foreign Rivals and Adversaries Around the World

Claire Chu
Senior China Analyst, Janes Group

November 15, 2022

Chairman Sherman, Ranking Member Huizenga, and members of the Subcommittee, thank you for the opportunity to appear here today.

I'm a senior China analyst at Janes, an open-source defense and geopolitical intelligence firm. I specialize in Chinese foreign policy and security policy, and in particular, the intersection of economic engagement and national security. In particular, I study how the Chinese government manipulates private-sector interests and commercial relationships in order to achieve strategic policy objectives.

Last year, I testified before the Subcommittee on the risks to investors posed by Chinese issuers in the U.S. markets. I provided context on the nature of Chinese corporate actors and their role in China's state-led economy, followed by recommendations for policymakers and government stakeholders. I'm pleased and excited to see that some of these ideas, such as widening the scope of the SEC's regulatory jurisdiction to treat index providers as investment advisors, have been amplified by congressional and federal efforts.[1]

Today, I have been asked to speak on U.S. capital flows to China in light of the U.S. response to Russia's invasion of Ukraine, and the various ways in which U.S. institutional investors and public funds are exposed to China-specific material financial risk. I will also provide

[1] "SEC Requests Information and Comment on Advisers Act Regulatory Status of Index Providers, Model Portfolio Providers, and Pricing Services," U.S. Securities and Exchange Commission, June 15, 2022, https://www.sec.gov/news/press-release/2022-109.

recommendations for ways in which the United States can refine its economic and financial toolkit to counter future threats to peace, security and prosperity.

U.S. Economic and Financial Statecraft in Recent Years

The concept of economic statecraft is not new. President Roosevelt formed the now-defunct U.S. Board of Economic Warfare in 1941 to coordinate international economic and defense policy, characterizing the agency's scope as "of commerce and shipping, of barter and buying, of loans and agreements, of blacklist and blockade … It means fighting the tank before it is a tank, smashing the submarine before it can go to sea. It means preventing the Axis from getting raw materials. It means getting raw materials for our production."[2]

And yet the national security community today, with its predilection for conventional armed forces, has been at times reticent to recognize the international financial system as a warfighting domain and commercial actors as potential adversaries. Classic economic sanctions and export controls are par for the course, but the Pentagon does not want to encroach on what it considers to be Wall Street's territory. Bankers and financiers are uninterested in the "politicization" of private markets, and do not feel compelled by "non-material" U.S. foreign policy objectives to contradict their profit-seeking, fiduciary responsibilities.[3]

In December 2017, the Trump Administration released its National Security Strategy and declared, "economic security is national security." The document called for the use of "economic expertise, markets, and resources" to reinforce ties with allies while applying economic and financial pressure on adversaries. It indicated a major focus on the economy as a pillar of national security, representing a policy shift towards integrating economic and security policy in order to counter foreign economic aggression in a broader strategic context.[4]

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[2] Tor Egil Førland, "'Economic Warfare' and 'Strategic Goods': A Conceptual Framework for Analyzing COCOM," Journal of Peace Research, vol. 28, no. 2, 1991, http://www.jstor.org/stable/424388.

[3] The former chief investment officer of the Employees Retirement System of Texas (ERS) gave an interview where was asked about the "weaponization of policy" by which the U.S. government is preventing pension funds from allocating funds to certain Chinese securities. His response: "I think there are two complications whenever governments get involved in dictating on where, how [and] when you get to invest … Whenever governments get involved it muddies the water." Iain Bell, "Exclusive Interview with Tom Tull: Be Proactive, but Don't Feel Pressure to Invest," Markets Group, October 18, 2022, https://www.marketsgroup.org/news/Exclusive-Tom-Tull.

[4] "National Security Strategy of the United States of America," The White House, December 2017, https://history.defense.gov/Portals/70/Documents/nss/NSS2017.pdf?ver=CnFwURrw09pJ0q5EogFpwg%3d%3d.

The Biden Administration has carried forward this spirit of great power competition. The new National Security Strategy released in October 2022 envisions a strategic competition toolkit incorporating both industrial strategy and economic statecraft, and seeks to galvanize private industry to "protect our core economic and national security interests."[5] Earlier in the year, the United States responded to Russia's invasion of Ukraine with a sweeping range of economic sanctions, financial restrictions, and export controls intended to isolate Russia from the world economy and legitimate financial system. The sanctions, imposed in coordination with several U.S. allies and partners, have been characterized in government statements as unprecedented in scope, scale, and speed.[6,7]

U.S. Investor Response to Russia: Sanctions and Divestment Efforts

Following Russia's invasion of Ukraine in February 2022, the U.S. government enacted a suite of sanctions targeting key sectors of the Russian economy in order to degrade the Russian military's warfighting capabilities. The sanctions packages have included measures to target Russian military production and supply chains, an Executive Order prohibiting all U.S. investment in Russia, and restrictions on Russia's ability to participate in the global financial system.

Outside of Russia, third party countries such as China have been targeted by U.S. sanctions authorities for providing support to Russia's military. In June 2022, the U.S. Department of Commerce's Bureau of Industry and Security (BIS) added five Chinese companies to the Entity List for providing unspecified support to Russia's military and/or defense industrial base.[8,9] The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) has also issued guidance indicating willingness to enforce its Russia sanctions programs with secondary

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[5] "National Security Strategy," The White House, October 2022, https://www.whitehouse.gov/wp-content/uploads/2022/10/Biden-Harris-Administrations-National-Security-Strategy-10.2022.pdf.
[6] "FACT SHEET: United States and Allies and Partners Impose Additional Costs on Russia," The White House, March 24, 2022, https://www.whitehouse.gov/briefing-room/statements-releases/2022/03/24/fact-sheet-united-states-and-allies-and-partners-impose-additional-costs-on-russia/.
[7] "U.S. Treasury Announces Unprecedented & Expansive Sanctions Against Russia, Imposing Swift and Severe Economic Costs," U.S. Department of the Treasury, February 24, 2022, https://home.treasury.gov/news/press-releases/jy0608.
[8] "Commerce Rule Applies Powerful Restrictions Directly on Entities Seeking to Supply Russia's Military Since Start of Invasion of Ukraine," U.S. Department of Commerce, Bureau of Industry and Security, June 28, 2022, https://www.bis.doc.gov/index.php/documents/about-bis/newsroom/press-releases/3042-2022-06-28-bis-press-release-russia-backfill-entity-list/file.
[9] "Addition of Entities, Revision and Correction of Entries, and Removal of Entities From the Entity List," Federal Register, June 30, 2022, https://www.federalregister.gov/documents/2022/06/30/2022-14069/addition-of-entities-revision-and-correction-of-entries-and-removal-of-entities-from-the-entity-list.

sanctions, and has subsequently designated a Chinese entity for providing "financial, material, or technology support" for a Russian defense procurement firm.[10]

Russian Stocks, Index Providers, and Financial Risk

On February 28, four days after Russian forces invaded Ukraine, both the New York Stock Exchange and Nasdaq temporarily halted trading in stocks of Russia-based companies, citing "regulatory concern" in light of U.S. and allied sanctions.[11] The stocks were not delisted, and U.S. investors are not required to divest Russian debt and equity securities if they were acquired prior to the new investment prohibitions issued in spring 2022 under a tranche of Executive Orders issued by President Biden.[12]

Major global index providers began removing Russian equities from their widely tracked indexes during the first week of March 2022. Russia was deleted from all FTSE Russell Equity Indexes effective March 7. [13] MSCI and S&P Dow Jones Indices (DJI) followed closely behind and both reclassified Russia from Emerging Markets to Standalone Markets status on March 9, removing Russian securities from any index with global exposure.[14,15] All index constituents listed on the Moscow Exchange (MOEX) were affected, including companies involved in key sectors such as banking, power production, mineral extraction, oil, and military equipment.

This was not an ethical response to Russia's aggression in Ukraine, so much as a financial choice. There were technically no profits forfeited because the Moscow Exchange (MOEX) had suspended trading on all markets. As a result, Russian stocks became inaccessible, worthless, and effectively uninvestable. Had the index providers divested from Russia back when it

[10] "Sanctions Update: EU and US Impose New Sanctions and Export Controls Relating to Russia," Latham & Watkins, October 11, 2022, https://www.lw.com/admin/upload/SiteAttachments/Alert-3019.pdf.
[11] Alexander Osipovich, "NYSE and Nasdaq Halt Trading in Russian Stocks," The Wall Street Journal, Feburary 28, 2022, https://www.wsj.com/livecoverage/russia-ukraine-latest-news-2022-02-28/card/nyse-and-nasdaq-halt-trading-in-russian-stocks-cTRdEpwhpdUspKwAISo1.
[12] "FAQ: Russian Harmful Activities Sanctions," U.S. Department of the Treasury, updated July 22, 2022, https://home.treasury.gov/policy-issues/financial-sanctions/faqs/1054.
[13] "Treatment of Russia in FTSE Russell Equity Indices," FTSE Russell, March 2, 2022, https://research.ftserussell.com/products/index-notices/home/getnotice/?id=2603553.
[14] "MSCI to Reclassify the MSCI Russia Indexes from Emerging Markets to Standalone Markets Status," MSCI, March 2, 2022, https://ir.msci.com/news-releases/news-release-details/msci-reclassify-msci-russia-indexes-emerging-markets-standalone.
[15] "S&P Dow Jones Indices' Consultation on Sanctions and Russia Market Accessibility – Results," S&P Global, March 4, 2022, https://www.spglobal.com/spdji/en/documents/indexnews/announcements/20220304-1450352/1450352_spdjiconsultationonsanctionsandrussiamarketaccessibilityresults3-4-2022.pdf.

invaded and annexed Crimea in 2014, then there might be plausible deniability that the decisions were driven by moral principles.

Index providers have already outlined a way for removed Russian securities to rejoin global indexes. Although MOEX partially reopened at the end of March 2022, restrictions that bar foreign investors from offloading stocks still remain in place.[16] FTSE Russell has stated that once regular trading resumes on MOEX and "restrictions on non-resident investors have been lifted," the Russian securities will be re-evaluated for inclusion during an annual classification review.[17] MSCI and S&P DJI will also consider potential re-inclusion of Russia into their Emerging Markets indexes during 2023 annual review processes.[18,19]

Institutional Investors Face Russia Divestment Obstacles

Large public pension plans acted quickly to try to reduce their Russia exposure. Within a week of the invasion, state legislatures began announcing pledges to divest Russia-linked investments. Leadership at many state retirement and pension funds issued public statements raising the moral imperative for divestment. Connecticut's state treasurer directed the Connecticut Retirement Plans & Trust Funds to divest its Russian holdings, stating in a news release that: "We cannot stand idly by as the humanitarian crisis unfolds and Russian markets crumble, and I cannot continue to invest these pension funds in a way that runs counter to the foreign policy and national interests of the United States."[20] In March, 36 state treasurers that signed a joint letter advocating for Russia divestment also referenced a financial reason behind their stance: "The current crisis also constitutes a substantial risk for states' investments and our economic security."[21]

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[16] Eshe Nelson, "Russia's stock index reopens and rises with government intervention," March 24, 2022, https://www.nytimes.com/2022/03/24/business/russian-stock-exchange-moex.html.
[17] "Treatment of Russia in FTSE Russell Equity Indices," FTSE Russell, March 2, 2022, https://research.ftserussell.com/products/index-notices/home/getnotice/?id=2603553.
[18] "Q&A: Reclassification of MSCI Russia Indexes to Standalone Markets Status," MSCI, March 2022, https://www.msci.com/eqb/methodology/meth_docs/QAMSCI_Russia.pdf.
[19] "S&P Dow Jones Indices' Consultation on Sanctions and Russia Market Accessibility – Results," S&P Global, March 4, 2022, https://www.spglobal.com/spdji/en/documents/indexnews/announcements/20220304-1450352/1450352_spdjiconsultationonsanctionsandrussiamarketaccessibilityresults3-4-2022.pdf.
[20] Geoff Mulvihill, "Russia divestment promises by US states largely unfulfilled," August 26, 2022, https://apnews.com/article/russia-ukraine-economy-government-and-politics-78ab15796482b16077baedeb68d354c2.
[21] "McRae: Divesting from Russian Investments to Support Ukraine," State Treasury of Mississippi, March 25, 2022, https://treasury.ms.gov/2022/03/25/mcrae-divesting-from-russian-investments-to-support-ukraine/.

Although there were no formal divestment mandates enacted, some state institutions and fund administrators were called on by state governors including New York Gov. Kathy Hochul and California Gov. Gavin Newsom in early March to sell their holdings. An Associated Press review found in August 2022 that it had become apparent it was very difficult for institutional investors to sell their virtually worthless stocks.[22] Most public funds would have lost money whether they voted to divest from Russia or not.

The California Public Employees' Retirement System (CalPERS) did not attempt to sell, and the value of its Russia investments went from $765 million at the time of the invasion to $194 million by the end of June 2022.[23] The MOEX continues to maintain strict capital controls on foreign investors, and a significant portion of public funds' exposure to Russia is tied up in investment vehicles such as exchange-traded funds (ETFs) and index funds that cannot sell their underlying securities.

Targeting China with Economic and Financial Sanctions

The unprecedented and expansive nature of the economic and financial sanctions imposed on Moscow has raised the specter of the U.S. taking a similar approach with Beijing if red lines were to be crossed. Although China and Russia are often mentioned in the same breath when it comes to the U.S. national security landscape and great power competition, they present very different challenges for Washington.

The Russian readout of a June 2022 phone call between General Secretary Xi Jinping and Russian President Vladimir Putin stated that Russia and China agreed to "expand cooperation in energy, finance, the manufacturing industry, transport, and other areas, taking into account the global economic situation that has become more complicated due to the illegitimate sanctions policy pursued by the West."[24] Interestingly, these details were not included in the Chinese readout of the call.[25] In some industries, such as cross-border payments, transport and logistics, and energy, China has stepped in as other countries have shifted away. But in general,

[22] Geoff Mulvihill, "Russia divestment promises by US states largely unfulfilled," August 26, 2022, https://apnews.com/article/russia-ukraine-economy-government-and-politics-78ab15796482b16077baedeb68d354c2.
[23] Wes Venteicher, "Plummeting stocks and a Moscow shopping mall. CalPERS is stuck with its Russia investments," The Sacremento Bee, July 25, 2022, https://www.sacbee.com/news/politics-government/the-state-worker/article263749188.html.
[24] "Telephone conversation with President of China Xi Jinping," Presidential Executive Office (Kremlin), June 15, 2022, archived at https://web.archive.org/web/20220615171638/http:/en.kremlin.ru/events/president/news/68658.
[25] "Summary: China's Position on Russia's Invasion of Ukraine," U.S.-China Economic and Security Review Commission, October 27, 2022, https://www.uscc.gov/research/chinas-position-russias-invasion-ukraine.

Chinese companies appear to have scaled back operations in Russia to avoid exposure to secondary sanctions, despite lip service to the contrary.

China has a significantly larger economy than Russia, and a more sophisticated financial and monetary system. It is deeply integrated into global value chains and markets while also endeavoring to build a parallel system of international economic institutions. By the end of 2021, there were 26 million registered companies in Russia, compared to 48.42 million companies registered in China (not including Chinese companies domiciled in Hong Kong).[26] Bloomberg has estimated that Russia's stock market was valued at $781 billion at the start of 2022, compared with the cumulative value of $19 trillion of the mainland China and Hong Kong exchanges.[27] And data compiled by CSIS shows that in 2021, "Chinese banks had more than 30 times as many assets as Russian banks, and cumulative foreign direct and portfolio investment in China was more than six times the amount that had flowed into Russia."[28]

The scale of U.S. economic and financial exposure to China is significantly greater than it is to Russia, and some analysts have wondered whether China's weight in the global economy – despite recent data indicating an incoming recession or economic contraction – insulates it from Western sanctions. Mikael Wigell of the Finnish Institute of International Affairs observed in April 2022 that the U.S. and Europe are more comfortable using financial sanctions due to their central role in the global economy's financial architecture. Whereas China "is not central in the financial world economy, so China doesn't … use financial sanctions very effectively. But China can use trade sanctions effectively. It has a lot of effect when it does."[29] This is not to say that Washington cannot win in an economic or financial war with Beijing, but the stakes are high and the United States' strategy will be different from what is being deployed to deter and punish Russia.

Passive Investment, Exposure to Risky Corporate Structures

Variable interest entities (VIEs) are legally ambiguous corporate structures that Chinese companies frequently employ to list on U.S. exchanges to meet the requirements of listing on

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[26] Data retrieved from Statista.
[27] Sofia Horta e Costa, "China Markets in Turmoil as Russia Ties Add to List of Risks," March 11, 2022, https://www.bloomberg.com/news/articles/2022-03-11/china-s-markets-in-crisis-as-russia-ties-add-to-list-of-risks.
[28] Gerard DiPippo, "Deterrence First: Applying Lessons from Sanctions on Russia to China," CSIS, May 3, 2022, https://www.csis.org/analysis/deterrence-first-applying-lessons-sanctions-russia-china.
[29] "What are sanctions, and are we in a new era of economic war? This week's Radio Davos," World Economic Forum, April 8, 2022, https://www.weforum.org/agenda/2022/04/what-are-sanctions-radio-davos/.

U.S. and other foreign securities exchanges, allowing Chinese companies to raise funds overseas. The VIE model allows overseas listed entities to control domestic Chinese business entities through a series of agreements and offshore shell companies. Because of the complex holding structure, U.S. investors have no legal recourse to the underlying assets of VIE-structured Chinese companies. A 2017 report by the Council of Institutional Investors (CII) found that VIE corporate structures had been used by 62% of Chinese companies listed on U.S. exchanges at the time.[30]

The popularity of passive investment strategies, which allow fund managers to delegate their investment decisions to index providers, gives companies using VIE structures a steady pool of willing buyers that perform no analysis of company fundamentals to assess whether the underlying assets of a Chinese stock, for example, are real. ETFs and other index products are derivative instruments that mimic the performance of the securities in a target index created by an index provider like MSCI, FTSE Russell, or S&P DJI, and cannot sell off problematic or risky holdings without violating fiduciary duty to parallel the returns of the benchmark index as closely as possible. And index providers that are responsible for the underlying indexes do not assess business fundamentals beyond market capitalization, liquidity, and other technical attributes.

Institutional Investors and China Investment Strategy

Public employee pension funds, endowment funds, and other institutional investors invest in diversified portfolios across stocks, fixed-income securities, U.S. and foreign government bonds, alternative investments (private equities, hedge funds), and other asset classes. Fund administrators may employ managers for a portion of their portfolio and rely on passive investment strategies to gain additional exposure to specific industries or geographic areas. U.S. investor access to publicly traded Chinese companies has expanded dramatically over the past few years with the rapid inclusion and weighting of China A-shares in major global stock indexes – and consequently, in investment products that benchmark against them.[31]

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[30] Brandon Whitehill, "Buyer Beware," Council of Institutional Investors, December 2017, https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf.

[31] A-Shares are mainland Chinese companies that trade on the Shanghai Stock Exchange or the Shenzhen Stock Exchange. Prior to the inclusion of A-Shares in 2018, global index providers had exposure only to H-Shares, which are Chinese companies listed on the Hong Kong Exchange.

After the A-Share transition began in 2018, index products with Emerging Markets (EM) and global mandates quickly flooded with Chinese company stocks. Over 1,500 A-shares were available to U.S. retail and institutional investors as of August 2020. As mentioned above, the criteria used by index providers to decide whether to add or remove securities are strictly financial and based on standardized attributes like company size, market capitalization, and liquidity, regardless of business fundamentals.[32] As a consequence, many of the publicly traded companies included were associated with various reputational, regulatory, and supply chain risk factors including non-proliferation sanctions, advanced weapons manufacturing, and providing surveillance technology used in the Chinese government's detention facilities and prisons.[33] U.S. investors were inadvertently supporting Chinese companies involved in activities contrary to the national security and foreign policy interests of the United States.

Some of this risk exposure was neutralized with the Trump Administration's issuance of Executive Order (E.O.) 13959, which prohibited Americans from holding the securities of Chinese military companies as designated by the U.S. Department of Defense.[34] In June 2021, this divestment authority was strengthened when President Biden issued E.O. 14032 to include not only Chinese military-industrial complex companies (CMICs), but also Chinese surveillance technology companies and the direct owners and subsidiaries of CMICs. The new list of Chinese companies subject to this divestment mandate has been expanded in the past year, but is not comprehensive and is not synchronized with other U.S. sanctions authorities. For example, the China A-Shares that U.S. institutions continue to have investment exposure to, via index products, include AECC Aviation Power (AVIC) Co., Ltd., which has been designated as a Military End User (MEU) by the U.S. Department of Commerce's Bureau of Industry and Security, and Avicopter Plc, which has developed helicopters currently in service with the People's Liberation Army (PLA) Air Force, Navy, and Ground Force Army.[35,36,37]

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32 "Comparing benchmark providers," Vanguard, accessed on November 11, 2022, https://institutional.vanguard.com/VGApp/iip/institutional/csa/investments/benchmarks/home.
33 Zhen Wei, "China A Shares: What Have We Learned?," MSCI, October 30, 2020, https://www.msci.com/www/blog-posts/china-a-shares-what-have-we/02164045217.
34 "Executive Order on Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," The White House, June 3, 2021, https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/.
35 "Commerce Department Will Publish the First Military End User List Naming More Than 100 Chinese and Russian Companies," U.S. Department of State, Global Public Affairs, December 21, 2020, https://2017-2021-translations.state.gov/2020/12/21/commerce-department-will-publish-the-first-military-end-user-list-naming-more-than-100-chinese-and-russian-companies/index.html.
36 "Harbin Z-19 (Black Whirlwind) (WZ-19)," Military Factory, last edited July 6, 2020, https://www.militaryfactory.com/aircraft/detail.php?aircraft_id=992.
37 "CAIC Z-18," Military Factory, last edited August 12, 2022, https://www.militaryfactory.com/aircraft/detail.php?aircraft_id=2273.

State and Federal Pension Funds

Some states are more bullish on Chinese markets than others. The California State Teachers' Retirement System put out a hiring notice in August 2022 for China public equity managers to establish three new investment categories targeting Greater China, China A-share, and MSCI China securities.[38] Months earlier, in May, the Massachusetts Pension Reserves Investment Trust's Management Board (PRIM) approved a $150 million commitment to four funds managed by venture capital firm Sequoia China.[39] PRIM has already hired the partially Chinese state-owned China International Capital Corp. as a pension fund brokerage firms.[40] This new commitment increases PRIM's China exposure at a time when other public retirement systems are re-evaluating their China investment strategy and considering reducing their holdings to hedge against heightened risks and uncertainty.

One such system is the Florida Retirement System, which entirely stopped funding new China investments in April 2022 pending a review of "increasing risks" to investors, including volatility in China's education and tech sectors.[41] The Teacher Retirement System of Texas secured approval in September 2022 to halve its China investment exposure from 3% to 1.5%.[42] And the Tennessee Consolidated Retirement System (TCRS) manages what is perhaps the only state public pension fund with no known exposure to China or Russia, because TCRS actively screens out countries based on levels of democracy by investing in country-focused ETFs.[43]

At the federal level, the Federal Retirement Thrift Investment Board (FRTIB), which manages retirement savings on behalf of U.S. service members and government employees, is facing pressure to address concerns about the Thrift Savings Plan (TSP)'s exposure to Chinese military companies.[44] The Board introduced a mutual fund window in summer 2022 that offers investors

[38] Rob Kozlowski, "CalSTRS launches first search for China equity managers," Pensions & Investments, August 30, 2022, https://www.pionline.com/searches-and-hires/calstrs-launches-first-search-china-equity-managers.
[39] "PRIM Board Quarterly Update First Quarter 2022," MassPRIM, May 2022, https://mtrs.state.ma.us/wp-content/uploads/2022/05/Q1-2022-PRIM-Board-Quarterly-Update-FINAL.pdf.
[40] "Annual Comprehensive Financial Report, Fiscal Year 2021," MassPRIM, December 2021, https://www.mapension.com/wp-content/uploads/2021/12/ACFR_Fiscal_Year_2021.pdf.
[41] Jessica Hamlin, "Florida SBA Halts Funding to Chinese Investments," Institutional Investor, April 6, 2022, https://www.institutionalinvestor.com/article/b1xhgfxdgt6byc/Florida-SBA-Halts-Funding-to-Chinese-Investments.
[42] "Texas Teachers' Pension to cut China target allocation," Reuters, October 14, 2022, https://www.reuters.com/world/us/texas-teachers-pension-cut-china-target-allocation-2022-10-14/.
[43] Heather Bell, "Well-Funded TCRS Is Primarily Active," ETF.com, February 12, 2014, https://www.etf.com/publications/journalofindexes/joi-articles/20761-well-funded-tcrs-is-primarily-active.html?nopaging=1.
[44] Ralph R. Smith, "TSP Investments in China: No TSP for the CCP?," FedSmith, August 11, 2022, https://www.fedsmith.com/2022/08/11/tsp-china-investments-mutual-fund-window/.

access to 4,728 mutual funds. The options include international funds, such as the Vanguard FTSE All World ex U.S. Index Fund and Vanguard Emerging Markets Stock Index Fund – both of which include publicly traded Chinese companies that are involved with China's military-industrial complex and/or affiliated with Chinese companies that have been subject to the Executive Order's divestment mandate.[45] This is the second chapter in the TSP saga, in which the FRTIB had planned to benchmark its International Fund against an index with heavy China exposure, and the White House intervened in May 2020 before the transition took place, citing the "significant and unnecessary risk" of investing federal retirement funds in Chinese companies posing national security risk.[46]

University Endowment Funds

Although public universities operate using taxpayer dollars and ought to be subject to open records acts, very few have publicly released their endowment portfolios with information on individual debt and equity holdings. In 2016, the Associated Press sent open records requests for investment disclosures from 50 universities, both public and private, and was met with refusals from 39 schools and no response from four. The public universities that responded provided only limited records, revealing a sampling or aggregate view of their portfolios. Universities and colleges often employ what has been referred to as a "stealth investment strategy" when it comes to endowment funds.

This aversion to public disclosure can be attributed to reasons including the desire to avoid political influence or scrutiny, fiduciary responsibility to maximize returns, concerns about competitive advantages, and confidentiality agreements with external investment managers and consultants.[47]

A California court ruled in December 2013 that the University of California was not obligated to disclose investment return information for its externally-managed endowment fund, despite previous rulings that the return information was to be considered public record under the

[45] "TSP Mutual Fund Window (MFW) — List of all available funds," TSP Folio, accessed November 10, 2022, https://www.tspfolio.com/mfw/mutualfundlist.
[46] Demetri Sevastopulo, "Trump orders federal pension fund not to invest in Chinese stocks," Financial Times, May 12, 2020, https://www.ft.com/content/37ee5097-8ae2-4bc6-9c1f-048a242a4f33.
[47] Collin Binkley, "Colleges secretive about endowment investments," Associated Press via Milwaukee Journal Sentinel, March 17, 2016, http://archive.jsonline.com/news/statepolitics/colleges-secretive-about-endowment-investments-b99689686z1-372399571.html.

California Public Records Act.[48] As a result of the University of Michigan's lobbying efforts, the State of Michigan enacted the "Confidential Research and Investment Information Act" in April 1994, exempting public universities and colleges from the public disclosure of certain investment information when provided by a private external source (for example, private equity or venture capital fund).[49] And when asked to disclose its investment portfolio, the University of Virginia has claimed exemption because its endowment resources are housed externally with the University of Virginia Investment Management Company, which was involved in the May 2019 joint filing of a legal brief in opposition to an expansion of the Virginia Freedom of Information Act that would increase transparency and openness in University fundraising and investment activity.[50]

To a certain extent, we can deduce undisclosed but passively managed investment holdings by referencing the investment benchmark indexes due to the close replication of their underlying securities. The MSCI All Country World Index (ACWI) created by Morgan Stanley is one of the most popular options for institutions seeking exposure to a range of developed and emerging market companies. It has exposure to large swaths of Chinese and (formerly) Russian securities, which include companies that have not been screened for reputational, regulatory, or supply chain risk factors. As of 2021, all three universities – the University of California, University of Michigan, and University of Virginia – benchmark passive investments against MSCI ACWI or a derivative.[51,52,53]

In June 2022, Rep. Greg Murphy sent a letter to 15 private universities with a request for them to divest problematic Chinese companies and "adversarial entities."[54] After receiving what he characterized as "lackluster responses" to the letter, Murphy introduced a bill in July that uses

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[48] Sarah McBride, "University of California need not disclose venture returns: court," Reuters, December 19, 2013, https://www.reuters.com/article/us-funds-california-ucal/university-of-california-need-not-disclose-venture-returns-court-idUSBRE9BJ04I20131220.

[49] "Confidential Research and Investment Information Act," Michigan State Legislature, April 5, 1994, accessed November 10, 2022, http://www.legislature.mi.gov/%28S%285gg10rn2wbsibe453kyedb45%29%29/documents/mcl/pdf/mcl-Act-55-of-1994.pdf.

[50] Ruth Serven Smith, "UVA foundations support donor privacy effort," The Daily Progress, June 8, 2019, https://www.dailyprogress.com/news/uva/uva-foundations-support-donor-privacy-effort/article_5b3c152c-8a3e-11e9-b314-2322ff1b3f6d.html.

[51] "Annual Report 2020-2021," Office of the Chief Investment Officer of the Regents, June 30, 2021, https://www.ucop.edu/investment-office/210924_ucannualreport2021_digital.pdf.

[52] "Report of Investments 2021," University of Michigan, December 6, 2021, https://www.bf.umich.edu/wp-content/uploads/2021/12/2021.ROI_.Final_.12.6.2021.pdf.

[53] "Annual Report 2020-2021," University of Virginia Investment Management Company, 2021, https://s3.amazonaws.com/cdn.vssl.io/files/UVIMCO%202021%20Annual%20Report.pdf.

[54] Phelim Kline, "Congress targets Harvard, Yale and top universities with China-linked endowments," June 9, 2022, https://www.politico.com/news/2022/06/09/congress-targets-harvard-yale-and-top-universities-with-china-linked-endowments-00038625.

tax incentives to pressure university endowments on the issue of divestment.[55] In what appears to be an indirect response, the University of California's investment arm stated in September 2022 that it was working to taper its China investment exposure, while sources claim that Harvard University's endowment is considering reducing its holdings in China as well.[56,57]

Alternative Investments: Private Funds

Broadly speaking, the private market consists of alternative investments such as hedge funds, private equity funds, and venture capital funds that raise capital in private, outside of the public markets – all while being shielded from SEC registration requirements. Under to the Investment Company Act of 1940, private funds are considered "pooled investment vehicles" rather than investment companies and are therefore exempt from the rules and regulations governing investment company activity. Someone who manages private funds, however, is required to register as an investment advisor with the SEC.[58]

Private funds, which represent a significant portion of institutional portfolios, essentially function as unregistered investment vehicles that are not required to verify or disclose investors' identities, source of funds, or other credentials. This presents an ideal environment for Russian oligarchs to park their wealth, and for Chinese state-owned entities to gain non-transparent access to U.S. businesses and technologies of strategic significance.

Chinese private equity and venture capital have an outsized role in financing U.S. high-tech chip innovation. This is particularly evident when looking into the origin of the private funds backing artificial intelligence (AI) chip start-ups in Silicon Valley. SambaNova Systems is based in Palo Alto, California and builds AI hardware and systems. It is primarily backed by major players such as Google Ventures, Intel Capital, and BlackRock, but has also received funding from Walden International, a San Francisco-based venture capital firm with close ties to China, and Redline Capital, a UK venture capital firm with close ties to Russia.

[55] "Murphy Introduces Bill to Pressure University Endowments to Divest from Dangerous Chinese Entities," Congressman Greg Murphy, July 21, 2022, https://gregmurphy.house.gov/media/press-releases/murphy-introduces-bill-pressure-university-endowments-divest-dangerous-chinese.
[56] David G. Barry, "UC Investments Seeks to Reduce China Holdings," Markets Group, September 22, 2022, https://www.marketsgroup.org/news/UC-Investments-China.
[57] Cathy Chan and Janet Lorin, "Investor pullback shows private equity funds' China struggle," Bloomberg, April 10, 2022, https://www.bloomberg.com/news/articles/2022-04-10/harvard-endowment-s-debate-shows-private-equity-s-china-struggle#xj4y7vzkg.
[58] "Private Fund," U.S. Securities and Exchange Commission, accessed November 12, 2022, https://www.sec.gov/education/capitalraising/building-blocks/private-fund.

- Walden International has offices in Beijing and Shanghai and claims to enjoy "extensive government and industry relationships [in China] that bring critical added value."[59] The firm's chairman is a founding shareholder of Chinese state-owned Semiconductor Manufacturing International Corporation (SMIC). In July 2011, Walden International partnered with the National Development Reform Commission of China and the Shanghai municipal government to launch a venture capital fund to invest in Chinese semiconductor companies.[60]

- Before joining Redline, partner Tatiana Evtushenkova was an advisor to the CEO of Sberbank and also served as vice president at Mobile Telesystems (MTS) – which has been sanctioned by the U.S. under the Foreign Corrupt Practices Act in 2019 and delisted by the NYSE. Tatiana has also headed M&A at Sistema Telecom, where her oligarch father, Vladimir Yevtushenkov, is the chairman. Another Redline partner is Alastair Cookson, who previously worked as a managing director at Russian investment bank Renaissance Capital.

One of the most prominent names in American venture capital and private equity is Sequoia Capital. The firm is headquartered in Menlo Park, California but has substantial interests in China, including offices in Beijing and Shanghai, and a subsidiary in Hong Kong known as Sequoia Capital China Advisors. In 2016, Sequoia China established a new venture capital fund with a Chinese state-owned enterprise that invests in new emerging industries and sectors related to national security.[61,62] Sequoia has backed controversial companies such as machine-learning firm Yitu Technology and drone manufacturer DJI Technology, both of which have been sanctioned by the U.S. government and are subject to capital markets restrictions for their involvement in the Chinese government's mass surveillance apparatus in Xinjiang.

[59] "Walden International, China," Walden International, accessed November 13, 2022, archived at https://archive.ph/nBP8b.
[60] "Walden International Announces New China Semiconductor Industry Focused Fund," Walden International, July 6, 2011, http://www.waldenintl.com/docs/ShanghaiWaldenVentureCapitalFund.pdf.
[61] "China Reform Holdings Corporation Ltd," China Daily, December 5, 2018, https://govt.chinadaily.com.cn/s/201812/05/WS5c0744f7498eefb3fe46e2ba/china-reform-holdings-corporation-ltd.html.
[62] "Member Overview: China Reform Fund," Zhongguancun Private Equity & Venture Capital Association (中关村股权投资协会), accessed on November 12, 2022, archived at https://web.archive.org/web/20210617001821/http://www.zvca.org/enindex.php/a/7367.html.

The biggest private equity investors are pension funds and university endowments.[63] Of the 178 U.S. public pension funds that the American Investment Council examined in its annual study, 85% had some level of private equity fund exposure.[64] The amount of state and local pension funds' private equity investments has also grown steadily in recent years, climbing from around $300 billion in 2018 to $480 billion in 2021, according to investment data provider Preqin.[65] As such, U.S. institutional investors that have taken steps to divest problematic or risky Chinese and Russian companies may continue to have high levels of exposure through private equity investments.

Over the past year, federal regulators have rallied around plans to expand oversight of private markets and increase reporting requirements to address the lack of transparency. The SEC has voted twice to propose amendments to the reporting form for SEC-registered investment advisors. The January proposal, which was approved on February 9, will lower the reporting threshold, introduce new timely reporting requirements, and require advisors to disclose more granular details about their portfolio holdings.[66,67] The August proposal, if adopted, would require fund advisors to provide additional identifying information about themselves and their funds, such as details about beneficial ownership, creditors, and operations.[68]

Recommendations

Establish an interagency committee of the U.S. government to develop programs to strengthen U.S. international economic relations and to coordinate the federal government's policies and activities in response to various economic and financial issues related to foreign policy and national security.

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[63] Drew Maloney, "America for Sale? An Examination of the Practices of Private Funds," U.S. Congress, Hearing of the House Financial Services Committee, November 19, 2019, https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-maloneyd-20191119.pdf.
[64] "2021 Public Pension Study," American Investment Council, July 2021, https://www.investmentcouncil.org/wp-content/uploads/2021/07/2021_pension_report.pdf.
[65] Heather Gillers, "Retirement Funds Bet Bigger on Private Equity," The Wall Street Journal, January 10, 2022, https://www.wsj.com/articles/retirement-funds-bet-bigger-on-private-equity-11641810604.
[66] "SEC Proposes Amendments to Enhance Private Fund Reporting," U.S. Securities and Exchange Commission, January 26, 2022, https://www.sec.gov/news/press-release/2022-9.
[67] Celia Cohen, "US SEC approves proposal to adopt broad disclosure rules for private investment funds," Norton Rose Fulbright, February 14, 2022, https://www.nortonrosefulbright.com/en/knowledge/publications/bc84e594/us-sec-approves-proposal-to-adopt-broad-disclosure-rules-for-private-investment-funds.
[68] "SEC Proposes to Enhance Private Fund Reporting," U.S. Securities and Exchange Commission, August 10, 2022, https://www.sec.gov/news/press-release/2022-141.

This committee would coordinate with other departments and agencies as needed to address issues such as foreign procurement, critical minerals security, infrastructure investment, supply chain resilience and ally-shoring, and export of strategic materials.

Effective sanctions programs are linked to clear policy objectives, and this committee would work to facilitate alignment between different sanctions programs with shared objectives to prevent the inconsistent application of economic and financial penalties. It would also prevent abnormal situations in which U.S. investors are able to freely purchase or transact in the securities of an entity that U.S. Departments of Defense, Treasury, or Commerce have determined poses significant risk and placed under economic sanctions or export restrictions.

It would also be charged with engaging with Silicon Valley and Wall Street stakeholders to facilitate close cooperation, communicate guidance on sanctions efforts, and garner support for policies. Lack of clarity around new sanctions programs has, in some cases, muddled public messaging and made it difficult for U.S. banks and financial institutions to comply.

In April 2022, Sen. Robert Menendez introduced a bill to establish the "Countering Economic Coercion Task Force" to "oversee an integrated government strategy to respond to any economic practices by China that are abusive, arbitrary, and contrary to international rules." The task force would engage with U.S. Customs and Border Protection and Department of State on economic strategy.[69] I would urge support for this bill, and any similar legislative initiatives to introduce a whole-of-government approach to economic and financial statecraft.

Enact divestment requirements at the state and local level to prevent U.S. institutional investors from inadvertently providing capital to Russian companies helping to sustain the war in Ukraine, and Chinese companies supporting the government's military modernization efforts.

Congress should supplement federal sanctions on certain Chinese and Russian entities by directing state and local governments to enact legislation mandating divestment of state and city funds from companies that operate in key Russian business sectors, and in the Chinese military-industrial or surveillance technology sectors.

[69] "S.4112 - Economic Statecraft for the Twenty-First Century Act," 117th Congress (2021-2022), April 28, 2022, https://www.congress.gov/bill/117th-congress/senate-bill/4112.

This directive would also require state chief procurement offices to publish an annual list of entities determined to be engaged in activities supporting Russia and China's defense industrial bases. Concurrently, state and local governments should prohibit entering into any procurement or contract over a set dollar threshold with an entity on this list.

Congress should also pass legislation requiring the identification of companies that operate in key Russian business sectors, including military or defense-industrial companies. This would mirror the Chinese military-industrial companies (CMIC) list administered by the U.S. Treasury Department's Office of Foreign Assets Control, and provide guidance for states that might not otherwise have the resources to adopt independent screening processes for investments in high-risk Russian and Chinese companies.

These actions would support the efforts of state and local governments, educational institutions, businesses, and investors that have already taken steps to disassociate themselves from companies engaged in activities contrary to U.S. national security and foreign policy interests, but are bound by fiduciary duty to retain such holdings.

Consider strengthening regulatory authorities to prevent or even ban the U.S. listings of companies that use corporate structures preventing high-quality disclosure and transparency.

The Securities Exchange Commission (SEC) released a "Sample Letter to Chinese Companies" in December 2021, which serves as a template for the SEC Division of Corporation Finance's outreach to China-based companies regarding specific risks, such as the use of a variable interest entity (VIE) structure.[70] The guidance in the letter does not prevent or ban companies using a VIE structure from listing on U.S. exchanges altogether, but asks for enhanced disclosure and acknowledgment that a Chinese regulatory crackdown on VIEs could result in material change in the value of securities.

Three days later, the China Securities Regulatory Commission (CSRC) released draft administrative regulations stating that Chinese companies will be permitted to continue using variable interest entity (VIE) structures for overseas listings so long as they meet

[70] "Sample Letter to China-Based Companies," U.S. Securities and Exchange Commission, December 20, 2021, https://www.sec.gov/corpfin/sample-letter-china-based-companies.

"compliance requirements."[71] This contradicts months of speculation that Chinese regulatory authorities were planning to crack down on Chinese businesses using VIE structures for overseas listings, and appears to be a green light for Chinese companies to continue using offshore vehicles to carry out overseas fundraising plans.[72]

As a consequence, U.S. retail and institutional investors that use passive investment strategies, and own funds tracking international or emerging markets indexes, will continue to have exposure to this China-specific category of material financial risk.

This testimony was prepared with research support from my colleagues Melissa Ladner and Annie Payson. Thank you.

[71] "The relevant person in charge of the China Securities Regulatory Commission answers reporters' questions (证监会有关负责人答记者问), China Securities Regulatory Commission (中国证券监督管理委员会), December 24, 2021, archived at https://web.archive.org/web/20211224134643/http://www.csrc.gov.cn/csrc/c100028/c1662240/content.shtml.
[72] "China Puts VIE-Structured Overseas Listings under Regulatory Spotlight," Ropes & Gray, January 24, 2022, https://www.ropesgray.com/en/newsroom/alerts/2022/january/china-puts-vie-structured-overseas-listings-under-regulatory-spotlight.

INVESTING IN OUR RIVALS: EXAMINING U.S. CAPITAL FLOWS TO FOREIGN RIVALS AND ADVERSARIES AROUND THE WORLD

Before the House Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets on November 15, 2022

WRITTEN TESTIMONY

BY JEFF FERRY, CHIEF ECONOMIST | SUBMITTED November 14, 2022

The Coalition for a Prosperous America (CPA) thanks the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee for holding this hearing to explore the risks posed to American investors by nations that are adversarial and hostile to U.S. interests— most notably Russia and the People's Republic of China (PRC). CPA is a bipartisan, nonprofit organization representing exclusively domestic manufacturers, producers, and workers across many sectors of the U.S. economy. Especially alarming to us and our members are the risks posed to U.S. investors by CCP-linked Chinese companies' that are actively exploiting our free and open capital markets.

Introduction

The topic of this hearing is very timely. However, for American investors, there is no greater exposure to any rival than the People's Republic of China (PRC) led by the Chinese Communist Party (CCP).

In 2020, U.S. holdings of Chinese securities neared $1.2 trillion. This is about five times the holdings than that of any other country. The exposure of U.S. investments in Chinese securities has never been greater, and it will continue to grow. y testimony today will primarily focus on the problem of U.S. investor exposure to Chinese securities, the risks this poses to U.S. economic and national security and potential solutions that should be considered.

A Shares and Passive Investments not Covered by HFCAA

Congress, the media, and independent regulators like the Securities and Exchange Commission (SEC) have recently focused on the risks posed to U.S. investors from Chinese companies directly listed on U.S. stock exchanges. While CPA welcomes this focus and encourages further action, it does not address the bulk of "bad actor" Chinese companies that are still present in American passive investment products. Their presence is in the form of over 4,200 A-share and H-share companies found throughout a multitude of financial vehicles, such as Exchange Traded Funds (ETFs) and index mutual funds, that have received little or no regulatory scrutiny or fiduciary due diligence. Tens of millions of Americans are unwittingly exposed to these A-shares in their investment portfolios and retirement investment accounts.

U.S. investors are inadvertently subsidizing Chinese companies involved in activities that are contrary to the national security, economic security, and foreign policy interests of the United

States. We are also subsidizing the economic growth of the United States' top global adversary. A-shares are securities listed on mainland Chinese exchanges and only accessible to American and foreign investors via inclusion in indexes and associated index funds. Similarly, H-shares are Hong-Kong listed shares. These companies are oftentimes non-compliant with U.S. securities laws and financial reporting norms and, in some cases, have been sanctioned by the U.S. Government for egregious human rights and national security abuses.

The financial industry will not lead. Congress must do so. To ensure against further American investment flowing to Chinese companies that pose investor protection, national security, and human rights concerns, Congress should take the following actions:

- Pass legislation that requires index providers and asset managers to address the risks posed by A-share and H-share companies.
- Expand the Holding Foreign Companies Accountable Act (HFCAA) to cover Chinese companies traded in the United States via passive investment products, despite not being directly listed on U.S. exchanges, to ensure that ETF products traded on U.S. exchanges are PCAOB compliant, consistent with the investor protection imperatives of the Act.
- Compel the SEC to require further disclosures and issue new rules for index providers as it pertains to oversight of quality control and minimizing conflicts of interest.
- Compel the SEC and other U.S. Government agencies to provide and require more information to be made known to investors and fiduciaries in regard to the geographic location of companies, their industries or sectors, their linkages to foreign governments or foreign actors, the presence of companies on U.S. sanctions lists, or other national security, human rights, or governmental and political risk factors.
- Require index providers to reevaluate their index inclusion criteria, which currently expose U.S. investors to material and reputational China-specific risks. nd further require them to justify continued inclusion of any such risky China-specific investments.
- Harmonize U.S. sanctions policy against Chinese companies in order to close current gaps that exist between different sanctions lists. This will clarify for and assist index managers and investors in compliance and due diligence.
- Establish a new capital markets list to include Chinese corporate human rights abusers.
- Consider a national policy to prohibit investors from investing - either here or abroad - in companies which have Chinese Communist Party (CCP) cells in their management.

A-Shares in U.S. Index Funds: Just How Massive is U.S. Exposure?

In May 2018, after three years of deliberation and negotiations with Chinese regulatory authorities (and considerable arm-twisting from Beijing), major index provider MSCI released a list of large-cap China A-shares to be included in the MSCI China Index, Emerging Markets (EM) Index, and All Country World Index (ACWI) beginning in June. The MSCI EM Index previously only included shares of Chinese companies listed in Hong Kong or the United States. As of June 2018, MSCI had over $1.8 trillion in assets benchmarked globally to its Emerging Markets Index suite, 30.99% of which was comprised of China-based securities.

By November 2019, MSCI had increased and expanded its index exposure to mainland Chinese companies significantly by including mid-cap China A-shares and quadrupling the inclusion ratio of China A-shares in the MSCI EM Index from 5% to 20%. The total index weighting of China A-shares jumped from 0.7% to 3.3%, drawing in an estimated $80 billion in foreign inflows to the Chinese market.37 As of August 2020, the overall weight of China A-shares in the MSCI EM Index had risen to 5.1%, where it currently remains.

FTSE Russell followed in MSCI's footsteps and was the second major index provider to include China A-shares in its indices. In June 2019, FTSE added 1,097 China A-shares into its FTSE Global Equity Index Series (GEIS, which covers the FTSE Emerging and All-World Indices) in the first stage of inclusion (20%), drawing an expected $10 billion from U.S. passive investors. As of June 2020, China A-shares represented approximately 6% of the FTSE Emerging Index. Over 4,200 China A-shares are available to U.S. investors at this point through their inclusion in indices.

Undisclosed Risks to Investors

Index providers neglect to consider the full range of China-specific material risks to investors when determining index constituents and weighting. These include considerations of reputational risks relating to national security, export controls and sanctions regimes, human rights violations, political factors, or even full consideration of traditional environmental, social, and governance (ESG) factors.

Retail and institutional investors are exposed to a wide range of publicly traded Chinese companies involved in developing weapons systems, new technologies, and building infrastructure in support of China's military modernization goals; and companies involved in facilitating the ongoing genocide of Uyghurs and other Turkic Muslims in Xinjiang, the systematic intimidation and coercive assimilation of Tibetans, and the mass surveillance and government interference in people's lives in Hong Kong. Beyond these, additional risk factors to consider include U.S. sanctions designations and any other blacklists that may signify a material reputational and financial risk to investors.

As of at least June of this year, a look at five of the larger index mutual funds offered by industry leaders—Fidelity Emerging Markets Index Fund (FPADX), State Street Emerging Markets Equity Index Fund (SSKEX), BlackRock iShares MSCI Total International Index Fund (BDOKX), Vanguard Emerging Markets Stock Index Fund (VEMAX), DFA Emerging Markets Core Equity I (DFCEX), which just so happen to be included in the new Mutual Fund Window available to TSP beneficiaries—includes at least 14 underlying companies directly linked to China's military-industrial complex and listed on either the Department of Defense's Section 1260H list or the Treasury Department's NS-CMIC List or both, in just these five funds. This is in addition to a number of companies on BIS's Entity List and others with documented links to the oppressive Chinese surveillance state and connected to Uyghur forced labor.

Federal Government Thrift Savings Plan Investing in our Adversaries

The U.S. Government is facilitating the investment of billions of taxpayer dollars in Chinese Communist Party (CCP) controlled companies via the federal workers' retirement system, the

Thrift Savings Plan (TSP). The Thrift Savings Plan is the largest defined contribution pension system in the world, with more than $730,000,000 in assets. In June 2022, the TSP's administrators on the Federal Retirement Thrift Investment Board (FRTIB) enabled TSP participants to invest up to 25% of their savings (a minimum of $10,000) in more than 5,000 mutual funds via a new platform called the "Mutual Fund Window." The TSP's Mutual Fund Window initiative was launched in June and has already received more than $47 million in investments. No due diligence or screening has been performed to ensure the mutual funds included in the new TSP platform exclude U.S.-sanctioned or other Chinese corporate "bad actors."

Participants are unable to determine what mutual funds are included in the Window until after they have transferred a minimum of $10,000. The Coalition's research has demonstrated that the Window's largest emerging markets funds include problematic CCP-controlled companies in their investment portfolios.

CPA's research also found that five of the largest international funds in the Window had an average weight of 22 percent toward Chinese companies, and all five funds held companies listed on the U.S. Department of Treasury's list of Chinese Military-Industrial Companies, the Department of Commerce Entity List, the Commerce Department's Unverified list, or the Department of Defense Chinese Military Companies list. Companies are placed on these lists because they threaten U.S. national interests, have been involved in serious technology theft, and/or are implicated in the genocide of the Uyghur people.

The FRTIB claims it has neither the time, expertise, nor the resources to research the mutual funds offered to current and retired federal employees, military personnel, and veterans in order to ensure CCP controlled bad actors are excluded from their portfolios. The FRTIB also claims they are not obligated to restrict investment in problematic Chinese companies. For example, the FRTIB has not fulfilled its 2020 public pledges to remove Chinese companies from the TSP's International or "I" Fund.

Of further concern, in May 2020, the Department of State notified Congress that the passage of the Beijing-drafted National Security Law obviated the distinction between Hong Kong and the People's Republic of China, and that Hong Kong could no longer be considered autonomous. Despite this determination, the FRTIB, has refused to remove 35 Hong Kong based Chinese companies from the International Fund of the TSP.

Through the research conducted by CPA and its allies, we found a number of Chinese Communist Party-owned companies in the funds to include the Aviation Industry Corporation of China (AVIC), China General Nuclear Power Group (CGN), and COSCO Shipping. The funds also included companies under scrutiny for forced labor practices, as well as those involved in China's growing surveillance technology state.

By some estimates, American investors have provided as much as $3 trillion in investment capital to Chinese companies. This is due to a 2013 bilateral MOU between U.S. and Chinese securities regulators, U.S.-listed Chinese companies' enjoy preferential access to U.S. capital markets because they are not required to meet the same requirements as U.S. public companies. U.S. capital markets have funded China's unprecedented military build-up; its One Belt One Road Initiative; gross violations of human rights, including genocide and crimes against humanity against the Uyghurs; predatory and market distorting trade practices; and the wholesale theft of American technology and intellectual property.

The U.S. government has sanctioned hundreds of Chinese companies for their role in enhancing the threats to our national security posed by the PLA and egregious human rights violations, but they still enjoy unfettered access to U.S. capital markets and are held by hundreds of widely available mutual funds, public pension funds, and university endowments. In 2019, BlackRock – as the lead asset manager of the investment portfolio of the Thrift Savings Plan – advised the FRTIB to increase the TSP International Fund's exposure to CCP-controlled firms. BlackRock continues to be one of the most vocal investment managers encouraging expanded investment in China, and in 2021 became the first U.S. investment management firm to provide investment products directly to Chinese retail investors.

Let's be very clear, no U.S.-listed Chinese-domiciled companies held by either the core TSP funds or the Mutual Fund Window are in compliance with federal securities laws and regulations, such as legally mandated audit requirements designed to protect American investors. Due to the negligence of the TSP's managers, American servicemen and women, and other government employees may be unwittingly funding their country's leading adversary – including companies involved in the Peoples Liberation Army's modernization or the CCP's genocide of the Uyghur people.

We can all agree that CCP-controlled companies should not be financed through the retirement savings of U.S. government employees. The FRTIB should not be allowed to abdicate its due diligence and fiduciary responsibilities to our military and federal workforce. At a minimum, the FTRIB should take steps to ensure that the TSP Mutual Fund Window publicly discloses: 1) which TSP regular or mutual funds hold Chinese-domiciled companies, including those based in Hong Kong; 2) whether any such company has been sanctioned or otherwise listed by an agency of the United States government; and 3) whether any such companies are non-compliant with U.S. securities laws and regulations, including PCAOB audit requirements.

Harmonizing Government Sanctions — How to Guide Investors Away from Bad Actor Chinese Companies

Capital markets sanctions are a relatively under-utlized yet highly effective tool to be brought to bear to force divestment from certain key sectors and bad actor companies in the best interests of investors, human rights, market transparency and accountability, and national security. These sanctions work when properly implemented and are an under-utilized tool of the U.S. Government that this Committee must work to establish and enforce legislatively. Especially for those interested in not going to an actual kinetic / physical war with China, cutting off China's resources - our capital flowing to them - now and decreasing our dependence on their exports decreases China's resources and wealth to then be able to ratchet up its pressure on Taiwan and to play in other key geopolitical sandboxes around the world.

Polling conducted by CPA shows an overwhelming majority of Americans are concerned with investment in risky Chinese companies and support stricter investment requirements. A poll conducted by Morning Consult shows Sixty-two percent of voters are concerned Americans can invest in Chinese and Russian companies that have been sanctioned by the U.S. government or have not complied with U.S. laws.

To accomplish this mission of decreasing and divesting U.S. capital from China, a series of executive orders have been promulgated by both Republican and Democratic presidents to try to selectively enforce capital investment bans on critical Chinese companies in critical industries and linked to the CCP military and military-civil fusion operations. The first two EO's, enacted by President Trump — EO 13959 (now amended by EO 14032) and EO 13974 (now rescinded) — focused on linked U.S. Department of Defense identified companies that are part of the DOD's required Chinese Military Company List (as required by the annual NDAA) to forced listing and a capital markets ban by Treasury's Office of Foreign Assets Control (OFAC). If a company were on the DOD list, then it was automatically required to be slated for a prohibition on the buying and selling of its securities within a certain window of time. Then under the Biden administration, these policies were updated with a new EO, 14032. This EO was important to the concept of the capital markets sanction as a tool because it expanded beyond just the scope of the DOD and now includes what are known as surveillance technologies companies in addition to the traditional military and military-industrial complex linked companies. The EO did rescind the concept of forced divestment by cnacling out EO 13974 but also created a new list within OFAC, as opposed to the DOD only list. Now OFAC - if acting urgently and judiciously can add a broader swath of companies across more categories to its Non-SDN Chinese Military Industrial Complex Companies List (NS-CMIC List0.

Regrettably, Treasury is incredibly reluctant to engage in the process of making additions to its list despite commitments from the White House to update the list on a rolling basis and that it is a top priority for the President. Treasury has a role to play and this Committee has a job to do to hold Treasury responsible for follow-through on sanctions updates at a regularized clip and in alignment with broader U.S. policy aims and priorities. Rather than adding companies to this list and updating the EO's annex, Treasury issued some paltry guidance at the one-year mark of the Biden EO and basically undercut the Whie House's own intentions by releasing a contradicting and intentionally vague FAQ sheet, which reads in part, in regard to the concept of "divestment":

> "U.S. persons are not required to divest their holdings of CMIC securities during the relevant 365-day divestment period and may continue to hold such securities after the divestment period. E.O. 13959, as amended, permits purchases or sales made solely to effect the divestment of CMIC securities, but only during the 365-day divestment period. Accordingly, any such purchase or sale is prohibited after the 365-day divestment period, absent OFAC authorization."

Further, in addition to this terribly confusing FAQ, Treasury fails to add new sanctioned entities, not yet releasing one new tranche of sanctioned entities since the initial EO - though a few companies were added when a rule in the federal register clarified the intermingling of the Trump Era EO list, the DOD list, and the new, updated Biden era EO , which allowed for less than ten addition companies to be further added to the NS-CMIC list annex.

As of October of this year, the Commerce Department's well-known Bureau of Industry and Security (BIS) Entity List contained 1,167 listed entities, while the NS-CMIC list contained only 68. While we understand that these lists are not the same, not interchangeable, and require different legal standards and thresholds for listing, common sense and U.S. policy would indicate these lists should be in greater actual alignment. Embarrassingly. Only 16 companies are on both lists. This means that only 1.4% of those companies being denied normal business practices and that are subject to specific license requirements for the export, reexport and/or transfer (in-country) of specified items are also being denied access to U.S. capital. As stated on the Commerce Department's BIS website, "Since its initial publication, grounds for inclusion on the Entity List have expanded to activities sanctioned by the State Department and activities contrary to U.S. national security and/or foreign policy interests." It would stand to reason, therefore, that these same concerns regarding sanctioned activities dn activities contrary to U.S. national security and / or foreign policy would also apply to outbound flowing capital - which facilitates the means of production of the very goods we are concerned about. Also, when a company is added to the NS-CMIC List, subsidiary or parent companies must also be considered and included at some reasonable threshold.

There is much room left to establish and utilize the capital markets sanction as a key force for economic statecraft and for cleaning up U.S. capital markets. As we see full implementation of the Accelerating Holding Foreign Companies Accountable Act (HFCAA), we also know that more capital is already flowing to mainland China based companies as companies delist or will be forcibly delisted from U.S. exchanges for non-compliance with U.S. securities laws as established by Sarbanes-Oxley and the PCAOB. In order to protect U.S. investors from non-compliant Chinese companies, placing the most egregious offenders on the U.S. NS-CMIC list for a ban on the buying and selling of their securities is crucial. Bipartisan, legislative work is required to make sure that capital markets sanctions policies are crafted, promulgated, and implemented correctly.

One key area for inclusion is the concept of sanctions harmonization. Better than a mere notion of sanctions reciprocity, sanctions harmonization links up current lists run by various U.S. Government Departments and Agencies in an interlocking process such that being sanctioned or listed by one enables the other to undertake consideration for legal sanctions action as well, and ultimately will ideally lead to increased listings by OFAC and more rigorous review. The current U.S. Government arrangement sees little transparency on why some Chinese companies are chosen to be on one list but not another. Across the U.S. Government, there are dozens of reports, lists, advisories, or sanctions tranches issued on a recurring basis. Some of these include: the U.S. Commerce Department's Bureau of Industry and Security (BIS) Entity

List; the Military End User List, the Unverified List, the Department of Defense's 1260H or CMC List (formerly 1237 CCMC List), the new Uyghur Forced Labor Prevention Act Entity List maintained by Department of Homeland Security, the OFAC NS-CMIC List, and more.

There is a strong need to put in place a process by which agencies responsible for enforcing and implementing sanctions better communicate with each other and Congress on ensuring every company that is listed by any agency goes through a review by all agencies for inclusion on each individual sanctions list. To that end we support draft legislation Congress is currently working on to address this very issue. The goal is to require the agencies that maintain malign entity lists (Departments of Treasury, Commerce, Defense, and Homeland Security) to better coordinate, review listing decisions of other agencies, and make a determination on listing such entities on their respective lists. The bill requires the agencies reviewing an entity that was listed by another agency to provide a legal justification to Congress (affirmative or negative) and notify the public. Further, Global Magnitsky Act sanctions must be included in this policy arena, requiring some necessary updates to separate out human rights accusations from those of corruption, enabling further actions and sanctioning to take place by Treasury. Additionally, the State Department must be included at the table as the U.S. government's preeminent authority on human rights. State Department warnings such as the one issued on December 8, 2020 on bad actors present in U.S. capital markets or the Hong Kong or Xinjiang Business Advisories must be issued and updated on a recurring basis and linked to sanctions from Treasury, notably expansion and inclusion on the NS-CMIC List.

While both houses of Congress unanimously passed legislation to require a report annually to be produced by Treasury —in consultation with DOD, State, and the intelligence community — on the presence of malign Chinese companies in U.S. capital markets, the measure failed to be included in the final China bill voted on this summer. If this Committee and Congress are serious about tackling China's exploitation of U.S.capital markets, Congress must have the necessary information. This can be done in consultation between Treasury, SEC, State Department, and others to ensure Congress has better information with which to make the right policy decisions to protect our capital markets, investors, and nation from China's exploitation.

As an illustration of the challenge facing the U.S, the federal government has recently implemented the CHIPS Act and export controls designed to prevent China building advanced semiconductors with military capabilities. Yet financial industry data shows that last year, investors invested $8.8 billion in Chinese semiconductor startups, more than six times greater than the $1.3 billion invested in comparable U.S. startups. Much of that $8.8 billion dollars came from U.S.-based public and private investment funds. Why are we trying to prevent Chinese access to advanced semiconductors with one hand, yet funding it with the other?

Another telling anecdote is that of CSSC Holdings Ltd. As of June 2022, household names in investing – BlackRock and Vanguard for example – are providing Exchange Traded Funds (ETFs) and other investment products to consumers that track indices containing Chinese companies building and modernizing the Chinese Communist Party's military. CSSC Holdings Ltd. was listed as a constituent of the MSCI Emerging Markets, MSCI ACWI, FTSE Emerging, and FTSE All-World indices. These indices are tracked by trillions of dollars of assets under management globally through associated ETFs. Most Americans do not know or can analyze the indices tracked by their ETFs, nor to know fully what is in their ETF or other investment products, and simply cannot do their own analysis – or remove – bad actor Chinese companies from their investment accounts.

On June 17, 2022, The People's Liberation Army Navy (PLAN) successfully launched its third aircraft carrier from Shanghai's Jiangnan Shipyard. The new carrier enables PLAN to launch a wider variety of aircraft and is reportedly equipped with technology furthering PLAN blue water naval capabilities. Jiangnan Shipyard, where the Fujian was built, is a commercial and naval shipbuilding facility.

Jiangnan was wholly acquired in 2019 as a subsidiary of China State Shipbuilding Corporation Holdings Limited (CSSC Holdings Ltd.). CSSC Holdings Ltd. is the publicly-traded arm of China State Shipbuilding Corporation Ltd., a Chinese state-owned enterprise carrying out shipbuilding and repairs for cargo customers and PLAN military vessels, and is included in some of the world's most prominent investment indices. Foreign capital flowing into Jiangnan Shipyard directly via its commercial business or indirectly via CSSC Holding Ltd securities, may both directly and indirectly support PLAN modernization.

Development of the PLAN's fourth aircraft carrier is reportedly underway at Jiangnan shipyard, with the carrier's launch expected between 2025 and 2027.

CSSC was designated as a Non-SDN Chinese Military Industrial Complex Company (NS-CMIC) on June 3, 2021. This listing, under Executive Order 13959 (as amended by President Biden in Executive Order 14032), prohibits U.S. persons from purchasing or selling any securities of companies deemed to be supporting China's military-industrial base. This prohibition does not apply to subsidiaries, like CSSC Holding Ltd. or Jiangnan Shipyard, that are not also explicitly designated by the Treasury Department's Office of Foreign Assets Control (OFAC). Correspondingly, CSSC was designated by the Department of Defense as a Chinese Military Company operating directly or indirectly in the United States by the Biden Administration in June 2021, in accordance with the FY21 NDAA's section 1260H.

As of June 2022, CSSC Holdings Ltd. was listed as a constituent of the MSCI Emerging Markets, MSCI ACWI, FTSE Emerging, and FTSE All-World indices. These indices are tracked by trillions of dollars of assets under management globally, for example, through the associated Exchange-traded funds (ETFs). The primary ETF providers include Blackrock's iShares products and Vanguard's UCITS products, respectively.

In addition to issuing yuan-bonds, as of 2015, the CSSC corporate family has raised nearly $2.6 billion through euro and dollar-denominated debt placement via markets such as the U.S. Over-the-Counter market, Frankfurt, and Bank Sarasin (Switzerland) markets and JP Morgan bond-focused ETFs, among other debt markets. Nearly all of which were underwritten by Western banks, most commonly Barclays and Société Générale. Four of CSSC's euro- and dollar-bonds have yet to mature:

Transparency and disclosures must be required of index providers and fund managers. Sanctioned and known bad actor Chinese companies must be prohibited from investment exposure by Americans through application of capital markets sanctions. In light of recent CCP-led aggression against Taiwan, the U.S. must stop funding the People's Liberation Army and Navy, and enabling the military modernization of the Pentagon's named strategic rival. It is foolish for America to be simultaneously financing our own military modernization *and* that of the CCP. America must get serious about using tools of economic statecraft to avert an arms race with the Chinese – or worse, a kinetic exchange. Stop sending U.S. capital to the CCP and its companies.

Conclusion

The U.S. government should take the necessary steps to ensure passive investment and government pensions are safe and secure from adversarial, authoritarian regimes like China. They should do so because it is in the best interest of the U.S. from both a national security and economic sovereignty perspective. I'll leave the committee with some of the latest returns on being invested in China.

- "The MSCI China is down 26% year-to-date, similar to the Nasdaq, and underperforming the MSCI Emerging Markets Index." Source.
- Overseas investors became the net sellers of mainland shares
- The offshore real estate credit market collapsed
- Emerging market fund equity allocations to China reached the lowest number in three years
- Goldman Sachs predicted no earnings growth for MSCI China Index constituents in 2022.
- "An American Chamber of Commerce (AmCham) in China survey in May found that 51% of respondents have already delayed or decreased investments" Source. (mostly due to Covid though)
- BlackRock Investment Institute added U.S.-China competition to its list of top 10 geopolitical risks for 2022.

To be a good fiduciary entails appropriately managing and minimizing risk in the stewardship of client money. But the financial industry will not fix these problems which are existential national and economic security risks to America. he risks are increasing and returns are less certain than ever before, Congress must pass laws that the financial industry must comply with in the national interest. To say that one must be in China to be a good fiduciary completely undercuts the base premise of fiduciary duty and supports the ascendance of authoritarianism and non-market economies.

Yale SCHOOL OF MANAGEMENT
Chief Executive Leadership Institute

The Unprecedented Exit of 1,000+ Multinational Businesses from Russia

Investing in our Rivals: Examining U.S. Capital Flows to Foreign Rivals and Adversaries Around the World

Professor Jeffrey Sonnenfeld
Yale School of Management

Prepared for the House Financial Services Committee

Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

November 15, 2022 Subcommittee Hearing – Abbreviated Version

Table of Contents

Brief Introduction and Background

Chairman Sherman, Ranking Member Huizenga, and the distinguished members of the Subcommittee: thank you for the opportunity to testify today; and thank you to Chairwoman Waters and Ranking Member McHenry for your leadership.

I am Jeffrey Sonnenfeld, Senior Associate Dean for Leadership Studies, Lester Crown Professor of Management Practice at Yale School of Management, and Founder and President of the Yale Chief Executive Leadership Institute, a division of Yale University and the world's first school for incumbent CEOs – well before the WEF/Davos and CEO-targeted events by Forbes; FORTUNE; BusinessWeek; The Wall Street Journal; and The New York Times. I founded this institute when I was a professor at the Harvard Business School 30 years ago and migrated it to Yale 22 years ago. We have continued to hold over 150 CEO forums hosting thousands of top leaders around the world including events in Washington DC, New York City, Atlanta, Beijing, New Delhi, Shanghai, Mumbai, Mexico City, Montreal, and Phoenix. These events are all non-commercial; educational; informal; non-partisan forums bringing together business leaders and leaders from across civil society, including political leaders from both sides of the aisle including Presidents Joe Biden and Donald Trump.

I have been working in the corporate social responsibility space for 45 years; my first book was entitled Corporate Views of the Public Interest, published in 1981, and since then, I have published 200 scholarly journals and 7 books. I have advised thousands of CEOs on corporate social responsibility challenges and am a weekly corporate governance commentator for CNBC with additional regular appearances on MSNBC, CNN, PBS, CBS, NBC, and ABC.

I am appearing before the Committee today to offer some insights on the historic exits of 1,000+ major multinational companies from Russia after Russia invaded Ukraine. I have been credited by media outlets for having had some role in catalyzing this mass stampede from Russia, but my testimony today and the readings in this compendium will provide a more comprehensive explanation over how this unfolded, what the impact has been on the firms which exited, and the impact upon our adversary Russia – as well as transferable lessons towards other adversarial countries. If time permits, I will also discuss our research on the unappreciated, unparalleled tech transfer of our most sophisticated, sensitive weapons systems to the Saudi – who are now colluding with Russia. The readings in this compendium contain both articles written about our work on this front as well as articles written by my team and I.

(PAGE BREAK)

https://www.washingtonpost.com/business/2022/03/11/sonnenfeld-russia-ukraine-corporations/

The Washington Post
Democracy Dies in Darkness

BUSINESS

How a Yale professor's viral list pressured companies to pull out of Russia

A longtime advocate of corporate social responsibility gets a boost as Americans rally behind sanctions

By Tracy Jan
March 11, 2022 at 3:00 a.m. EST

Jeffrey A. Sonnenfeld at the last in-person CEO summit in December 2019 in New York. (Yale School of Management)
Share

The sheer volume of companies clamoring to join the list of corporations withdrawing business from Russia after President Vladimir Putin's invasion of Ukraine came as a shock to Yale management professor Jeffrey Sonnenfeld.

Founder of the Chief Executive Leadership Institute, Sonnenfeld has spent four decades pushing CEOs to act to benefit society, not just shareholders, on social issues ranging from gun control to voting rights. But nothing has drawn as much attention or support from business leaders, media or the public as his inventory of companies that have cut ties with Russia.

“So many CEOs wanted to be seen as doing the right thing,” Sonnenfeld, 67, said in a telephone interview. “It was a rare unity of patriotic mission, personal values, genuine concern for world peace, and corporate self-interest.”

The list, updated hourly by his research team, has grown to more than 330 as of Friday. “What these lists do is give courageous CEOs the confidence to keep going, and the wannabe courageous ones the reinforcements to deal with their boards so they come off as responsible business leaders when they can see a stampede of their peers leaving Russia,” Sonnenfeld said.

His latest list started with a dozen corporations spanning oil giants BP, Shell and ExxonMobil, consulting firms McKinsey, Bain and BCG, as well as Big Tech companies IBM, Dell, Meta, Apple and Alphabet, right after the Ukraine invasion on Feb 24. Many companies pulled out in response to employee outrage over the exposure of the firms to Russia, leaving billions of assets and revenue on the table, he said.
Technology companies race to extract their workers from Russia

Sonnenfeld said the “laggards” followed this week, when the public relations arms of more than two dozen consumer products, fashion, fast food and packaged goods companies contacted him in a single day to be included.

The rapid growth of the list in contrast to Sonnenfeld's earlier efforts could be explained as an economic decision amid increasing instability in Russia, or as a sign of American public support for a tough stand against Putin. A large bipartisan majority of Americans support sanctions against Russia for its invasion of Ukraine, according to a Washington Post-ABC poll.

But as the numbers seeking to join the list grows, Sonnenfeld's team is scrambling to categorize how exactly companies are curtailing business activity in Russia. His team planned to cull the list into three buckets: companies that shuttered their operations in Russia, those that temporarily suspended them and those that made cosmetic promises about future investments without changing their operations.

“The public is getting confused about who to celebrate and who to shame,” Sonnenfeld said. Still, some critics say even the corporate activism with the best intentions can imperil democracy.

Vivek Ramaswamy, an entrepreneur and author of "Woke, Inc.," sees companies cynically weighing in on "whatever is most politically convenient to accomplish their power aggregating goal," be it voting rights, Black Lives Matter, climate change or Ukraine.

"It tells everyday citizens that their voices do not count the same as those who exercise market power when settling a moral question," Ramaswamy said. "Whether it's the truckers in Canada or protesters in Western Europe or people who attend rallies in the U.S., they are saying that we deserve to be heard every bit as much as some CEO sitting in a corner office."

Internet watches with glee as yachts of Russian oligarchs are seized

From the time he was a doctoral student interviewing corporate executives imprisoned for price fixing, Sonnenfeld has focused his research on corporate social responsibility. That was the late 1970s, long before a powerful group of CEOs known as the Business Roundtable in 2019 distanced themselves from the idea that companies must maximize profits for shareholders above all else.

As a young Harvard Business School professor, Sonnenfeld wrote his first book, "Corporate Views of the Public Interest," about the broader role of business leaders in society. In the 1980s, Sonnenfeld said the withdrawal of 200 Western companies from South Africa in protest of apartheid galvanized him. He recently argued in a Fortune column that such divestment should provide a "powerful road map for why and how CEOs should affirm American values amid global challenges."

He started the first school for CEOs in his 30s, amid skepticism from senior Harvard Business School faculty that executives would want to spend their time listening to each other. He moved the enterprise to Emory University in Atlanta in 1989, the start of regular powerhouse gatherings of business leaders to address social issues and business challenges.

Former Atlanta Mayor Andrew Young, a civil rights leader alongside Martin Luther King and former ambassador to the United Nations, told CEOs at an early Sonnenfeld summit that the business community held more influence over doing the right thing than clergymen or activists. "He was my inspiration," Sonnenfeld said.

Since then, Sonnenfeld has convened chief executives, virtually for the past two years, to take a stand. Business Insider has dubbed him the "CEO Whisperer." After the 2018 Parkland school shooting, executives discussed their plans to sever ties with the NRA and promote gun safety.

In a meeting days after George Floyd was murdered by Minneapolis police in 2020, Kenneth Frazier, then chief executive of pharmaceutical giant Merck, spoke personally about how Floyd could easily have been him had somebody not invested in him. Sonnenfeld said that conversation prompted CEOs to hold town hall meetings with employees to discuss how to promote racial justice.

Corporate America makes a $50 billion promise on racial justice
On Jan. 5, 2021, the day before supporters of President Donald Trump attacked the Capitol, Sonnenfeld gathered nearly six dozen CEOs in a virtual meeting amid increasing fears that Trump would interfere with the transfer of power.

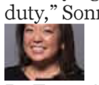
The Post had just published the transcript of a call to Brad Raffensperger, Georgia's secretary of state, in which Trump repeatedly urged Raffensperger to alter the outcome of the 2020 election in the state. The CEOs discussed suspending donations to members of Congress who had said they would not certify the votes for President Biden.
At another Sonnenfeld meeting, held over Zoom last April, two Black executives, Frazier and Ken Chenault, former chief executive of American Express, launched their drive to get fellow CEOs to sign onto a letter opposing restrictive voting rights bills being considered in dozens of states. Hundreds did in full-page ads published in the New York Times and The Washington Post. Some Republicans derided them as "woke CEOs." Sonnenfeld said he received death threats. Skeptics said the business leaders overstepped when they became involved in political debates.

"The purpose of a corporation is to produce a superior good or service at a fair price," said Charles Elson, founding director of the Weinberg Center for Corporate Governance at the University of Delaware. "When you get beyond that into tertiary areas, it affects the primary mission of the business itself because it's naturally divisive anytime a CEO takes a stand. Inevitably you lose customers, you lose employees, or you anger investors."

Some activists decried the corporate efforts as too little, too late. The Georgia bill had already been signed into law. Lawmakers in Florida and Texas also approved legislation imposing new rules on voting and new penalties for those who do not follow them.

"They literally did it a day late and a dollar short," said Malia Lazu, an entrepreneur and former bank executive who teaches at MIT Sloan School of Management. "If they were really willing to stick their necks out and take a little more risk, they would have come out strong four weeks earlier when activists were asking them to join the fight."
The voting rights campaign was Sonnenfeld's highest-profile effort until now. His next forum will be held in Washington on March 21. At the top of the agenda is Gen. Mark A. Milley, chairman of the Joint Chiefs of Staff, who will address the corporate response to Russia.

"Fortifying world peace, just like fortifying democracy, is absolutely a part of corporate duty," Sonnenfeld said.



By Tracy Jan

Tracy Jan covers the intersection of race and the economy for The Washington Post, a beat she launched in December 2016. She previously was a national political reporter at https://fortune.com/2022/03/07/great-business-retreat-matters-russia-sanctions-1986-south-africa-putin-ukraine-world-politics-jeffrey-sonnenfeld/

FORTUNE

COMMENTARY UKRAINE INVASION

The Great Business Retreat matters in Russia today–just as it mattered in 1986 South Africa

BY
JEFFREY SONNENFELD

March 7, 2022 6:59 AM EST

Closed self-service checkouts at an Ikea store in St. Petersburg. Dozens of Western companies have suspended their operations in Russia until further notice.IGOR RUSSAK - PICTURE ALLIANCE - GETTY IMAGES

All major company boardrooms are reconsidering their Russian presence–but does it even matter?

The 1980s voluntary withdrawal of 200 major companies from South Africa, in protest over apartheid, in combination with U.S. Congressional sanctions, reinforced U.S. foreign policy successfully at the time.

In an oft-cited 1996 pronouncement, *New York Times* columnist Tom Friedman offered his "Golden Arches" theory of conflict prevention. Friedman proclaimed when a country "has a middle class big enough to support a McDonald's, it becomes a McDonald's country, and people in McDonald's countries don't like to fight wars; they like to wait in line for burgers."

Nevertheless, military conflicts between India and Pakistan in 1999 or Israel and Lebanon in 2014 were not prevented by Big Macs. Sadly, the presence of 108 McDonalds in Ukraine and 847 McDonalds in Russia has done little to prevent war. Thus, it is disappointing that McDonalds has chosen to remain in Russia.

In fact, scores of prominent brands owned by groups such as Estee Lauder, Coty, Hilton, Hyatt, and Unilever are keeping their presence in Russia. At the same time, over 230 other major Western companies have curtailed their business with Russia. Experts have suggested varied explanations for why some companies have pulled out and others have stayed.

Despite the cost of abandoning major investments and the loss of business, there is a strong reputational incentive to withdraw. Companies that fail to withdraw face a wave of U.S. public resentment far greater than what they face on climate change, voting rights, gun safety, immigration reform, or border security. A new Morning Consult survey reveals that over 75% of Americans demand corporations cut business ties with Russia after the invasion of Ukraine. These results show rare and equal support across parties and independents.

Differences in the pattern of corporate disengagement can be attributed to differences in public understanding of the situation in Russia versus the West. The general Russian citizenry is in the dark, especially the older population who rely heavily on censored traditional media. The average Russian consumer is (for now) more susceptible to Putin's propaganda that blames the West–and is more likely to punish consumer goods companies.

Disengagement may also be a little easier for finance and heavy industry than for consumer products firms. Fashion and packaged goods firms usually lead the pack in social justice and human rights causes because their brands are susceptible to public condemnation. In Russia's case, Western heavy industry, business-to-business tech, and professional services are leading the boycott.

The far better-informed oligarchs and leaders of major enterprises in Russia are the primary clients of heavy industry, big tech, and professional services. They know the truth and understand the boycott–and will likely re-engage with these Western enterprises without resentment when the crisis ends.

By contrast, U.S. sanctions against South Africa in 1986 passed with a crushing 76 to 21 Congressional override of President Reagan's veto. Senator Mitch McConnell and Senator Bob Dole led the GOP majority which defied Reagan. As McConnell explained: "I think he is ill-advised. I think he's wrong, and I think we've waited too long for him to come on board."

Reagan's argument was that sanctions would in fact hurt South African Black people and not solve the problems of Apartheid, while we lose positive influence. Those are the same counterarguments echoed today about not hurting Russia's population. The purpose of sanctions, however, is to impose pain without the violence of war. Historian Norma Cohen explained this week that blockades of capital were essential for Allied victory in World War I.

The sanctions against South Africa included a ban on new U.S. loans and investments in the country, a prohibition on the importation of South African coal, steel, iron, uranium, textiles, and agricultural products, and a halt to direct air links between South Africa and the United States.

These sanctions alone were not sufficient. Within months of the bill's passage, several leading companies such as GM, IBM, Ford, GE, Kodak, and Coca-Cola all announced their complete and collective withdrawal from South Africa when the Apartheid regime continued to prove intractable. Even as they made clear they were withdrawing because, as Coca-Cola stated, "so little progress [was] being made toward the dismantling of apartheid", the companies simultaneously re-affirmed their commitment to the people of South Africa through civic-minded human rights initiatives. For example, Coca-Cola established a $10 million "Equal Opportunity Fund", administered by a board of prominent South Africans including the late Bishop Desmond Tutu, to open up opportunities in business, housing, and education for Black South Africans while pledging to sell its South African facilities to a local investor group which included Black South Africans.

In total, after the passage of the sanctions bill in 1990, well over 200 Western companies cut all ties with South Africa, resulting in a loss in excess of $1 billion in direct American investment. The companies remained unified through collective action despite a barrage of criticism. Nobel Peace Prize winner Bishop Tutu told me over a private lunch I had with him in Atlanta in September of 1996 that the message of this U.S. corporate blockade "was essential to reach the larger public that systemic change was vital or there would be no future."

Just as the Russian withdrawal is likely to cost participating corporations billions, an underappreciated aspect of the collective withdrawal from South Africa was that it came at great economic cost to these companies. Although South Africa's population represented only about 12% of the U.S. population at the time, South Africa exerted significant control over critical raw commodities that gave it much more economic heft than its population would suggest. South Africa was the world's largest gold producer, holding over 75% of all global reserves at the time. The country was also the world's largest supplier of platinum and chromium, both heavily used in industrial and chemicals manufacturing. The withdrawal of almost every major Western company from South Africa led to an immediate surge in the price of these critical commodities that affected global supply chains and industrial manufacturing.

The hardline government of PW Botha fell, succeeded by FW De Clerk who immediately negotiated the release of African National Congress leader Nelson Mandela after 27 years of imprisonment, erasing the blight of Apartheid from the nation's history.

Vladimir Putin, the most vicious autocrat of this century, rules through tyranny and fear. As he continues to fail, people will lose their fear and he will lose his power.

The collective withdrawal of 200 Western companies from South Africa in protest of the Apartheid government's violations provides a powerful roadmap for why and how CEOs should affirm American values amidst global challenges.

Jeffrey Sonnenfeld is a senior associate dean and Lester Crown Professor of Leadership Practice at the Yale School of Management, and author of The Hero's Farewell (Oxford).
Jeffrey Sonnenfeld (@JeffSonnenfeld) / Twitter

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Opinion

Taking Stock of Politics – It Pays to Exit Russia

By Jeffrey Sonnenfeld, Steven Tian and Steven Zaslavsky

Today at 12:46 p.m. EDT

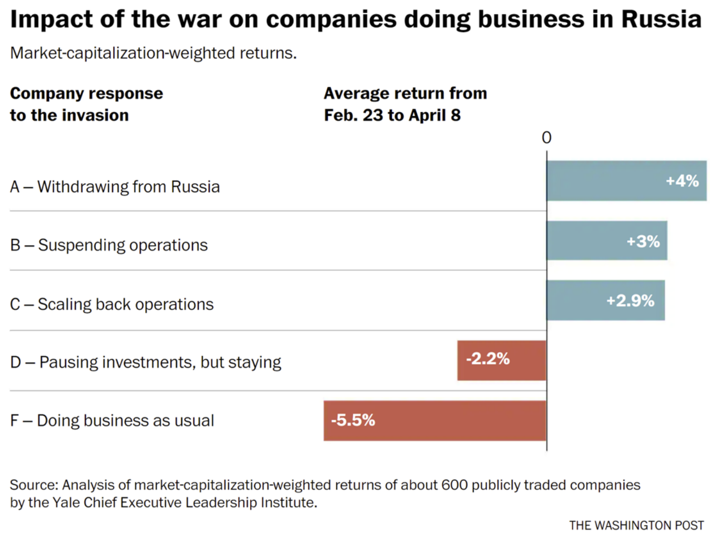
Russian President Vladimir Putin appears on a television screen at the stock market in Frankfurt, Germany, on Feb. 25. (Michael Probst/AP)

Jeffrey Sonnenfeld is a senior associate dean and the Lester Crown professor of management practice at the Yale School of Management and president of the Yale Chief Executive Leadership Institute. Steven Tian is director of research for the institute. Steven Zaslavsky is deputy research director for the institute.

A spate of misleading headlines in recent days have harped on the supposed heavy financial costs that companies are bearing for withdrawing from Russia. This has it exactly wrong. Companies that have exited Russia are not only accruing substantial costs; they are also showing financial benefits. And those that refuse to leave are experiencing the greatest costs.

One recent, much-discussed case illustrates this well: Societe Generale's stock price jumped 5 percent earlier this month after it announced it was leaving Russia despite incurring a $3.4 billion write-down. This is only the tip of the iceberg.

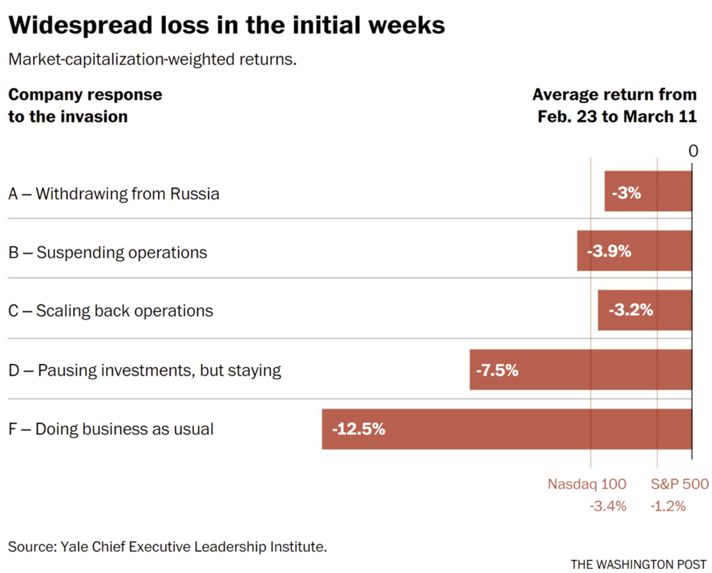
By looking at the market-capitalization-weighted returns of about 600 publicly traded companies, we found that since Russia invaded Ukraine on Feb. 24, companies that curtailed operations in Russia have dramatically outperformed companies that did not over the past two months. Remarkably, the total shareholder returns correspond precisely with the letter grades we assigned companies based on their level of withdrawal from Russia. Those with an A rating — those that have made a clean break or permanent exit from Russia — have performed the best on average, and those with an F rating — those that are "digging in" and defying demand to reduce activities in Russia — are performing the worst.



We have been maintaining an authoritative list tracking the responses of more than 1,000 global companies since the invasion of Ukraine began. As soon as our list appeared on CNBC two months ago, many of the companies we identified as remaining in Russia saw their stocks plummet 15 to 30 percent, even though key market indexes fell only about 2 to 3 percent.

We noticed the same trend play out over time, amplified by the release of investment research reports based on our list. That's why our financial and economic researchers, led by Steven Zaslavsky, Yash Bhansali and Ryan Vakil, used our proprietary database to examine this phenomena. The findings confirm that financial markets are strongly rewarding companies that withdraw while punishing those that remain.

The strong response from markets was particularly pronounced in the initial weeks following the invasion. Companies that curtailed operations to some degree over the first three weeks generally tracked the broader market sell-off of about 3 percent across major market indices, while companies that refused to withdraw were down a startling 7.54 percent for those with a D rating and 12.54 percent for those with an F rating.



Further analysis reveals that this pattern of outperformance by companies that withdrew held true across multiple factors, including the regions and sectors of the companies included. We saw the trend remained consistent even across different market capitalization segments, suggesting that even smaller, less well-known companies that remained in Russia were not immune to strong investor backlash.

Even smaller companies that remained in Russia saw investor backlash

Average return from Feb. 23 to April 8.

Company size	Response to the war: A – Withdrawing from Russia	F – Doing business as usual
Small cap	+6.5%	-12.2%
Mid cap	-2%	-7.8%
Large cap	+4.2%	-5.3%

Source: Yale Chief Executive Leadership Institute.

THE WASHINGTON POST

Some have suggested that companies that draw large proportions of their revenue from Russia might be more hesitant to leave Russia or that these Russian-reliant companies would suffer more financially, yet our research shows that companies that draw upward of 5 percent of revenue from Russia have not differed in total returns from those that draw less.

Indeed, many of the companies that are most reliant on Russian revenue are commodity producers that have been more than offset by rising global commodity prices. For example, ExxonMobil stock has increased by 13 percent since the invasion despite writing off billions in Russian assets and forswearing its profitable Russian operations. Meanwhile, Kinross Gold has gone up by 13 percent even though it exited its investment in the Russian Kupol gold mine, which accounted for 20 percent of its revenue. Even BP, which took a hefty $25 billion hit by writing down its holdings in Rosneft, is in the green.

Thus, contrary to media narratives, when it comes to companies exiting Russia, the focus should not be on their lost revenue or the assets they had to write off. Russian revenue makes up a small percentage of most companies' revenue. And even for the multinational companies that previously drew significant revenue from Russia, investors are clearly much more concerned with the far more important reputational risk of funding the Putin regime and with the potential for large-scale corporate boycotts around the world.

In other words, the far more dangerous financial threat to shareholders is remaining in Russia — not with writing off Russian assets. Those companies that have stayed their course should take note.

BUSINESS
INSIDER

Leaders at America's biggest companies all listen to one man. Meet Jeffrey Sonnenfeld, the 'CEO whisperer.'

Brandon T. Harden
Dec. 1, 2021

https://markets.businessinsider.com/news/stocks/jeffrey-sonnenfeld-the-ceo-whisperer-2021-11

From left: JPMorgan CEO Jamie Dimon, Starbucks Chair Mellody Hobson, Yale School of Management professor Jeffrey Sonnenfeld, and Merck & Co. Chair and CEO Kenneth Frazier.
Kimberly White/Getty Images for Fortune; David Livingston/Getty Images; Noam Galai/Getty Images; Spencer Platt/Getty Images; Samantha Lee/Insider

More than a distinguished Yale professor, more than an accomplished author, more than a leadership guru: Jeffery Sonnenfeld is corporate America's biggest open secret.

When events like an insurrection or debates on voting rights threaten our society, Sonnenfeld activates his clout and gathers hundreds of business leaders and dignitaries for an impromptu discussion on solutions, which has earned him the moniker of "CEO whisperer."

Chief executives are notoriously elusive. Many abide by rigid, impenetrable schedules managed by a protective assistant. But Sonnenfeld is the exception; CEOs make time for him. Before the pandemic, Sonnenfeld would host regular CEO seminars worldwide, which were typically planned up to eight months in advance. But recent events have increased Sonnenfeld's cadence.

"I send out the invitations personally," Sonnenfeld, 67, told Insider. "There is a standard core to the facts, but I customize many of them to address issues relevant to their enterprise or expertise, which we will draw upon."

With his Rolodex brimming with the likes of JPMorgan CEO Jamie Dimon and the former head Merck head Kenneth Frazier, one naturally questions how Sonnenfeld is able to sustain relationships with the most important decision-makers in corporate America. Why do CEOs listen to Sonnenfeld? What happens during these off-the-record seminars? And why do CEOs continue to show up?

Sonnenfeld called an emergency forum when restrictive voting laws gripped Georgia in April. Forty-eight hours later, nearly 100 CEOs and government officials convened on a Zoom call.

In an effort led by Frazier and former American Express CEO Ken Chenault, 72 Black executives signed a letter to galvanize all of corporate America to condemn legislation that would restrict the rights of Black voters.

"The statements that they eventually formulated and published were quite courageous for that sector of executives who tend to, in times past, see their role as simply being focused on shareholder value," Faye Wattleton, a former president of Planned Parenthood, said.

Most of Sonnenfeld's career has been anchored by CEO-leadership and corporate-governance research. Since 1999, he's been the senior associate dean for executive programs at Yale School of Management. Before then, he was a professor at Harvard Business School for a decade.

Insider talked to sitting and former executives from American Airlines, 1-800-Flowers, Xerox, and others about Sonnenfeld's influence on their leadership — and how he's shaping the workplace of tomorrow.

Future of business

Sonnenfeld has earned the trust of the business elite over decades of relationship building, and by proxy, he's attained an indirect influence over corporate America, and perhaps even world affairs.

In recent years, Sonnenfeld has been a leading voice in articulating the new social and political demands of chief executives. This generation of leaders is more colloquially known as "woke CEOs." In a Wall Street Journal column published in May, Sonnenfeld said, "This business awakening shouldn't be ridiculed but celebrated as the rediscovery of a misunderstood pillar of America's industrial greatness."

With his strong belief that consumers care about the social positioning of the companies they purchase from and work for, Sonnenfeld's forums also are a space of accountability.

"CEOs and leaders will often try to give you their version of a really theoretical treatise," Sonnenfeld said. The forum demands candor. "We don't need theories," he added. "We want to know what decisions they're actually making. These things are supposed to be pragmatic."

Sonnenfeld spends hours toiling through research, news stories, videos, and other documents to prepare for his seminars. The topics he chooses — voting rights, racial and gender inequality, sustainability, government taxation, and other geopolitical issues — are those that CEOs might not otherwise talk about in their day-to-day, several attendees said.

The forums are "a genuine interchange between senior people in business," Reuben Mark, the former CEO of Colgate-Palmolive, told Insider, adding: "You're exposed to a wide selection of business opinions which you wouldn't ordinarily get."

Judy Marks, the CEO of Otis Elevator Co., echoed this: "In a short burst of time, you can participate in the exchange and walk away with trend data and a sense of how peers are assessing or dealing with a timely global business topic."

Trust and spontaneity

According to multiple CEOs, Sonnenfeld's forums always sit at the pinnacle of predictability and spontaneity. They know they might get called on to speak — they just don't know when.

Doug Parker, the CEO of American Airlines, attended his first CEO seminar five years ago. Before the event, Sonnenfeld sent Parker an agenda and indicated where he'd like Parker to chime in.

"It was something more tech-related, and I remember thinking, 'I'm not an expert on that. I'd rather be commenting on some of these other agenda items,'" Parker told Insider. "So I sat with my CIO and got up to speed on that topic, only to realize he doesn't live by that agenda at all. He ended up calling on me at a much more appropriate time."

Parker said he appreciated Sonnenfeld's discernment, and many executives have agreed. Sonnenfeld knows whom to call to the stage and, most importantly, when to call them.

While the invitation to rub elbows with other corporate executives and dignitaries, free of the press, is appealing, several executives said Sonnenfeld built trust in a more nuanced manner.

Jim McCann, 1-800-Flowers' founder, has attended several of Sonnenfeld's forums. For McCann, the events have facilitated necessary conversations, even if they're uncomfortable. During one of the forums in years past, McCann made his way to his assigned area and took a seat.

"All of a sudden, this gentleman comes walking in from behind the stage," McCann said. "He makes his way up to my row and sits directly next to me. I gave him a little poke, and he turns around and almost fainted because he's the guy that's been suing us with some harassment claims on our trademarks to keep us competing with them. That was not an accident."

McCann said he learned how to be more vulnerable as a leader through Sonnenfeld's events. Having witnessed other prominent leaders speak about their obstacles and seen how others have supported, he feels more confident doing so in his own affairs. He, like many others, credited Sonnenfeld with the ability to foster an environment of forthrightness and candor.

"And that's what Jeffrey believes, preaches, and practices," McCann said. "It's all about relationships."

An eye for talent

Sonnenfeld said a diversity in ideology, discipline, and demographics was key to the success of his events. He makes sure there are attendees from across the political spectrum. He also hosts special panels dedicated to furthering women in leadership.

About five years ago, Wattleton, the former Planned Parenthood president, didn't know what to expect when she walked through the doors of the Waldorf Astoria hotel in New York City. Wattleton had been asked to be a speaker at one of Sonnenfeld's forums.

She went in with an open mind.

"I found him to be very supportive," she said. "His intellectual agility is mind-boggling. He can spot talent and experience," often including people from underrepresented communities, she added.

Anne Mulcahy, Xerox's former CEO, has known Sonnenfeld for nearly 20 years and can attest to his eye for talent. She said Sonnenfeld was an early supporter of her career. He invited her to speak during his lectures at Yale and boosted her visibility as the CEO of Xerox by mentioning her work during interviews, she added.

"He has this capability to really see who people are and what they're doing, and he brings attention to them," Mulcahy said. "Jeff has a way of cutting through the superficial and getting to the essence of what people represent, good or bad."

It's this ability that allows Sonnenfeld to curate a guest list that will foster a genuine discussion on the obstacles that business leaders face. In many ways, Sonnenfeld is holding court for corporate America, something that's not lost on him.

"I'm pleased that people see these events to be truthful, fair, and balanced," Sonnenfeld said. "I respond to where the group wants to go. I'm not beholden to any CEO, so I'm not worried about somebody being offended."

This story is part of the Future of Executive Leadership project.

https://foreignpolicy.com/2022/07/22/russia-economy-sanctions-myths-ruble-business/?tpcc=recirc_latest062921

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ARGUMENT

An expert's point of view on a current event.

Nine myths about the effects of sanctions and business retreats, debunked.

By **Jeffrey Sonnenfeld**, the Lester Crown professor in management practice and a senior associate dean at the Yale School of Management, and **Steven Tian**, the director of research at the Yale Chief Executive Leadership Institute.

A view of the Russian Central Bank headquarters in downtown Moscow on May 26. NATALIA KOLESNIKOVA/AFP VIA GETTY IMAGES

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JULY 22, 2022, 5:56 PM

Five months into the Russian invasion of Ukraine, there remains a startling lack of understanding by many Western policymakers and commentators of the economic dimensions of President Vladimir Putin's invasion and what it has meant for Russia's economic positioning both domestically and globally.

Far from being ineffective or disappointing, as many have argued, international sanctions and voluntary business retreats have exerted a devastating effect over Russia's economy. The deteriorating economy has served as a powerful if underappreciated complement to the deteriorating political landscape facing Putin.

That these misunderstandings persist is not entirely surprising given the lack of available economic data. In fact, many of the excessively sanguine Russian economic analyses, forecasts, and projections that have proliferated in recent months share a crucial methodological flaw: These analyses draw most, if not all, of their underlying evidence from periodic economic releases by the Russian government itself. Numbers released by the Kremlin have long been held to be largely if not always credible, but there are certain problems.

First, the Kremlin's economic releases are becoming increasingly cherry-picked—partial and incomplete, selectively tossing out unfavorable metrics. The Russian government has progressively withheld an increasing number of key statistics that, prior to the war, were updated on a monthly basis, including all foreign trade data. Among these are statistics relating to exports and imports, particularly with Europe; oil and gas monthly output data; commodity export quantities; capital inflows and outflows; financial statements of major companies, which used to be released on a mandatory basis by companies themselves; central bank monetary base data; foreign direct investment data; lending and loan origination data; and other data related to the availability of credit. Even Rosaviatsiya, the federal air transport agency, abruptly ceased publishing data on airline and airport passenger volumes.

Since the Kremlin stopped releasing updated numbers, constraining the availability of economic data for researchers to draw upon, many excessively rosy economic forecasts have irrationally extrapolated economic releases from the early days of the invasion, when sanctions and the business retreat had not taken full effect. Even those favorable statistics that have been released are dubious, given the political pressure the Kremlin has exerted to corrupt statistical integrity.

Mindful of the dangers of accepting Kremlin statistics at face value, our team of experts, using private Russian-language and direct data sources including high-frequency consumer data, cross-channel checks, releases from Russia's international trade partners, and data mining of complex shipping data, have released one of the first comprehensive economic analyses measuring Russian current economic activity five months into the invasion, with contributions from Franek Sokolowski, Michal Wyrebkowski, Mateusz Kasprowicz, Michal Boron, Yash Bhansali, and Ryan Vakil. From our analysis, it becomes clear: Business retreats and sanctions are crushing the Russian economy in the short term and the long term. Based on our research, we are able to challenge nine widely held but misleading myths about Russia's supposed economic resilience.

Myth 1: Russia can redirect its gas exports and sell to Asia in lieu of Europe.

This is one of Putin's favorite and most misleading talking points, doubling down on a much-hyped pivot to the east. But natural gas is not a fungible export for Russia. Less than 10 percent of Russia's gas capacity is liquefied natural gas, so Russian gas exports remain reliant on a system of fixed pipelines carrying piped gas. The vast majority of Russia's pipelines flow toward Europe; those pipelines, which originate in western Russia, are not connectable to a separate nascent network of pipelines that link Eastern Siberia to Asia, which contains only 10 percent of the capacity of the European pipeline network. Indeed, the 16.5 billion cubic meters of gas exported by Russia to China last year represented less than 10 percent of the 170 billion cubic meters of natural gas sent by Russia to Europe.

Long-planned Asian pipeline projects currently under construction are still years away from becoming operational, much less hastily initiated new projects, and financing of these costly gas pipeline projects also now puts Russia at a significant disadvantage.

Overall, Russia needs world markets far more than the world needs Russian supplies; Europe received 83 percent of Russian gas exports but drew only 46 percent of its own supply from Russia in 2021. With limited pipeline connectivity to Asia, more Russian gas stays in the ground; indeed, the Russian state energy company Gazprom's published data shows production is already down more than 35 percent year-on-year this month. For all Putin's energy blackmail of Europe, he is doing so at significant financial cost to his own coffers.

Myth 2: Since oil is more fungible than gas, Putin can just sell more to Asia.

Russian oil exports now also reflect Putin's diminished economic and geopolitical clout. Recognizing that Russia has nowhere else to turn, and mindful that they have more purchasing options than Russia has buyers, China and India are driving an unprecedented approximately $35 discount on Russian Urals oil purchases, even though the historical spread has never ranged beyond $5—not even during the 2014 Crimean crisis—and at times Russian oil has actually sold at a premium to Brent and WTI oil. Furthermore, it takes Russian oil tankers an average of 35 days to reach East Asia, versus two to seven days to reach Europe, which is why historically only 39 percent of Russian oil has gone to Asia versus the 53 percent destined for Europe.

This margin pressure is felt keenly by Russia, as it remains a relatively high-cost producer relative to the other major oil producers, with some of the highest break-evens of any producing country. The Russian upstream industry has also long been reliant on Western technology, which combined with the loss of both Russia's erstwhile primary market and Russia's diminished economic clout leads to even the Russian energy ministry revising its projections of long-term oil output downward. There is no doubt that, as many energy experts predicted, Russia is losing its status as an energy superpower, with an irrevocable deterioration in its strategic economic positioning as an erstwhile reliable supplier of commodities.

Myth 3: Russia is making up for lost Western businesses and imports by replacing them with imports from Asia.

Imports play an important role within Russia's domestic economy, consisting of about 20 percent of Russian GDP, and, despite Putin's bellicose delusions of total self-sufficiency, the country needs crucial inputs, parts, and technology from hesitant trade partners. Despite some lingering supply chain leakiness, Russian imports have collapsed by over 50 percent in recent months.

China has not moved into the Russian market to the extent that many feared; in fact, according to the most recent monthly releases from the Chinese General Administration of Customs, Chinese exports to Russia plummeted by more than 50 percent from the start of the year to April, falling from over $8.1 billion monthly to $3.8 billion. Considering China exports seven times as much to the United States than Russia, it appears that even Chinese companies are more concerned about running afoul of U.S. sanctions than of losing marginal positions in the Russian market, reflecting Russia's weak economic hand with its global trade partners.

Myth 4: Russian domestic consumption and consumer health remain strong.

Some of the sectors most dependent on international supply chains have been hit with debilitating inflation around 40-60 percent—on extremely low sales volumes. For example, foreign car sales in Russia fell by an average of 95 percent across major car companies, with sales ground to a complete halt.

Amid supply shortages, soaring prices, and fading consumer sentiment, it is hardly surprising that Russian Purchasing Managers' Index readings—which capture how purchasing managers are viewing the economy—have plunged, particularly for new orders, alongside plunges in consumer spending and retail sales data by around 20 percent year-over-year. Other readings of high-frequency data such as e-commerce sales within Yandex and same-store traffic at retail sites across Moscow reinforce steep declines in consumer spending and sales, no matter what the Kremlin says.

Myth 5: Global businesses have not really pulled out of Russia, and business, capital, and talent flight from Russia are overstated.

Global businesses represent around 12 percent of Russia's workforce (5 million workers), and, as a result of the business retreat, over 1,000 companies representing around 40 percent of Russia's GDP have curtailed operations in the country, reversing three decades' worth of foreign investment and buttressing unprecedented simultaneous capital and talent flight in a mass exodus of 500,000 individuals, many of whom are exactly the highly educated, technically skilled workers Russia cannot afford to lose. Even the mayor of Moscow has acknowledged an expected massive loss of jobs as businesses go through the process of fully exiting.

Myth 6: Putin is running a budget surplus thanks to high energy prices.

Russia is actually on pace to run a budget deficit this year equivalent to 2 percent of GDP, according to its own finance minister—one of the only times the budget has been in deficit in years, despite high energy prices—thanks to Putin's unsustainable spending spree; on top of dramatic increases in military spending, Putin is resorting to patently unsustainable, dramatic fiscal and monetary intervention, including a laundry list of Kremlin pet projects, all of which have contributed to the money supply nearly doubling in Russia since the invasion began. Putin's reckless spending is clearly putting Kremlin finances under strain.

Myth 7: Putin has hundreds of billions of dollars in rainy day funds, so the Kremlin's finances are unlikely to be strained anytime soon.

The most obvious challenge facing Putin's rainy day funds is the fact that of his around $600 billion in foreign exchange reserves, accumulated from years' worth of oil and gas revenues, $300 billion is frozen and out of reach with allied countries across the United States, Europe, and Japan restricting access. There have been some calls to seize this $300 billion to finance the reconstruction of Ukraine.

Putin's remaining foreign exchange reserves are decreasing at an alarming rate, by around $75 billion since the start of the war. Critics point out that official foreign exchange reserves of the central bank technically can only decrease due to international sanctions placed on the central bank, and they suggest that nonsanctioned financial institutions such as Gazprombank could still accumulate such reserves in place of the central bank. While this may be technically true, there is simultaneously no evidence to suggest that Gazprombank is actually accumulating any reserves given sizable strain on its own loan book.

Furthermore, although the finance ministry had planned to reinstate a long-standing Russian budgetary rule that surplus revenue from oil and gas sales should be channeled into the sovereign wealth fund, Putin axed this proposal as well as accompanying guidelines directing how and where the National Wealth Fund can be spent—as Finance Minister Anton Siluanov floated the idea of withdrawing funds from the National Wealth Fund equivalent to a third of the entire fund to pay for this deficit this year. If Russia is running a budget deficit requiring the drawdown of a third of its sovereign wealth fund when oil and gas revenues are still relatively strong, all signs indicate a Kremlin that may be running out of money much faster than conventionally appreciated.

Myth 8: The ruble is the world's strongest-performing currency this year.

One of Putin's favorite propaganda talking points, the appreciation of the ruble is an artificial reflection of unprecedented, draconian capital control—which rank among the most restrictive of any in the world. The restrictions make it effectively impossible for any Russian to legally purchase dollars or even access a majority of their dollar deposits, while artificially inflating demand through forced purchases by major exporters—all of which remain largely in place today.

The official exchange rate is misleading, anyhow, as the ruble is, unsurprisingly, trading at dramatically diminished volumes compared to before the invasion on low liquidity. By many reports, much of this erstwhile trading has migrated to unofficial ruble black markets. Even the Bank of Russia has admitted that the exchange rate is a reflection more of government policies and a blunt expression of the country's trade balance rather than freely tradeable liquid foreign exchange markets.

Myth 9: The implementation of sanctions and business retreats are now largely done, and no more economic pressure is needed.

Russia's economy has been severely damaged, but the business retreats and sanctions applied against Russia are incomplete. Even with the deterioration in Russia's exports positioning, it continues to draw too much oil and gas revenue from the sanctions carveout, which sustains Putin's extravagant domestic spending and obfuscates structural economic weaknesses. The Kyiv School of Economics and Yermak-McFaul International Working Group have led the way in proposing additional sanctions measures across individual sanctions, energy sanctions, and financial sanctions, led by former U.S. Ambassador to Russia Michael McFaul and the experts Tymofiy Mylovanov, Nataliia Shapoval, and Andriy Boytsun. Looking ahead, there is no path out of economic oblivion for Russia as long as the allied countries remain unified in maintaining and increasing sanctions pressure against Russia.

Defeatist headlines arguing that Russia's economy has bounced back are simply not factual—the facts are that, by any metric and on any level, the Russian economy is reeling, and now is not the time to step on the brakes.

Jeffrey Sonnenfeld *is the Lester Crown professor in management practice and a senior associate dean at the Yale School of Management. Twitter: @jeffsonnenfeld*

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ARGUMENT

An expert's point of view on a current event.

How to Take Down a Tyrant

Three steps for exerting maximum economic pressure on Putin.

By Jeffrey Sonnenfeld, the Lester Crown professor in management practice and a senior associate dean at the Yale School of Management, and Steven Tian, the director of research at the Yale Chief Executive Leadership Institute.

Russian President Vladimir Putin

Russian President Vladimir Putin holds a meeting at the Kremlin in Moscow on April 20. MIKHAIL TERESHCHENKO/SPUTNIK/AFP VIA GETTY IMAGES

AUGUST 10, 2022, 10:47 AM

Cynics have been quick to sound off over the supposed inefficacy of multinational business retreats and global government sanctions in changing the behavior of brutal autocrats such as Russian President Vladimir Putin, pointing to ineffective examples such as Cuba, Iran, Venezuela, Syria, and North Korea. French politician Marine Le Pen recently called for an end to "useless" sanctions on Russia in response to its invasion of Ukraine, echoing a *Guardian* columnist who declared that "Western sanctions against Russia are the most ill-conceived and counterproductive policy in recent international history." The *New York Times*' Paul Krugman, too, selectively listed examples of ineffective economic embargoes reaching far back into the 19th century in a recent op-ed.

However, our 42-person research team, which includes teams of researchers on the ground in Russia and across Eurasia, and with crucial contributions from Franek Sokolowski and Michal Wyrebkowski, found in a comprehensive analysis that the Russian economy is already under serious strain. Yet we continue to hear that an authoritarian regime can always simply ignore the economic distress and outlast Western liberal democracies in a "war of attrition."

That economic pressure cannot change or even end authoritarian regimes is a contention simply not supported by the evidence. In fact, our research highlights that over the past several decades alone, there are at least 10 prominent examples reaffirming that when civil society crumbled through externally induced economic implosion, autocratic leaders were overthrown abruptly. In each of these cases—which include Muammar al-Qaddafi of Libya, Slobodan Milosevic of Yugoslavia, Augusto Pinochet of Chile, Wojciech Jaruzelski of Poland, Erich Honecker of East Germany, Nicolae Ceausescu of Romania, P.W. Botha of South Africa, the military junta of 1980s Argentina, Ian Smith of Rhodesia, and British colonial rule in India—autocrats lost legitimacy when economic collapse preceded internal revolution.

Every regime collapse is obviously caused by a confluence of factors, as other experts have explored. Yet, at the same time, some patterns are readily apparent from analyzing the cases where economic implosion preceded collapse, revealing at least three crucial, transferable lessons of how economic pressure can be most effective.

1. Isolate the sanctioned nation as completely as possible.

The vexing survival of sanctioned nations, such as North Korea and Cuba, is regularly invoked by those skeptical of economic blockades. North Korea is completely economically dependent on China, which represents over 90 percent of its total trade, including most food and energy imports. Despite some limited admonitions to cool its bellicosity in the region, China has avoided any actions that would imperil North Korea's leadership regime by weakening its economic lifeline.

Of course, North Korea is a strategic defense asset for an increasingly expansionism-minded China. Some experts even believe that China may rely on North Korea's offensive strike capability to disable the U.S. early warning system, enhancing China's surprise capabilities.

The situation in Cuba echoes that of North Korea. Cuba and the Soviet Union, and later Russia, enjoyed a deep economic and military partnership since Fidel Castro's 1959 revolution. The United States imposed a naval and economic blockade of Cuba following the 1962 installation of Soviet nuclear missiles in Cuba. While tensions have subsided since that nuclear brinkmanship, U.S. sanctions against Cuba did not topple its government thanks, in part, to Soviet and Russian support. Russian-Cuban relations waned over time but intensified this year as Cuba has hosted high-level recent visits from Russian officials, showing support for Russia's assault on Ukraine while benefitting from increased humanitarian assistance from Russia—as well as Russia's newfound willingness to accept delays in Cuban repayment of billions of dollars of debt for infrastructure projects.

It is not as clear that Russia would forge a vassal state relationship with China along the lines of Cuba's and North Korea's relationships with the two larger powers. Russia has long been a vital source of oil, gas, and other raw materials that have fueled China's growth, allowing it to become the world's second-largest economy. And just weeks in advance of Russia's February attack on Ukraine and on the eve of the Winter Olympics in Beijing, Russia and China signed an agreement expressing "no limits" to this friendship while criticizing NATO. In a phone call with Putin four months later, Chinese President Xi Jinping reaffirmed his country's renewed support for Russian sovereignty and security.

However, in recent weeks, Russia arrested three of its own top scientists, charging them with treason for conspiring with China's security services. Moreover, while China avoided condemning the Russian invasion of Ukraine and attempted to remain neutral regarding the faltering Russian economy, it has not moved to make up for an apparent significant drop in imports into Russia in recent months.

In fact, as shown by the most recent monthly releases from the Chinese General Administration of Customs, Chinese exports to Russia also plummeted by more than 50 percent for the first four months of this year, falling from over $8.1 billion monthly to $3.8 billion in April with only a slight rebound since. A studied neutrality is in China's strategic interest given it exports seven times more to the United States than it does to Russia.

2. Pair government sanctions with voluntary private sector action.

When businesses exit countries voluntarily beyond what is required by government sanctions, they make independent decisions based on moral, financial, and business risk reasons, often facing pressure from key stakeholders; as one of our studies found, the stocks of companies that exited Russia were strongly rewarded by investors.

There are some instances, such as on toppling apartheid in South Africa, when governments and businesses have directly strengthened the other's positioning. In the 1980s, over 100 multinational companies agreed to a voluntary code of conduct relating to business activity in South Africa known as the Sullivan Principles.

The apartheid regime's refusal to allow businesses to adhere to the Sullivan Principles provoked widespread backlash, which spurred Congress to pass the Comprehensive Anti-Apartheid Act of 1986, then mirrored by other nations. Although then-U.S. President Ronald Reagan initially vetoed the sanctions package, a bipartisan 78-member Senate majority overrode the veto, with even

Reagan's fellow Republicans—such as current Senate Minority Leader Mitch McConnell—saying, "I think he is ill-advised. I think he is wrong. We have waited long enough for him to come on board."

At the same time, 200 companies, including GM, IBM, Ford, GE, Kodak, and Coca-Cola, all announced their complete withdrawal from South Africa beyond sanctions compliance, hollowing out the South African economy within a few short years. There was massive private capital outflow of over $10 billion in the late 1980s, and $2 billion of trade was lost annually preceding the fall of the tyrannical Botha regime.

Not all successful instances of embargos feature such overt convergence between government mandates and business withdrawals. That's in part because there are many forms of business withdrawal from a country short of a full, trumpeted exit. Still, these are no less consequential and, in fact, often more important than government mandates, in eroding a country's economic productivity and innovation base.

For example, in confronting the military junta autocrats of Argentina in the 1980s, international sanctions applied in the immediate aftermath of the Falklands War soon rolled off as the immediate crisis passed, but multinational businesses, and particularly financial institutions, rattled by the regime's capriciousness, quietly looked for the exits, exacerbating an already-challenging inflationary debt crisis. Over the ensuing months and years, there was massive capital flight equivalent to nearly 10 percent of Argentine GDP and a 91 percent drop in stock prices. The feedback loop created by the loss of revenue soon resulted in a balance-of-payments crisis, as Argentina was saddled with $40 billion in foreign debt equivalent to around half of GDP. The country, too, was forced to devalue its currency by 93 percent—but not before spending down 83 percent of its foreign reserves amid hyperinflation of 5,000 percent, persistent rioting, and even more dramatic capital flight.

The private sector's ability to withhold and withdraw capital was also felt keenly by Augusto Pinochet of Chile. Long a controversial figure in diplomatic circles, Pinochet was accustomed to staring down periodic bouts of government sanctions, implemented with varying levels of intensity, starting from the 1970s; it was not until the rapid "hot money" private capital outflow from the 1982 debt crisis onward, equivalent to 40 percent of GDP, and associated curtailment of Western private lending in Chile that Pinochet began to feel the economic squeeze. Unemployment reached 33 percent; real wages dropped 10 percent annually, per our calculations; and foreign exchange reserves fell by 53 percent while Chile worked off foreign debt levels equivalent to 145 percent of GDP.

Given the important economic role of the private sector, multinational business leaders have sometimes assumed the thankless but vital position of counseling truth to holed-up autocrats detached from reality. Take Wojciech Jaruzelski's Poland. After the Solidarity union movement was born from with a strike of 17,000 shipbuilders in 1980, farming boycotts and a general countrywide strike followed. This in turn created the Eastern Bloc's first independent trade union, which grew to include a quarter of Poland's population.

When the government targeted the democratic opposition, foreign businesses took it as a cue to flee en masse—even before the government declared martial law in 1981 and international sanctions were quickly implemented—with rapid capital outflows exacerbating Poland's deficits. Isolated from global capital markets, Poland struggled to service its massive foreign debt of $23 billion while refusing to declare official default. The ensuing economic chaos led to drastic rationing, food shortages, and the imposition of draconian martial law.

By the late 1980s, Jaruzelski, indebted and economically isolated, was forced to come back to the negotiating table with Western creditors. Under pressure from business leaders such as David Rockefeller to soften his political oppression, ultimately Jaruzelski was forced in 1989 to negotiate a power-sharing agreement with the democratic opposition led by Lech Walesa, which quickly led to a peaceful transfer of power and democratization of the country. Walesa replaced the discredited and isolated Jaruzelski as president in 1990.

The reverse is also true: When the private sector works at cross-purposes to government pressure campaigns, the economic effect can be diluted, helping authoritarian regimes stay in power. In one of the most egregious cases, Occidental Petroleum under its longtime leader Armand Hammer—the same Armand Hammer who frequently skirted U.S. embargos of the Soviet Union—played a role in shielding Muammar al-Qaddafi from challenges to his dictatorial rule of Libya during his early reign, interceding with officials from various governments on Qaddafi's behalf (and his own), as Libya's rich oil fields were a crucial component of his empire.

It was only when Hammer had substantively lost his grasp over Occidental in old age that it finally acceded to U.S. government pressure and suspended operations in Libya. The loss of Western exploration and production upstream technology in the years afterward, combined with international sanctions, steadily eroded Libya's oil production and growth capabilities and, by extension, its domestic economy, through periodic fits and starts, for years prior to Qaddafi's ultimate fall in 2011.

3. Make government sanctions comprehensive, across sectors and between countries.

Sanctions experts are generally much more comfortable with precise, limited measures—what they refer to as "smart sanctions"—aimed at transforming a blunt macroeconomic hammer into surgical strikes. These target only a few presumed key industries in order to limit unintended spillover.

But the playbook of prior business retreats and consumer boycotts of international consequence embraced the opposite ethos: comprehensiveness across sectors, aimed at disrupting civil society. The Swadeshi movement, with Mahatma Gandhi's leadership, encouraged millions of Indians to stop buying all British goods—everything including textiles, tea, and steel. This had the effect of drastically cutting the value of British exports in these key industries prior to Indian independence in 1947. Similarly, the anti-apartheid movement began as an organic grassroots boycott movement, organized in 1959 by consumers around the world answering Albert Luthuli's call for an international boycott of all South African products until the abolition of apartheid. These consumer boycotts proved remarkably persistent and resonant for decades, well before the development of the Sullivan Principles and government sanctions, and cost South Africa up to a billion dollars a year in lost trade by expert estimates.

Likewise, many prior government mandates followed the same logic of comprehensiveness between countries. For example, during the Cold War, the Coordinating Committee for Multilateral Export Controls placed a blanket embargo on trade across all sensitive technologies with all countries in the communist trade organization Comecon, including East Germany, Romania, and Poland. The export controls were so tight that, as one example, even East Germany, the strongest economy of the Eastern Bloc, fell several generations behind in semiconductor design and manufacturing. At the same time as Erich Honecker was boasting about the development of a 1-megabit semiconductor chip, Japan and the United States were already manufacturing 4-megabit semiconductors many generations more advanced, with some types of chips costing 130 times less to import than to manufacture in East Germany, reflecting the comprehensive and effective sanctions regimen which degraded Comecon access to technology.

By contrast, even though the United Nations Security Council passed obligatory comprehensive economic embargo resolutions against Rhodesia (now Zimbabwe) in the mid-1960s, it took nearly 15 years for these sanctions to flow through, as, by the admission of top officials, they willingly ignored significant shortcomings in sanctions enforcement. Some major trade partners such as Portugal and South Africa outright refused to recognize the validity of the sanctions regime, while others such as France and Switzerland were chronic violators until increased enforcement finally stemmed the flow of illicit goods into and out of Rhodesia.

Clearly, these partial diplomatic compromises targeting only a few presumed key industries with significant leakages end up diluting the efficacy of economic pressure, in stark contrast to a more comprehensive approach—across sectors and with broad buy-in.

These lessons suggest that at a minimum, economic pressure is only maximally effective if it combines the full force of government mandates with massive voluntary private sector exits, and if it consists not only of partial targeting of a few perceived strategic industries but of a more comprehensive approach, matched with a proactive communications effort. This is quite the opposite approach to what many sanctions experts advocate for, but as Walesa reminds us, "The fall of the Berlin Wall makes for nice pictures. But it all started in the shipyards."

Sanctions must not be understood as a fragmented default option when diplomacy dissolves or when military action is stalemated through sequential cease-fire violations and negotiation collapses. Instead, they must be seen as a primary strategic alternative to war as they degrade aspiring totalitarians, forcing them to surrender total control of civil society. In this way, through these steps, Putin will be revealed to be the true enemy of the Russian people, and the courageous opposition voices will be joined by disgruntled masses concealed by sham public opinion polls.

Given Putin's open saber-rattling of the prospect of thermonuclear war and drawn-down but nevertheless ample cash cushion, some military leaders consider him to be the most dangerous person on Earth. Around 90 percent the world's 12,700 nuclear warheads are held by Russia and the United States, with a significant portion ready for military use.

Eroding Putin's internal legitimacy is a safer path than attempting to disarm him in permanent direct battle—or ignoring his bloody imperial agenda and falling victim to the cowardly self-defeating path of appeasement. And this can only be done by broadening economic pressure toward comprehensiveness, working hand in hand with business.

This article has been adapted from original research by the Yale Chief Executive Leadership Institute on the current state of the Russian economy and case studies of economic collapse preceding the downfall of authoritarian regimes.

https://www.politico.com/news/magazine/2022/10/09/the-u-s-has-leverage-over-saudi-arabia-its-time-to-use-it-00061082

POLITICO

WASHINGTON AND THE WORLD

Opinion | The U.S. Has Leverage Over Saudi Arabia. It's Time to Use It.

Sen. Richard Blumenthal and Rep. Ro Khanna propose new legislation to respond to Saudi's embrace of Vladimir Putin and to rebalance the U.S.'s relationship with Riyadh.

Opinion by SEN. RICHARD BLUMENTHAL, REP. RO KHANNA and JEFFREY SONNENFELD
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This week, Saudi Arabia colluded with Russia — deciding to cut 2 million barrels a day of oil production at the OPEC+ meeting, thus raising the price of gas to Russia's advantage. The shocking move will worsen global inflation, undermine successful efforts in the U.S. to bring down the price of gas, and help fuel Putin's unprovoked invasion of Ukraine.

The Saudi decision was a pointed blow to the U.S., but the U.S. also has a way to respond: It can promptly pause the massive transfer of American warfare technology into the eager hands of the Saudis. Simply put, America shouldn't be providing such unlimited control of strategic defense systems to an apparent ally of our greatest enemy — nuclear bomb extortionist Vladmir Putin.

That is why we are proposing bicameral legislation in the Senate and House on Tuesday that will immediately halt all U.S. arms sales to Saudi Arabia. For several years now, our colleagues have been considering similar proposals, but those measures haven't passed. Due to intense bipartisan blowback to Saudi's collusion with Russia, we think this time is different. Based on our conversation with colleagues, our legislation is already garnering bipartisan support in both chambers.

What would lead the Saudis so unwisely to err with their recent OPEC+ mistake? Stunned energy commentators have suggested that the Saudis were merely concerned about their endangered financial returns, acting rationally. Denying any political motives, Ali Shihabi, a Saudi analyst, insisted in the *New York Times* that the move was merely "to keep the price in an acceptable band."

But this claim is unjustified. OPEC has never cut production in such a record tight market and these production cuts will lead to unsustainably low oil inventories, sending the price of oil skyrocketing out of any "acceptable band." Furthermore, the G-7 oil price caps plan is not targeted at OPEC; it is strictly limited to Russian oil.

Nor can this Saudi move be justified by the non-existent global recession its leaders cite. Presently markets are very tight, with lush 73 percent profit margins for Saudi Arabia. In other words, there was no immediate need for Saudi Arabia to reduce supply unless they were seeking to harm the U.S. to the benefit of Russia.

Every OPEC member has been making massive profits recently — except Russia because it is OPEC's least efficient producer. It costs Russia $46/barrel to extract oil but, with U.S. technology, the Saudi's cost is only $22/barrel. Plus, only Russia has had to offer huge $35/barrel discounts to customers like India and China since few others want sanctioned Russian oil.

To be clear, Saudi Arabia remains important to energy security and stability in the Middle East, to global economic prosperity, and as a regional ally against Iran, but it made a terrible mistake this week. The country's support for Russia should spark a far-reaching review of the U.S.-Saudi relationship — even as the regime tries to "sportswash" its international image in the wake of *Washington Post* columnist Jamal Khashoggi's brutal murder and the humanitarian disaster caused by Saudi's war in Yemen.

Members of Congress are already talking about how best to respond. Some propose extending domestic antitrust laws to international commerce. Others propose reviving a GOP initiative to withdraw U.S. troops from Saudi Arabia. But that idea has failed previously given that the U.S. would rather have its own troops there than Russian or Chinese troops.

A simpler, far more urgent move to fortify U.S. national security would be to pause all U.S. military supplies, sales and other weapons aid to Saudi Arabia. This includes the controversial, new and hastily planned Red Sands testing facilities in Saudi Arabia.

U.S. military collaboration with the Saudi regime is more extensive than many realize, but that also gives the U.S. significant economic and security leverage over Riyadh. Today, Saudi Arabia is hugely dependent on U.S. defense assistance, purchasing the vast majority of its arms from the United States. The country cannot substitute defense suppliers unless it wishes to partner with Russia, Iran or China for far inferior systems which have no interoperability with their existing weaponry. (While Saudi does source some military technology from other countries, that's typically low-grade weaponry and small arms such as legacy grenade launchers, rifles and ammunition.)

Perhaps even more important than Saudi's reliance on U.S. arms is its reliance on U.S. companies to help build up the local defense industry through big-ticket joint ventures. These sensitive and intensive arrangements — which have received little public attention — were largely initiated in 2017 and have outsourced U.S. sensitive technology and U.S. jobs to Saudi Arabia without any U.S. control. The U.S. doesn't have arrangements of this magnitude with any other allies.

Given the early-stage nature of these joint ventures as well as minimal interoperability between Saudi's current weapons system and potential foreign replacements, Saudi can do little to respond to this proposed legislation other than come back to the table and negotiate with the U.S. in good faith. As one expert noted, "it would take decades to transition away from U.S. and UK aircraft, for example, to Russian or Chinese aircraft. Same is true for tanks, communication and other hi-tech equipment." It would be a severe challenge, if not downright impossible, for Saudi to execute an overnight short-term sourcing pivot if faced with a ban on arms sales. And any ban could be temporary — until Saudi Arabia reconsiders its embrace of Putin.

Maybe it is worth considering some ancient Russian wisdom ourselves. Over a century ago, Russian playwright Anton Chekhov warned, "Knowledge is of no value unless you put it into practice." Perhaps the same is true about leverage. It is of no value unless used.

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