

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

**Taking Stock of “China, Inc.”: Examining Risks to Investors and the U.S. Posed by Foreign  
Issuers in the U.S. Markets**

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Chairman Sherman, Ranking Member Huizenga, distinguished members of the Subcommittee:  
thank you for the opportunity to testify today.

I am a senior analyst at RWR Advisory Group, a research and advisory firm based in DC. I  
specialize in the geopolitical and national security risk implications of Chinese commercial  
activity and engagement overseas.

I have been asked to provide some context on the nature of Chinese corporate actors and their  
role in China’s state-led economy. I will also lay out several risks to investors and the United  
States, posed by Chinese issuers in the U.S. markets, followed by recommendations for  
policymakers and government stakeholders.

**Risk: The CCP’s involvement in and control of the private sector means that Chinese  
companies are beholden to the party-state and can be compelled to sacrifice corporate  
interests for government favor.**

The Chinese government has the authority to direct the behavior of its commercial actors,  
including companies in the private sector, which are ultimately controlled or controllable by the  
government under national laws and regulations. The party-state is embedded in commercial

decision-making processes through the Communist Party of China (CCP)'s integration in corporate structures. And although state-owned enterprises remain central to China's planned economy, the Chinese government has called for the CCP to guide and develop the private sector enterprises as an important part of China's construction of a "socialist market economy."

The CCP has long called on its private sector to establish party organizations and strengthen the CCP's role in the private economy. Party organizations such as committees and branches are intended to link corporate activities with CCP policy frameworks and norms. According to government statistics, in 1999, only 1.5% of private sector enterprises in China had established internal party organizations.<sup>1</sup> By 2017, however, party organizations existed in 67.9% of China's private sector companies (and even 70% of foreign-owned firms).<sup>2</sup>

The CCP's current target is for all private sector enterprises with over 50 employees to have a formal CCP member on its staff. If a company has three or more Party members, then a separate Party organization must be established. If a private company has not yet established a Party organization, the CCP advises that it should still carry out Party work by assigning employees Party-building roles and by establishing Communist Youth League organizations.<sup>3</sup> Chinese government authorities at the provincial level also embed CCP officials and cadres (personnel) within the operations of large, privately-owned companies to ostensibly coordinate government policy and ensure regulatory compliance.

In September 2019, a government website announced that the Hangzhou Municipal Government planned to transfer 100 CCP officials to serve as government affair representatives at 100 "key enterprises" including tech giant Alibaba Group, automotive company Zhejiang Geely Holdings, and food and beverages producer Hangzhou Wahaha Group. Each official would be embedded in their designated company for one year to "conduct government affairs."<sup>4</sup> Similarly, the Henan Provincial Government dispatches CCP officials to private sector entities. As of September 2019, Hebi City had 161 such "service stewards" stationed at private companies. The deputy director of Hebi City's Development and Reform Commission, for example, was assigned to Hebi Baofa Energy Technology Co., Ltd. Other local governments

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<sup>1</sup> [https://baike.baidu.com/reference/15116933/9859qLw8MDD0wx\\_48BjVkzU-ZRsampKsE0dk8rj0fLUwM2qK4E8FDn-C6lPRmqnenO82aq-7iUxvA0ME06ySem1InsoLOTkXk8CiMRIYwe3z-v5B2Vd4n5FRcp0W](https://baike.baidu.com/reference/15116933/9859qLw8MDD0wx_48BjVkzU-ZRsampKsE0dk8rj0fLUwM2qK4E8FDn-C6lPRmqnenO82aq-7iUxvA0ME06ySem1InsoLOTkXk8CiMRIYwe3z-v5B2Vd4n5FRcp0W)

<sup>2</sup> <http://cpc.people.com.cn/19th/n1/2017/1019/c414536-29596679.html>

<sup>3</sup> [http://www.samr.gov.cn/djzsj/scdjgz/wjfg/201902/t20190215\\_281570.html](http://www.samr.gov.cn/djzsj/scdjgz/wjfg/201902/t20190215_281570.html)

<sup>4</sup> [https://biz.zjol.com.cn/zjjbd/zjxw/201909/t20190921\\_11055873.shtml](https://biz.zjol.com.cn/zjjbd/zjxw/201909/t20190921_11055873.shtml)

have adopted “two-way” programs to exchange mid-level CCP cadres with mid-level company employees.<sup>5</sup>

There are clear incentives for companies in China’s private sector to welcome CCP guidance, and to operate in ways that are conducive to state strategic interests. Studies have found that private entrepreneurs with Party membership are more likely to obtain loans from banks and other state institutions, and private companies with CCP organizations have an easier time obtaining administrative approval and government support.<sup>6</sup> Chinese corporate actors are directed to meet the targets of state planning through industrial policies, guidance catalogues, strategic sectors, and other measures. This results in an atmosphere that compels Chinese companies to behave differently from profit-seeking commercial businesses in the U.S. free market. On the other side of the coin, Chinese companies are subject to economic coercion and arbitrary punishment for crossing red lines laid down by CCP leadership.

This allegiance can be observed across companies in the private sector, including those that are publicly traded. China CITIC Bank Corp. Ltd. is listed on the Shanghai and Hong Kong exchanges. Despite being owned by state-owned CITIC Group, it is considered a non-public company (private sector). In an article published in September 2021, China CITIC Bank president Fang Heying said that the bank will “always put political construction in the first place” and integrate party decisions into the bank’s strategic goals and corporate governance.<sup>7</sup>

**Risk: The Chinese government prioritizes state stability and social control over commercial gains. China’s financial markets are leveraged to serve the CCP’s strategic goals and objectives.**

The heavy-handed and reactive nature of the Chinese government’s regulatory apparatus can sometimes undermine its own companies and, consequently, American investors in those companies. Index providers, fund managers, and other financial intermediaries that effectively control U.S. investor access to publicly traded Chinese companies should take into full consideration the reality that fluctuations in Chinese government policy can result in material

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<sup>5</sup> <https://finance.sina.cn/china/gncj/2019-09-22/detail-iicezzrq7690983.d.html>

<sup>6</sup> <https://www.sciencedirect.com/science/article/abs/pii/S0304387807000259?via%3Dihub>.  
[https://qks.sufe.edu.cn/mv\\_html/j00002/202010/c68a3c4c-011e-4104-9eff-8301dbbdec99 WEB.htm](https://qks.sufe.edu.cn/mv_html/j00002/202010/c68a3c4c-011e-4104-9eff-8301dbbdec99_WEB.htm)

<sup>7</sup> [http://xw.sinoins.com/2021-09/24/content\\_410440.htm](http://xw.sinoins.com/2021-09/24/content_410440.htm)

and quantifiable damage to a company's performance across a variety of indicators. Actions taken by the Chinese government to gain state control, protect the party's legitimacy, or target perceived societal ills – like its recent crackdown on the entertainment industry and heightened scrutiny of tech companies – can affect companies' business prospects, financial performance, and even survival.

China's authoritarian government exercises significant state control over pricing, production, investment, resource allocation, and administrative and regulatory transparency. It is against this background that China was classified as a non-market economy (NME) when it joined the World Trade Organization (WTO) in 2001. After Beijing launched a formal complaint in 2016 challenging the continued use of this classification, the U.S. Department of Commerce conducted a review in 2017 and concluded that China is very much still a NME because "the state's role in the economy and its relationship with markets and the private sector results in fundamental distortions in the Chinese economy."<sup>8</sup>

The Commerce Department's decision rested on several examples of Chinese state control. The National Development and Reform Commission (NDRC)'s legislative and regulatory authority extends to setting prices for commodities and services, and approving large domestic and foreign investment projects. The prevalence of state owned and controlled enterprises gives the government the ability to regulate the means of production and allocate resources to strategically or fundamentally important sectors. And mechanisms like investment approvals, guidance catalogues, quantitative restrictions, and sectoral-level planning grant the central government significant power to influence and direct resource allocations.<sup>9</sup>

Against this background, it has been increasingly evident that Chinese leader Xi Jinping is on a path to rein in the private sector and to steer the country towards new stage of socialist development, with greater government intervention, intended to consolidate state power. Under Xi, the CCP has developed and promoted a model that it calls a "socialist market economy with Chinese characteristics," in which the party-state retains effective control over key commercial actors and institutions, industrial policy, and economic direction. The Chinese government is ultimately in control of all its commercial actors and has the power to determine whether a company is allowed to raise capital, provide services and goods, or even continue to exist as a for-profit enterprise. China's financial markets are leveraged to serve the CCP's strategic goals and objectives.

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<sup>8</sup> <https://enforcement.trade.gov/download/prc-nme-status/prc-nme-review-final-103017.pdf>

<sup>9</sup> <https://enforcement.trade.gov/download/prc-nme-status/prc-nme-review-final-103017.pdf>

According to a tally by *The Wall Street Journal* this September, Xi's socialist drive has generated over 100 "regulatory actions, government directives and policy changes" across industries.<sup>10</sup> China's recent regulatory broadside has left the U.S. financial industry faced with the challenge of quantifying the effect of government corporate intervention. The economic and financial effects of Chinese government regulation are not comprehensively measured by official sources.<sup>11</sup> The resulting uncertainty has a material adverse impact on companies and investors, who cannot be sure that IPOs will go ahead (like in the example of Ant Financial) or whether entire industries will be allowed to continue raising funds in the capital markets, resulting in unpredictable and unnatural losses to U.S. shareholders.

Industry targets of China's regulatory crackdown over the past few months have included financial technology, e-commerce, real estate, online gaming, liquor, private tutoring, overseas listings, and data security. When Chinese authorities ramped up restrictions on the private tutoring industry and private education companies in July by prohibiting stock listings and foreign capital investment, Chinese education stocks fell dramatically. Gaotu Techedu shares went down by 76.9%, TAL Education dropped by 70.8%, and New Oriental Education and Technology shares lost 54.2%.<sup>12</sup>

After China's new data privacy law was announced this past August, the Hang Seng Tech Index tracking the 30 largest tech companies on the Hong Kong exchange, including Tencent, Xiaomi, and Lenovo, dropped 2.5%. The shares of large-cap companies in the internet, e-commerce, and online services industries felt an immediate impact: Alibaba Group lost 3%, Meituan dropped 9%, Ping An Healthcare fell 14.5%, and Alibaba Health Information Technology sank 13%.<sup>13</sup> The CSI Overseas China Internet Index, which consists of U.S. and Hong Kong-listed Chinese internet and internet-related technology companies, dropped around 58% from its mid-February peak.<sup>14</sup>

The Nasdaq Golden Dragon China Index, tracking 98 of China's largest companies listed in the U.S., has plummeted nearly 53% in the six months since its peak in February, obliterating about

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<sup>10</sup> <https://www.wsj.com/articles/xi-jinping-aims-to-rein-in-chinese-capitalism-hew-to-maos-socialist-vision-11632150725>.

<sup>11</sup> <https://sgp.fas.org/crs/misc/RL32162.pdf>

<sup>12</sup> <https://www.cnbc.com/2021/07/23/us-listed-china-education-stocks-plunge-as-beijing-regulators-crack-down.html>  
<https://www.google.com/finance/quote/GOTU:NYSE?window=6M>.

<sup>13</sup> <https://fortune.com/2021/08/20/china-stocks-lows-regulation-tech-shares/>

<sup>14</sup> <https://www.google.com/finance/quote/H11137:INDEXNYSEGIS?window=YTD>

\$900 billion in market value.<sup>15</sup> And the MSCI Emerging Markets Index, in which China represents about 34% of the large and mid-cap stocks tracked across emerging markets countries, and which is tracked closely by passively managed public pension funds and endowment funds across the United States, fell 16% in that same period of time.<sup>16</sup>

It should be noted that although the intensity and velocity of China's recent regulatory crackdowns have been somewhat unprecedented, this type of regulatory targeting of industries and companies over the past year is not unusual for the Chinese government. As explained by CSIS Freeman Chair Jude Blanchette, the "massively disruptive" campaign-style targeting of sectors is a way in which the CCP fixes societal and other problems that have become so flagrant that they can no longer be ignored.<sup>17</sup> What has amplified the impact of this latest barrage of regulatory action is the high level of global investor exposure to the stocks of affected companies. The more intertwined U.S. and Chinese capital markets become, the more acutely U.S. investors will feel the aftershocks of capricious Chinese domestic policymaking.

In a recently published report on China's investment outlook, Goldman Sachs estimated that there are publicly traded Chinese companies totaling \$3.2 trillion in market capitalization in "risky social sectors," such as consumer finance, pharmaceuticals, and real estate development, that could be "disproportionately exposed" to further regulatory attention by the Chinese government.<sup>18</sup> Index providers, fund managers, and investors should all be keenly aware that the greater U.S. investor involvement in Chinese markets, the greater the risk exposure to politically-motivated Chinese government intervention and market turbulence.

**Risk: China's opaque bureaucratic and corporate structures prevent high-quality disclosure and transparency, preventing U.S. investors from making informed investment decisions.**

The Chinese party-state's sweeping bureaucratic authority, opaque legal system that practices rule by law rather than rule of law, and the complexity of corporate capital structures can obscure (often intentionally) a Chinese company's beneficial ownership and financial information. Financial due diligence is already difficult to conduct on companies residing

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<sup>15</sup> <https://www.ft.com/content/c5572f5a-d086-4ca2-995a-7b559f4e1d32>

<sup>16</sup> <https://www.google.com/finance/quote/EFS:INDEXCBOE?window=YTD>.

<sup>17</sup> <https://www.goldmansachs.com/insights/pages/gs-research/is-china-investable/report.pdf>

<sup>18</sup> <https://www.goldmansachs.com/insights/pages/gs-research/is-china-investable/report.pdf>

outside of the United States. These China-specific factors make it particularly challenging for U.S. regulatory authorities to conduct proper due diligence and be able to guarantee that the required investor protection measures have been taken.

### Chinese corporate structures: shell companies, reverse mergers, and VIEs

In 2011, press reports revealed that Chinese companies were listing on U.S. exchanges through reverse mergers, which allowed them to bypass standard disclosure requirements. This ultimately cost American investors an estimated \$18 billion due to several companies that not only used this approach as a backdoor, but to commit significant fraud – facilitated by the circumvention of the usual regulatory scrutiny that comes with going public.<sup>19</sup> Despite the scandal, Chinese companies have continued to list through backdoor methods.

The financial-services firm Wins Finance Holdings offers an illustrative example of this phenomenon. In 2015, Wins Finance Holdings was incorporated as a wholly-owned subsidiary of NASDAQ-listed Sino Mercury Acquisition Corporation. Sino was a special purpose acquisition company (SPAC), or a cash shell, registered in the Cayman Islands. Sino then merged into Wins Finance Holdings, allowing Wins to become a publicly-traded company through the reverse merger.<sup>20</sup> During an SEC investigation that concluded in March 2017, it was found that Wins had misrepresented its U.S. headquarters to gain Russell Index inclusion.<sup>21</sup> Wins faced imminent delisting after updating its SEC filings to change its offices from the U.S. to China, but successfully appealed and remained listed on NASDAQ until the fall of 2020 when it delisted for unrelated reasons.<sup>22</sup>

Variable interest entities (VIEs) are legally and functionally ambiguous corporate structures frequently employed by Chinese companies to list on U.S. exchanges, through which overseas listed entities control domestic Chinese business entities through agreements. A 2017 report by the Council of Institutional Investors (CII) found that VIE corporate structures are used by 62%

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<sup>19</sup> <https://www.forbes.com/sites/walterpavlo/2011/04/08/fraud-in-chinese-reverse-mergers-on-american-exchanges-and-were-surprised>

<sup>20</sup> [http://securities.stanford.edu/filings-documents/1061/WFHI00\\_01/201744\\_f01c\\_17CV02434.pdf](http://securities.stanford.edu/filings-documents/1061/WFHI00_01/201744_f01c_17CV02434.pdf)

<sup>21</sup> <https://seekingalpha.com/article/4059103-wins-finance-potential-sec-investigation-manipulation-russell-index>.

<sup>22</sup> Wins Finance delisted for reasons unrelated to its use of backdoor listing approaches or misrepresentations. Its assets were arbitrarily frozen by a public security bureau in China for undisclosed other reasons. <https://www.prnewswire.com/news-releases/wins-finance-holdings-announces-nasdaq-withdrawal-of-delisting-determination-letter-300540582.html>

of Chinese companies currently listed on U.S. exchanges, and by over 80% of Chinese companies that went public on U.S. exchanges between 2015-2017.<sup>23</sup>

Domestically, VIEs can circumvent China's foreign investment prohibitions on certain industries, and restrictions on "round-trip investments" by domestic entities via offshore special purpose vehicles (SPVs). Internationally, VIEs are able to meet the requirements of listing on U.S. and other foreign securities exchanges, allowing Chinese companies to raise funds overseas. Chinese analysts have suggested that the strength and speed of the Chinese Internet industry's development can be partly attributed to the VIE model.<sup>24</sup>

VIEs use two entities to raise money from foreign investors. The first is an offshore shell company, a new holding company registered overseas in locales such as Bermuda, the British Virgin Islands, the Cayman Islands, or the Dutch Caribbean, using the lowest possible capital investment. This process requires the Chinese company seeking to go public to own enough foreign exchange to register a new overseas entity. The process also requires patience, as it takes time from incorporation to listing to raising capital.<sup>25</sup> The holding company can then purchase a controlling stake in a domestic Chinese company and list itself on an overseas exchange, typically with the support of foreign banks.<sup>26</sup> The shell company is entered into an agreement-controlled relationship with a China-based company that owns the underlying business licenses to operate in China. This results in a separation between overseas registered, listed entities and business operating entities. The shell company has no operations but wields effective control over the business, operating enterprises, profits, decision-making, etc.

This model is complicated and its risks, including moral hazard and corporate governance risks, are numerous. ChinaCast Education (CEC) is a Chinese company that successfully listed on the NASDAQ through a reverse merger and using a VIE structure. In July 2007, special purpose acquisition company Great Wall completed its acquisition of a Bermuda-incorporated entity called ChinaCast Communication Holdings in a reverse merger acquisition and was renamed ChinaCast Education Corporation. After building out its VIE structure, ChinaCast Education

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[https://www.cii.org/files/publications/misc/12\\_07\\_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf](https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20Structure.pdf)

<sup>24</sup> <http://www.1xuezhexuezhexue.com/Ok/art/80666?dbcode=3&flag=2>

<sup>25</sup> <http://www.szse.cn/szseWeb/FrontController.szse?ACTIONID=15&ARTICLEID=1443&TYPE=0>

<sup>26</sup> For example, Bermuda-incorporated China Yuchai International Limited was established in April 1993 to own a controlling 76.4% interest in Sino-foreign joint venture Guangxi Yuchai Machinery. By December 1994, China Yuchai International (NYSE:CYD) had listed on the New York Stock Exchange as a foreign company. <https://www.sec.gov/Archives/edgar/data/932695/000095012309022447/u00272e20vf.htm>



was able to make the leap from trading over the counter to NASDAQ in October 2007 and achieve its ultimate goal of listing on a U.S. exchange.<sup>27</sup>

In 2012, the chairman of ChinaCast Education embezzled millions in company cash and transferred all the equity assets of two subsidiary companies without the knowledge of the ChinaCast Education's board of directors.<sup>28</sup> This was made possible by ChinaCast Education's very complex holding structure, wherein the operating company is owned and controlled by offshore companies, making shareholder supervision extremely difficult.

U.S. investors have very shaky legal rights to the underlying assets of VIE-structured companies because in reality, they are holding shares of a shell company with no intrinsic value or operations, that only mirrors the performance and value of a domestic Chinese company. In the event of a delisting or an undervalued take-private deal, it is unclear what recourse is available to U.S. shareholders of Chinese companies with VIE structures. This past July, SEC Chair Gary Gensler introduced new guidance seeking VIE-related disclosures from all China-based operating companies seeking to issue securities, and to conduct targeted additional filing reviews for companies with significant China-based operations.<sup>29</sup> These enhanced disclosure requirements have not yet, but should be codified as an amendment to the Securities Act.

#### Exemptions from Securities Act disclosure requirements create information asymmetry

Further, Chinese companies seeking to issue securities in the United States are able to circumvent strict U.S. disclosure standards by taking advantage of several SEC "safe harbors." The United States' commitment to high-quality, reliable disclosures, financial reporting, and other investor-oriented information is a key element of our ability to protect investors and market participants. The material information provided by disclosure documents is essential to an investor's ability to make informed investment decisions. These safe havens and exemptions were introduced two decades ago, before Chinese issuers began pursuing overseas and cross-border listings, dollar bond issuances, or other global financial activities at the velocity and volume that they are today.

Securities Act Rule 144A permits unregistered international firms to raise debt or equity capital from qualified institutional buyers (QIBs, or large U.S. institutional investors), without

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<sup>27</sup> <http://www.yidianzixun.com/article/0IqLEchk>

<sup>28</sup> <http://finance.sina.com.cn/roll/20120516/010012072410.shtml>

<sup>29</sup> <https://www.sec.gov/news/public-statement/gensler-2021-07-30>

incurring any additional costs of meeting U.S. disclosure standards. Chinese firms are consequently able to gain access to U.S. institutional investors without having to meet rigorous disclosure and procedural requirements typically required of equivalent U.S. firms.

Regulation S provides a safe harbor from Securities Act registration requirements for securities offerings made outside the United States. This is based on the presumption that the securities laws and regulations of the issuer's origin nation in which an offering is conducted provide a sufficient safeguard. However, in the case of Chinese issuers, the regulatory disparities are significant. Although the SEC has clarified that Reg S "may not be used to circumvent the registration requirements of the Securities Act," the potential use for abuse still exists.<sup>30</sup>

Reg-S securities must be issued outside of the United States and direct marketing efforts inside the U.S. are prohibited, but a large gray area exists whereby issuers resell securities, or offshore U.S. investors purchase them, allowing U.S. investors to access a veritable flood of unregistered Chinese securities. For example, Chinese tech giant Huawei Technologies issued a \$1 billion Reg-S bond offering on the Hong Kong Stock Exchange through its wholly-owned, BVI-incorporated subsidiary Proven Honour Capital in May 2015.<sup>31</sup> A banker close to the transaction claimed that the decision to issue the bond in the Reg-S format was not a decision "to steer clear of U.S. investors due to security issues."<sup>32</sup> Although neither the bonds nor the guarantee (by Huawei Investment & Holding) were registered under the Securities Act and technically could not be sold within the United States, a combined 23% of the bonds were allocated for sales to offshore U.S. and European investors, including asset managers, corporations, and private banks.<sup>33</sup>

**Risk: The U.S. financial industry is not equipped to identify, understand, and act in response to the market and reputational risks posed by China's rapid integration into global capital markets.**

The U.S. securities regulatory framework has not yet caught up to the increasing integration of China into the global capital markets, or to the growing exposure of U.S. investors to securities

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<sup>30</sup> <https://www.sec.gov/rules/final/33-7505.htm>.

<sup>31</sup> <https://secure.fundsupermart.com/main/bond/bond-info/downloadRelatedDocument.svdo?Category=bondDocument&DocumentNo=541>

<sup>32</sup> <https://www.reuters.com/article/asia-bonds/huawei-bond-signals-international-push-idUSL3N0Y50KI20150515>

<sup>33</sup> <https://www.reuters.com/article/asia-bonds/huawei-bond-signals-international-push-idUSL3N0Y50KI20150515>

listed overseas in countries with vastly different institutional environments, listing and disclosure requirements, and corporate governance practices that may not offer the same protections for investors as the United States does. More specifically, the increase in U.S. investors' exposure to Chinese issuers has introduced new and highly complex elements of risk that are not sufficiently addressed by the SEC's existing disclosure requirements or the constituent inclusion criteria used by global index providers.

U.S. investor access to publicly traded Chinese companies has expanded dramatically over the past few years, with the rapid inclusion of China A-shares into major stock indices, the launch and expansion of China's Stock Connect schemes, and the subsequent quadrupling of A-share weighting in certain investment benchmarks. Retail investors and institutional investors that want to add emerging markets or global markets to their portfolios frequently opt to use exchange traded funds (ETFs), which are a convenient and popular way to invest in specific industries, gain targeted exposure to specific geographic areas, or to gain broad exposure to a wide array of high performing stocks. ETFs aim to parallel the returns of a target index as closely as possible through replication of their underlying securities, and so ETF providers (and fund managers using passive investment strategies) essentially delegate their investment decisions to index providers.<sup>34</sup>

Because an ETF seeks to minimize tracking error in replication of the underlying benchmark, index rebalancing and weighting adjustments (determined by the index provider) are reflected directly in the fund flows from the associated product. The nature of ETFs means that inclusion of Chinese A-shares into an index results in the automatic inflow of funds to those companies from all ETFs associated with the index. Each index may have an unlimited number of associated ETFs, and those with the highest market capitalization often have at least several billion dollars under management. By providing access to the funds of American investors, ETFs and indices provide unregulated access for Chinese issuers to U.S. markets, without having to meet the accounting and disclosure requirements associated with a direct offering on a U.S. exchange.

### Index providers serve as independent arbiters of U.S. capital flow to China

Index providers have become a dominant and central force in global financial markets. They serve as intermediaries that provide Chinese companies with access to U.S. markets, and U.S.

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<sup>34</sup> <https://www.tandfonline.com/doi/full/10.1080/09692290.2019.1699147>

investors with exposure to Chinese companies. In May 2018, after three years of deliberation and negotiations with Chinese regulatory authorities (and considerable arm-twisting from Beijing), 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.<sup>35</sup> 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, which was 30.99% comprised of China-based securities.<sup>36</sup>

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%.<sup>37</sup> 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.<sup>38</sup> 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. Over 1,500 China A-shares are available to U.S. investors at this point.<sup>39</sup>

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. FTSE added the remaining 80% of A-shares in two tranches between September 2019 and March 2020. As of June 2020, China A-shares represented approximately 6% of the FTSE Emerging Index.<sup>40</sup>

In September 2019, S&P Dow Jones Indices (DJI) began the process of adding China A-shares to its global benchmarks, including the S&P China BMI and S&P Emerging BMI, at a partial inclusion factor of 25%. The additions took effect at the market open on September 23 and

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<sup>35</sup> MSCI's initial negotiations with Chinese authorities have been characterized by sources as "akin to business blackmail" due to the coercive approach in which China's national stock exchanges allegedly threatened to withdraw MSCI's access to market pricing data after MSCI failed to add A-shares on an expedited timeline.

<https://www.wsj.com/articles/how-china-pressured-msci-to-add-its-market-to-major-benchmark-11549195201>

<sup>36</sup> <https://www.msci.com/documents/1296102/1362201/MSCI-MIS-EM-May-2018.pdf/b1b05adf-4bf3-9acc-404c-9865da3e9997>

<sup>37</sup> <https://www.msci.com/www/blog-posts/china-a-shares-what-have-we/02164045217>

<sup>38</sup> <https://www.reuters.com/article/us-china-stocks-msci/msci-to-quadruple-weighting-of-china-a-shares-in-its-global-benchmarks-idUSKCN1QH318>

<sup>39</sup> <https://www.msci.com/www/blog-posts/china-a-shares-what-have-we/02164045217>

<sup>40</sup> <https://www.ftserussell.com/press/ftse-russell-completes-landmark-inclusion-china-shares>

included about 1,099 A-shares accessible via the northbound trading segments of the Hong Kong-Shanghai Stock Connect and Hong Kong-Shenzhen Stock Connect that met underlying index requirements.<sup>41</sup>

These and other planned inclusions have bolstered the Stock Connect's role as a leading channel for global investors to access the China A-share market. A report released by the Hong Kong Stock Exchange (HKEX) on September 30, 2019 highlighted that Stock Connect Northbound ADT saw a "record nine-month high for YTD Q3 2019, more than double the previous record achieved in YTD Q3 2018."<sup>42</sup>

While index providers exercise virtually unchecked authority to control how and where U.S. investors deploy their funds – which companies, countries, sectors and industries – they also operate outside of SEC regulation, without industry-wide rules on transparency or accountability. Calls for the SEC to introduce specific U.S. regulations covering index providers to ensure the accuracy integrity of benchmarks have ramped up lately, and SEC Commissioner Hester Peirce said in a statement earlier this year that she is open to exploring the need for a regulatory framework explicitly tailored to index providers.<sup>43</sup>

### Index inclusion and weighting criteria lack China-specific risk considerations

Beyond the need for the SEC to create rules for index providers as it pertains to oversight of quality control and minimizing conflicts of interest, it is critical for index providers to reevaluate their index inclusion criteria, which currently expose U.S. investors to material, reputational, China-specific risks.

Each index provider maintains its own criteria to screen securities for inclusion in its global market indices, based on standardized attributes like company size, market capitalization, and liquidity. However, the criteria evaluated by index providers to support the selection and

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<sup>41</sup> The northbound trading segments allow Hong Kong and international investors to trade in equities on the Shanghai and Shenzhen Stock Exchanges, routed through Hong Kong.  
<https://www.spglobal.com/spdji/en/landing/investment-themes/china/>  
<https://www.indexologyblog.com/2019/03/28/are-you-ready-for-china-a-share-inclusion/>  
<https://www.globalinvestorgroup.com/articles/3694991/stock-connect-changing-the-game-for-financing-china-a-shares>

<sup>42</sup> <https://www1.hkexnews.hk/listedco/listconews/sehk/2019/1106/2019110600237.pdf>

<sup>43</sup> <https://www.nytimes.com/2019/02/18/opinion/index-fund.html>  
<https://www.sec.gov/news/public-statement/peirce-statement-sp-dow-jones-indices-051721>

weighting of index constituents do not consider the full range of market and reputational material risks to investors, including considerations for risks in relation to national security, trade conflict and sanctions regimes, human rights violations, or even full consideration of traditional environmental, social, and governance (ESG) factors.<sup>44</sup> MSCI's methodology for index inclusion, for example, screens potential constituents for minimum size, market-cap, liquidity, and length of trading requirements. FTSE's methodology is primarily concerned with availability of timely data, demonstration of international interest, and whether the potential constituent meets liquidity requirements.<sup>45</sup>

**Risk: U.S. investors are inadvertently subsidizing Chinese companies involved in activities contrary to the national security and foreign policy interests of the United States.**

Retail and institutional investors are exposed to a wide range of publicly traded Chinese companies engaged in business activities that ultimately threaten U.S. national security interests and infringe on U.S. human rights values and commitments. Most strikingly problematic are the companies involved in developing weapons systems, new technologies, and building infrastructure to facilitate 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, Multilateral Development Bank (MDB) sanctions and debarments, and any other blacklists that may present a material risk to investors.

Several of these companies have already been sanctioned by the United States under one or more targeted sanctions programs, including the Department of Commerce's Military End User (MEU) List and Entity List, but are not subject to any financial sanctions, capital markets restrictions, or divestment mandates under the scope of those sanctions authorities. Washington is equipped, through various sanctions programs, to impose economic and financial restrictions on corporate entities it identifies as being involved in activities contrary to the national security or foreign policy interests of the United States. But there is little-to-no alignment between different sanctions programs. Effective sanctions programs are linked to clear policy objectives, and effective policies are coordinated across federal agencies. The U.S. government cannot fully

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<sup>44</sup> A constituent is a company whose shares are part of an index.

<sup>45</sup> <https://institutional.vanguard.com/VGApp/iip/institutional/csa/investments/benchmarks/home>

achieve those policy objectives if sanctions intended to achieve a similar outcome, like preventing Chinese high-tech companies from conducting military R&D using American resources, are applied inconsistently.

When the Commerce Department's Bureau of Industry and Security (BIS) identifies and publishes sanctions lists of Chinese companies and imposes restrictions on exports, it validates the fact that these companies are risky and damaging to U.S. interests. It signals that these companies are not suitable for U.S. economic engagement. Perhaps these companies should not be able to fundraise from U.S. investors in the U.S. markets. But presently, being added to the BIS Entity List doesn't automatically create any requirement to divest – even when the company is publicly traded. The U.S. government can designate a Chinese company as being implicated in human rights violations and abuses in Xinjiang, involved in acquiring U.S.-origin items for the Chinese military, or actively developing supercomputers for military end-use, but continue to permit these companies to raise funds from U.S. investors in the U.S. markets.

When MSCI released its final compilation of China A-Shares for inclusion in its Emerging Markets Index in May 2018, the list included companies that had been implicated in human rights abuses and violations; identified as active in Chinese military-civil fusion initiatives; involved in the implementation of high-tech mass surveillance; contracted for strategic infrastructure projects in disputed parts of the South China Sea; and targeted by U.S. sanctions programs in the past or were presently included on U.S. sanctions lists. The China A-shares added by FTSE Russell and other leading index providers included many of these same companies and same risk exposure, due to common inclusion criteria like market cap and liquidity. In effect, these index providers are steering U.S. financial flows to Chinese companies involved in activities that undermine U.S. national interests.

### Chinese military companies are ramping up their presence in global markets

The frequency of asset-backed securitization within China's military industrial complex has accelerated significantly since sweeping economic reforms were introduced by the CCP in 2013. Publicly traded companies have continued to carry out asset restructuring, shedding irrelevant and inferior assets, and gradually injecting core military assets into publicly traded, civilian companies. According to a 2017 report produced by investment research firm Sinolink Securities, China's 12 major military industrial groups had a total of 111 publicly traded companies listed on the Shanghai and Shenzhen stock exchanges, the National SME Share

Transfer System,<sup>46</sup> and overseas stock exchanges as of the end of 2016.<sup>47</sup> Chinese financial data and information provider Wind Information stated that the number of companies within China's major military industrial groups that have listed on mainland exchanges has increased every year since 2016.<sup>48</sup>

The China Securities Regulatory Commission (CSRC) Vice Chairman Yan Qingmin said in a 2019 speech that publicly traded Chinese military companies have played a leading role in China's military-civil fusion program and helped accelerate industry-wide development. Yan also announced that in 2018, the asset securitization rates of China National Nuclear Corporation (CNNC), Aero Engine Corporation of China (AECC), and the Aviation Industry Corporation of China (AVIC) all surpassed 50%. Asset securitization is an important financing vehicle through which Chinese companies raise funds and improve capital liquidity via the conversion of assets to securities.<sup>49</sup>

Chinese military companies have steadily increased issuances of not only stocks, but also bonds. China Shipbuilding Industry Corporation (CSIC) is presently working on China's third carrier and first nuclear-powered aircraft carrier with a speculative completion date of 2025, when China plans to launch its fully integrated and networked blue-water navy.<sup>50</sup> CSIC's nuclear ambitions were outlined in a company development strategy document released in February 2018.<sup>51</sup> CSIC issued a \$1 billion U.S. dollar-denominated bond on the Frankfurt Exchange the same month as the release of this strategy document, with a maturity date that coincides with the expected completion date of the carrier.<sup>52</sup> The chances that the bond issuance and the carrier development plans are related is reasonably high, particularly as a Chinese press report years ago stated the intention to issue bonds for big-ticket naval purchases on international markets.<sup>53</sup>

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<sup>46</sup> The National SME Share Transfer System is an independent national securities trading counter regulated by the China Securities Regulatory Commission (CSRC). It's currently known as currently known as the National Equities Exchange and Quotations, will soon be transitioned into the Beijing Stock Exchange.

<sup>47</sup> Since the Sinolink report was published, China's 12 military industrial groups have been consolidated into ten military industrial groups that continue to operate in the present day. The groups are funded and directly managed by the State Council. They are responsible for national defense research, production, and operations, and engage in the R&D of various weapons and equipment for China's armed forces.

[http://pdf.dfcfw.com/pdf/H3\\_AP201706050625961204\\_1.pdf](http://pdf.dfcfw.com/pdf/H3_AP201706050625961204_1.pdf).

<sup>48</sup> [http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201903/t20190327\\_353421.html](http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201903/t20190327_353421.html)

<sup>49</sup> [http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201903/t20190327\\_353421.html](http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201903/t20190327_353421.html)

<sup>50</sup> <https://www.popsci.com/china-nuclear-submarine-aircraft-carrier-leak>  
<http://mil.huanqiu.com/world/2018-02/11629945.html>.

<sup>51</sup> <http://www.globaltimes.cn/content/1091116.shtml>

<sup>52</sup> <https://www.popsci.com/china-nuclear-submarine-aircraft-carrier-leak>

<sup>53</sup> <https://thediplomat.com/2015/09/foreign-investors-and-chinas-naval-buildup>



It is likewise reasonable to expect that some of this bond offering was subscribed to by U.S. institutional investors, which, in turn, moved it into the portfolios of average Americans.

### U.S. capital markets sanctions target Chinese military companies... to an extent

In November 2020, President Trump issued Executive Order 13959, prohibiting U.S. persons from holding or transacting in the publicly traded securities of companies identified as “Communist Chinese military companies (CCMCs)” by the Department of Defense in accordance with the statutory requirement of Section 1237 of the NDAA for FY1999.<sup>54</sup> Section 1237 of the FY1999 NDAA had mandated that the Secretary of Defense determines and publishes a list of CCMCs in consultation with certain federal agencies and with ongoing additions or deletions.

In June 2021, President Biden issued E.O. 14032 to strengthen and expand the previous E.O. by prohibiting investments in not only Chinese military-industrial complex companies (CMICs), but also Chinese surveillance technology companies and the direct owners and subsidiaries of CMICs. Instead of using a preexisting list, the E.O. included in the Annex a new list of companies covered by the divestment mandate.<sup>55</sup> The Office of Foreign Assets Control (OFAC) of the Treasury Department is ultimately responsible for interpreting and administering the Chinese military companies sanctions program, which represents the implementation of multiple legal authorities, including executive orders and public laws passed by Congress.<sup>56</sup> Separately, Section 1260H of the FY2021 NDAA was signed into law earlier this year, supplementing Section 1237 with broader definitions of Chinese military companies (CMCs) and a clear timeline to identify and submit a list of all CMCs. Additions and deletions to the 1260H list are to be made on an ongoing basis, and published annually until December 31, 2030.<sup>57</sup> The initial list of CMCs was released on June 3, 2021, but there have been no further updates and no additions.<sup>58</sup>

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<sup>54</sup> <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/>

<sup>55</sup> <https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/>  
<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/>

<sup>56</sup> <https://home.treasury.gov/policy-issues/financial-sanctions/sanctions-programs-and-country-information/chinese-military-companies-sanctions>

<sup>57</sup> <https://www.congress.gov/116/bills/hr6395/BILLS-116hr6395enr.pdf>

<sup>58</sup> <https://www.defense.gov/News/Releases/release/article/2645126/dod-releases-list-of-chinese-military-companies-in-accordance-with-section-1260/>

The criteria for determining Chinese military companies is fairly expansive across legal authorities. E.O. 14032 defines a Chinese military-industrial complex company as one that operates in China’s “defense and related materiel sector or the surveillance technology sector.”<sup>59</sup> It includes parent and subsidiary companies (in accordance with OFAC’s 50 Percent Rule), which significantly expands the universe of companies that could qualify for list inclusion and divestment. Section 1260H defines a Chinese military company as one that is owned or controlled by the People’s Liberation Army (PLA) or any military service under the jurisdiction of the Chinese government’s Central Military Commission, and any company involved in China’s military-civil fusion program.<sup>60</sup>

The determination and official designation of Chinese military companies in practice, however, has been very constrained. There are currently 47 companies on the Department of Defense’s 1260H Chinese Military Company List (CMC List) and 59 companies on the E.O. 14032 Annex of Chinese Military-Industrial Complex Companies (CMIC Annex).<sup>61</sup> Many of the names overlap, so there are only 86 unique companies that have been designated as Chinese military companies across the two different lists. Although both lists were intended by their creators to be living, breathing documents that are expanded and updated over time, not single tranches, there have not been any additions of company names to date. There are also no clarifications on the timeline or expected frequency of future updates.

Yet there are hundreds of other publicly traded Chinese military companies that qualify for and warrant inclusion in one or both lists, but have been left out. For example, the Aviation Industry Corporation of China (AVIC) is one of China’s largest aerospace and defense conglomerates, and is included in both the CMC List and CMIC Annex. AVIC has a total of 25 publicly traded subsidiaries, most of which are directly involved in the development and production of aircraft and weapons systems for the Chinese military – but only eight subsidiaries are included in the two lists.<sup>62</sup> This omission is particularly glaring when considering the policy objective behind

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<sup>59</sup> <https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/>

<sup>60</sup> <https://www.congress.gov/bill/116th-congress/house-bill/6395/text>

<sup>61</sup> The 59 companies on OFAC’s Non SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List) mirror exactly the CMIC List.

<sup>62</sup> The eight publicly traded subsidiaries of AVIC on the CMC List, CMIC Annex, and included in OFAC’s NS-CMIC List are: AVIC Aviation High-Technology Co., Ltd.; AVIC Heavy Machinery Co., Ltd.; AVIC Jonhon Optronic Technology Co., Ltd.; AVIC Shenyang Aircraft Co., Ltd.; AVIC Xi’an Aircraft Industry Group Co, Ltd.; Jiangxi Hongdu Aviation Industry Group (HAIG); and Zhonghang Electronic Measuring Instruments Co., Ltd. (ZEMIC). <https://www.treasury.gov/ofac/downloads/ccmc/nscmiclist.pdf>

the Chinese military companies sanctions program: to prevent U.S. capital from flowing into the Chinese defense sector, including companies that support the Chinese military.<sup>63</sup>

The number of additional companies that do not qualify for list inclusion under the present criteria but should, for the purposes of achieving the sanction objectives, expands exponentially when considering the number of Chinese military companies that are not publicly traded, but have access to the U.S. capital markets through listed subsidiary units and investment vehicles. I would be happy to provide the Subcommittee with a more complete list of these companies in a separate addendum to this written testimony, for potential inclusion in future tranches of the CMC List and Annex List.

#### U.S. investors inadvertently invest in companies linked to human rights violations in Xinjiang

Over three decades of sweeping security measures and assimilationist policies enacted by the Chinese government in the Xinjiang Uyghur Autonomous Region (XUAR) have been aimed at repressing Uyghur religious beliefs and practices and erasing Uyghur ethnic identity and culture. The human rights violations that have taken place and continue to occur in Xinjiang have been designated as “genocide and crimes against humanity” by both the Trump and Biden administrations, and condemned by governments across the world.<sup>64</sup>

A supply chain business advisory issued by the State Department this past July acknowledged that Chinese surveillance tech companies receive support and funding from international investors, warning American businesses and individuals to be aware of the “significant reputational, economic, and legal risks of involvement with entities in or linked to Xinjiang that engage in human rights abuses, including but not limited to forced labor and intrusive surveillance.”<sup>65</sup> The international business community, however, continues to engage with many of the Chinese corporate entities known to be complicit in the implementation of mass arbitrary detention, high-tech surveillance, and forced labor transfer practices in Xinjiang.

Wealth managers argue that U.S. regulatory authorities haven’t actually imposed any investment restrictions that would prevent Americans from investing in companies, particularly

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<sup>63</sup> <https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/>

<sup>64</sup> <https://www.state.gov/reports/2020-country-reports-on-human-rights-practices/china/>

<sup>65</sup> <https://www.state.gov/wp-content/uploads/2021/07/Xinjiang-Business-Advisory-13July2021.pdf>

large-cap companies, with ties to Chinese human rights abuses. They insist that it would be fiducially unwise to shift client portfolios for discretionary reasons like human rights. And even when index providers seek to incorporate environmental, social, and governance (ESG) criteria into specific indices, they defer to an internally produced set of metrics that rarely capture all aspects of ESG risk. MSCI's ESG rating process, for example, takes into account factors like health and safety and carbon emissions, but does not consider human rights as a standalone "S" factor.<sup>66</sup> Investment companies (ETF providers) and fund managers are beholden to benchmark index performance objectives and therefore have their hands tied in regards to ability to remove certain companies for human rights reasons without incurring legal risk.

If there are sanctions imposed by the U.S. government that explicitly prevent or restrict investment in certain companies on the basis on human rights, then there is a clear divestment mechanism in place that gives index providers and investment firms the option to sell those securities or remove to them from indices and investment products. It is clear that without a congressionally mandated targeted sanctions program, American retail and institutional investors will continue to unknowingly, and without recourse, invest in publicly traded companies implicated in China's ongoing campaign of genocide against Uyghurs and other minorities in Xinjiang.

#### U.S. investors are financing and contributing technology to China's mass surveillance network

Over this past year, Congress has established new legislative frameworks in regards to the issue of forced labor in Xinjiang, seeking to implement greater regulatory scrutiny of U.S. companies' global supply chains. In June 2020, President Trump signed into law the Uyghur Human Rights Policy Act of 2020, which calls on U.S. companies and individuals that sell goods or services, or otherwise operate in Xinjiang to take steps, "including in any public or financial filings," to ensure that "their commercial activities are not contributing to human rights violations in [Xinjiang] or elsewhere in China," and "their supply chains are not compromised by forced labor."<sup>67</sup>

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<sup>66</sup> <https://www.msci.com/documents/1296102/17835852/MSCI-ESG-Indices-Factsheet.pdf/3b449b87-d470-977a-3b56-77095b8d8fc7>

<https://www.msci.com/our-solutions/esg-investing/esg-ratings/materiality-map>

<sup>67</sup> <https://www.congress.gov/bill/116th-congress/senate-bill/3744/text>

In June, the House of Representatives passed the ESG Disclosure Simplification Act of 2021 (Corporate Governance Improvement and Investor Protection Act) along with an amendment that includes the text of Congresswoman Wexton’s Uyghur Forced Labor Disclosure Act. The amendment requires U.S. publicly traded companies to “review and actively audit supply chains” manufactured goods and materials produced by Uyghur forced labor.<sup>68</sup> This focus on addressing and combatting Uyghur forced labor sets a welcome precedence for requiring U.S. companies to disclose certain risky corporate engagements in Xinjiang. It demonstrates that Congress has the intent, ability, and authority to protect Chinese investors from unknowingly supporting the Chinese government’s ongoing genocide. However, it only tackles one element of the Chinese government’s campaign of repression in Xinjiang, and does not address the ways in which publicly traded American companies also support and profit from China’s high-tech surveillance industry.

The Chinese government wields its high-tech surveillance apparatus – including facial recognition cameras, digital monitoring systems, and biometric tools – to monitor, censor, and control the populations not only in Xinjiang, but also in Tibet, Hong Kong, and elsewhere in China. Many of the Chinese tech companies that have reportedly equipped residential areas, cultural and religious spaces, reeducation facilities, and public security forces in Xinjiang with high-tech and biometric surveillance equipment include publicly traded companies Hangzhou Hikvision Digital Technology, FiberHome Technologies, Dongfang Netpower Technology, Zhejiang Dahua Technology, Xiamen Meiya Pico Information, Iflytek. Hikvision, for example, has equipped several detention facilities in Xinjiang and won hundreds of millions of dollars-worth of security contracts in the region, including Uyghur-specific projects at a paramilitary base in Urumqi.<sup>69</sup> Iflytek has supplied voiceprint collection systems to Kashgar police and partnered with the Xinjiang Public Security Bureau and telecommunications companies to integrate voice pattern data into surveillance systems.<sup>70</sup>

Large cap U.S. tech giants like Intel, Dell, and Microsoft have also been identified by researchers as having provided components, financing, or knowledge to China’s vast and growing surveillance network linked to human rights abuses in Xinjiang.<sup>71</sup> An earlier investigation by *The Wall Street Journal* named Intel, Seagate Technology, Western Digital, and Hewlett Packard among U.S. tech companies involved in China’s surveillance industry via financing,

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<sup>68</sup> <https://wexton.house.gov/news/documentsingle.aspx?DocumentID=566>

<sup>69</sup> <https://ipvm.com/reports/hik-xj-pap>

<sup>70</sup> <https://www.reuters.com/article/us-china-xinjiang-mit-tech-insight/risky-partner-top-u-s-universities-took-funds-from-chinese-firm-tied-to-xinjiang-security-idUSKCN1TE04M>; <https://www.hrw.org/news/2017/10/22/china-voice-biometric-collection-threatens-privacy>

<sup>71</sup> <https://www.hrw.org/news/2020/12/09/china-big-data-program-targets-xinjiangs-muslims#>

commercial, or supply-chain relationships. According to company marketing materials surfaced by the *Journal*, Hewlett Packard sells computer network components to the government of Aksu, a city in Xinjiang that conducts broad surveillance of Uyghur residents and is known for arbitrary detention practices.<sup>72</sup>

## Recommendations

Align U.S. economic and financial sanctions programs that have similar policy objectives, and introduce cross-debarment authorities, in order to achieve maximum impact and effectiveness.

- Congress should pass new legislation to grant different sanctions implementation authorities the ability to cross debar entities for the same misconduct. Entities that have been sanctioned by one U.S. sanctions implementing authority should be sanctioned for the same misconduct by other implementing authorities within the U.S. government. A Chinese company that is blocked from exporting U.S. tech components under the Entity List due to its involvement in developing state surveillance systems should also be prevented from raising capital in U.S. markets to fund R&D for state surveillance systems.

This would encourage consistency across sanctions programs, promote greater information sharing and coordinated investigations, amplify the impact of sanctions, and bolster joint messaging. It would also prevent abnormal situations where U.S. investors are able to freely purchase or transact in the securities of an entity that the Treasury Department has separately determined poses significant investor risk and placed under sectoral sanctions.

Codify and expand the use of capital markets sanctions to prevent the outflow of U.S. capital to Chinese companies involved in China's military, intelligence, and security activities.

- Congress should pass legislation to codify existing executive orders (13959 and 14032) that provide the president with the authority to impose capital markets sanctions on

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<sup>72</sup> <https://www.wsj.com/articles/u-s-tech-companies-prop-up-chinas-vast-surveillance-network-11574786846>

Chinese military-industrial companies, surveillance tech companies, and parent/subsidiary entities. The legislation should require the Secretary of Treasury, in consultation with the Secretary of State and the Secretary of Defense, to produce a quarterly review of list additions and updates.

Congress should also introduce language to expand and refine the sanctions, specifically to expand the divestment mandate to indices, index funds, mutual funds, and exchange traded funds; as well as public funds such as state and local pension systems, endowment funds, and domestic sovereign wealth funds. This would explicitly lay out actions for index providers, investment companies, and institutional investors that have previously been confused about their divestment obligations under the two executive orders.

Introduce a framework for regulatory oversight of index providers to review index governance practices and benchmark decision methodologies.

- The unanimous passage of the Holding Foreign Companies Accountable Act (HFCAA) introduced by Chairman Sherman in the House means that the SEC will be able to prohibit the trading of securities of Chinese companies with public accounting firms in foreign jurisdictions that the PCAOB is unable to inspect, on U.S. exchanges.<sup>73</sup> Following years of noncompliance with PCAOB audits, Chinese issuers on U.S. exchanges will finally be held to the same standards of transparency and disclosure as American issuers. I look forward to the Accelerating Holding Foreign Companies Accountable Act (AHFCAA) being signed into law.

I also urge Congress to consider that in order to fully protect investors who purchase securities in the U.S. capital markets, it is imperative to pass legislation that would increase regulatory scrutiny of index providers and their methodology for constituent inclusion and weighting. Index providers exercise virtually unchecked authority to control how and where U.S. investors deploy their funds

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<sup>73</sup> [https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket048/2021-004-hfcaa-adopting-release.pdf?sfvrsn=f6dfb7f8\\_4](https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket048/2021-004-hfcaa-adopting-release.pdf?sfvrsn=f6dfb7f8_4)

Protect U.S. investors from investing in companies implicated in serious human rights abuses by requiring annual public disclosures and public reporting.

- Congress should pass legislation requiring U.S. issuers to disclose involvement with China's surveillance technology industry and, in particular, the provision of related technologies and services in Xinjiang. Recent successes like the passage of the Uyghur Human Rights Policy Act of 2020 and the Uyghur Forced Labor Disclosure Act's inclusion in the ESG Disclosure Simplification Act of 2021 have set a precedence for requiring U.S. companies to disclose certain risky corporate entanglements with Xinjiang. They have also demonstrated Congress's ability and authority to protect Chinese investors from unknowingly supporting the Chinese government's perpetration of serious human rights abuses in Xinjiang.

If the U.S. government's objective is to constrain the Chinese government's ability to expand its mass surveillance apparatus by blocking the inflow of U.S. components and financing, then tech companies listed in the U.S. are more likely than companies listed on overseas exchanges to comply with requests for information from stakeholders like the SEC and index providers, participate in corporate engagement efforts, and ultimately follow through with risk mitigation proposals like moving supply chains or switching manufacturer contracts away from Xinjiang end-users.

- The Uyghur Human Rights Policy Act of 2020 requires the Director of National Intelligence, in coordination with the Secretary of State, to submit a report with a list of Chinese companies involved in the construction or operation of detention facilities in Xinjiang. This list of Chinese companies was to be submitted no later than 180 days after the Act was signed into law, in which case the deadline was December 14, 2020.

Congress should request the U.S. government to publicly release an unclassified version of the report, which would be hugely beneficial for the ability of U.S. investors and market participants to conduct due diligence and screen their investments for Chinese companies involved in the arbitrary detention, forced re-education, and abuse of Uyghurs in Xinjiang.