CONGRESSIONAL TESTIMONY: FOUNDATION FOR DEFENSE OF DEMOCRACIES

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 U.S. Markets

ERIC B. LORBER

Senior Director
Center on Economic and Financial Power
Foundation for Defense of Democracies

Managing Director
K2 Integrity

Washington, DC
October 26, 2021

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I. Introduction[1]

Chairman Sherman, Ranking Member Huizenga, Representative McHenry, and distinguished members of the committee, I am honored to appear before you today to discuss the risks to investors and the United States posed by Chinese issuers in U.S. markets.

I come before this committee as a sanctions and compliance professional, having worked at the U.S. Department of the Treasury and advised financial institutions, corporations, humanitarian organizations, and individuals on ensuring they operate in compliance with U.S., EU, and UN sanctions obligations. As part of my work in both the public and private sectors, I have seen firsthand the power of U.S. economic sanctions in furthering U.S. foreign-policy objectives. While sanctions are not a panacea, they can be used in narrow and targeted ways to great effect.

One area where the United States has increasingly used this tool is in the global competition with China. As Congress and the Biden administration consider ways to protect U.S. markets from abuse and push back against certain Chinese activities that threaten U.S. national security, sanctions remain one of the top policy levers to consider pulling.

Safeguarding transparency in the global financial system and in U.S. markets is critical to protecting U.S. national security and the strength of the U.S. financial system. A core part of providing this transparency is ensuring U.S. investors have access to relevant, material information about foreign companies in order to make informed decisions. Over the last few years, the United States has taken important steps to ensure that Chinese companies attempting to access U.S. markets must play by the same rules as U.S. companies and do not introduce significant, material risk into U.S. investors' portfolios due to those Chinese companies' lack of transparency.

At the same time, we must balance those considerations against the risk of creating an onerous set of disclosure requirements that deter companies from seeking to access U.S. markets or that make it overly burdensome to do business here in the United States. Such burdens can deter legitimate companies from seeking financing on U.S. capital markets. This is a delicate balance to strike.

Likewise, we must make sure that any additional disclosure requirements would be impactful. Implementing broad-based disclosure requirements on Chinese issuers seeking access to U.S. capital markets may not have the intended effect if those issuers are already refusing to comply with relevant rules and regulations. And if those disclosure requirements are overbroad, they may impact non-Chinese issuers that we want to attract to U.S. capital markets.

As Congress and the administration weigh whether to create new reporting and disclosure requirements and determine how to best protect U.S. investors, they should likewise consider the use of narrowly targeted sanctions, which offer a well-established tool to ensure U.S. companies — and U.S. national security — are protected from certain threats.

The United States has a range of sanctions tools to target specific Chinese companies whose activity it believes poses national security risks. In particular, over the last few years, the United States has deployed limited but powerful prohibitions on trading in public securities of certain

Chinese companies associated with the People's Liberation Army or otherwise alleged to be involved in China's "military-civil fusion" program.

Likewise, for companies or individuals who are alleged to engage in particularly egregious actions, such as sanctions evasion, crackdowns on human rights in Hong Kong, or mistreatment of the Uyghur population in Xinjiang, the United States maintains powerful sanctions authorities to block such persons. This targeted approach may be a narrow and effective way to limit these companies' access to U.S. markets and to U.S. capital.

In addition to sanctions designations, the U.S. Department of the Treasury also has effectively promulgated advisories and guidance warning the private sector of doing business with certain companies or in certain sectors, including in Chinese industries. For example, the Treasury Department, along with its interagency partners, issued a supply chain advisory designed to warn the private sector about the risks of human rights abuses and forced labor in Xinjiang.[1]

Furthermore, the Treasury Department and the Financial Crimes Enforcement Network routinely issue detailed guidance highlighting financial-crime risks in certain foreign jurisdictions and industries.[2] Providing such targeted information to U.S. persons operating in the capital markets space, including in conjunction with relevant regulatory agencies, such as the Securities and Exchange Commission (SEC), could be an effective way to warn U.S. investors of specific risks posed by particular Chinese persons.[3]

These tools could provide a narrow, targeted way both to warn U.S. companies and investors of the risks of doing business with certain Chinese companies or in certain Chinese industries, as well as to limit those Chinese companies' ability to secure capital on U.S. markets while threatening U.S. national security.

Nevertheless, sanctions are not a silver bullet for protecting U.S. investors from Chinese companies that are subject to lax regulatory controls in their home jurisdiction. For example, sanctions may not be a good policy tool for targeting Chinese companies that do not adhere to international standards of good governance and financial stewardship and do not provide that information to U.S. investors. Rather, sanctions are an appropriate tool for targeting specific Chinese companies that threaten U.S. national security.

[1] U.S. Department of State, Department of the Treasury, Department of Commerce, Department of Homeland Security, Department of Labor, and the Office of the Trade Representative, "Updated Xinjiang Supply Chain Business Advisory," July 13, 2021. (https://home.treasury.gov/system/files/126/20210713_xinjiang_advisory_0.pdf)
[2] See, for example: U.S. Department of the Treasury, Financial Crimes Enforcement Network, Advisory, "Updated Advisory on Widespread Public Corruption in Venezuela," May 3, 2019. (https://www.fincen.gov/sites/default/files/advisory/2019-05-03/Venezuela%20Advisory%20FINAL%20508.pdf).
[3] For a recent example of how the SEC has raised these considerations for investors, see: U.S. Securities and Exchange Commission, CF Disclosure Guidance: Topic No.10, "Disclosure Considerations for China-Based Issuers," November 23, 2020. (https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers)

II. Ensuring Investor Protections and U.S. Economic Competitiveness

U.S. regulatory and enforcement agencies have an important role to play in ensuring U.S. investors and companies have relevant, material information when making investment decisions. To date, Congress and the SEC have expressed serious concerns about the amount of information Chinese issuers routinely provide. In particular, the SEC, which relies on China's less stringent reporting and disclosure rules, has noted that the Chinese government prohibits the Public Company Accounting Oversight Board (PCAOB) from inspecting the work of auditors based in mainland China or Hong Kong. According to the SEC, "China has not provided the PCAOB access to inspect or investigate these registered public accounting firms with respect to their audits of China-based Issuers." While the SEC recommends asking Chinese issuers a range of questions to properly assess material information and relevant risks, these companies may not be forthcoming.[4]

The challenge in securing relevant, material information from Chinese companies about their financial information and potential risks to investors has, in certain instances, created significant negative impacts on U.S. investors. For example, last year Nasdaq delisted the Chinese company Luckin Coffee after it was alleged to have fabricated sales.[5]

To address these concerns, the SEC has directed China-based issuers to disclose certain risk factors, such as whether they are subject to an auditing firm under PCAOB oversight or rely on a Variable Interest Entity structure. Likewise, last year Congress passed the Holding Foreign Companies Accountable Act, which requires foreign issuers that rely on audit firms that cannot be reviewed by the PCAOB to make annual disclosures about their relationship to the Chinese government. The new law also prohibits foreign companies from listing their securities on U.S. exchanges if the companies have been unavailable for PCAOB inspection or investigation for three consecutive years. Furthermore, as part of this process, these companies will need to disclose the percentage of their shares owned by government entities, as well as certain information on their board members who are Chinese Communist Party (CCP) officials, among other information.[6]

As Congress and the administration consider taking additional actions to require foreign issuers to provide more information, they should keep in mind two key considerations. The first is whether the Chinese companies will actually provide additional, credible information if they are subject to increased due diligence or reporting requirements. While requiring such information can be an important way to help U.S. investors judge risk, the additional requirements may have little impact if those companies refuse to provide it or if they stonewall effectively. In such a situation, focusing on enforcement, to include delistings, will create additional leverage and should be pursued. Second, Congress and the administration should ensure that any options under consideration are narrowly targeted to provide investors with relevant, material information about the issuers while not unnecessarily increasing due diligence and reporting requirements.

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[4] Ibid.

[5] Jing Yang, "Nasdaq Moves to Delist China's Luckin Coffee," *The Wall Street Journal*, May 19, 2020. (https://www.wsj.com/articles/nasdaq-moves-to-delist-chinas-luckin-coffee-11589896619?mod=article_inline)

[6] Holding Foreign Companies Accountable Act, Pub. L. 116-222, 134 Stat. 1063, codified as amended at 15 U.S.C. §7201.

III. U.S. Economic Sanctions Related to China

Beyond disclosure requirements and delistings from U.S. exchanges, the United States currently has powerful sanctions authorities in place to prevent certain Chinese companies from accessing U.S. capital markets and raising funds from U.S. investors. Likewise, the United States has blocking authorities that can be used to sanction particularly egregious actors in China for a range of activity that may pose a threat to U.S. national security. These tools have been — and can continue to be — used to target specific Chinese companies or individuals the United States determines are engaged in China's military build-up, surveillance state, human rights abuses, sanctions evasion, or other malign activities.

Transaction-Specific Sanctions Limiting Financing

Beginning under the Trump administration in November 2020, the United States prohibited certain transactions in publicly traded securities of certain "Communist Chinese military companies." The purpose of this prohibition was to ensure that Chinese companies closely linked to the Chinese military — particularly those involved in China's military-civil fusion program — could not raise capital in U.S. markets.[7]

Citing Beijing's efforts to leverage China's private sector to support military research and development, Executive Order 13959, titled "Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies," sought to restrict those companies' access to U.S. capital by barring U.S. persons from conducting certain transactions involving publicly traded securities of "any Communist Chinese military company." As part of this effort to prevent Communist Chinese military companies from gaining access to U.S. capital markets, the U.S. government identified a few dozen such entities.[8]

Building on this initial effort, the Biden administration issued a new executive order to further refine these prohibitions. Like Executive Order 13959, Executive Order 14032 aims to prevent certain companies in the Chinese defense and surveillance technology sectors from benefiting from U.S. investment, and to prevent China's military-industrial complex from accessing U.S. capital

[7] See, for example: Emily de La Bruyère and Nathan Picarsic, "Defusing Military-Civil Fusion: The Need to Identify and Respond to Chinese Military Companies," *Foundation for Defense of Democracies*, May 27, 2021. (https://www.fdd.org/analysis/2021/05/26/defusing-military-civil-fusion)
[8] Executive Order 14032, "Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," June 3, 2021. (https://home.treasury.gov/system/files/126/eo_cmic.pdf). Two listed companies, Luokung Technology Corporation and Xiaomi Corporation, challenged their designations, arguing that the U.S. government failed to develop a sufficient factual record to establish a linkage between them and the Chinese military. Both companies were successful in their challenges and were delisted shortly thereafter.

markets.[9] The new executive order is more narrowly tailored than Executive Order 13959 in a number of ways.[10]

This approach — identifying specific Chinese entities the United States believes pose national security threats and preventing them from raising capital on U.S. markets — is narrowly tailored to limit those entities' ability to benefit from robust U.S. capital markets, while minimizing the risk that other companies will be unduly prevented from accessing U.S. markets. While these Chinese companies are not blocked persons and U.S. persons can continue to engage in certain business with them, they are now effectively cut off from U.S. capital markets.

Denying access to U.S. capital markets by specific Chinese companies or economic sectors that policymakers believe pose a national security threat provides the United States with a powerful tool to protect U.S. markets and U.S. national security. Expanding these types of prohibitions to cover additional Chinese military companies or economic sectors determined to pose national security threats could provide policymakers with another way to limit these actors' access to U.S. capital markets.

Blocking Sanctions Against Certain Chinese Persons

The United States also has authorities in place to target individuals and entities with powerful blocking sanctions, which not only cut those persons off from U.S. capital markets but also prohibit U.S. persons from conducting any transactions with them. In recent years, the United States has used its authorities under the Global Magnitsky Human Rights Accountability Act,[11] signed into law in 2017, as well as authorities related to Hong Kong,[12] to target Chinese individuals and entities alleged to have engaged in human rights abuses or the suppression of rights.

[9] Executive Order 14032, "Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," June 3, 2021. (https://home.treasury.gov/system/files/126/eo_cmic.pdf). For a discussion of these restrictions, see: "Biden Revises Ban on U.S. Investors Buying Certain Chinese Securities," *K2 Integrity*, June 7, 2021. (https://www.k2integrity.com/en/knowledge/policy-alerts/biden-revises-ban-on-us-investors-buying-certain-chinese-securities)

[10] For example, when Executive Order 13959 was issued, it caused considerable confusion in the markets due to ambiguity surrounding the application of the prohibitions to targeted companies and their subsidiaries. In particular, the prohibitions under the original executive order applied to entities whose name exactly or "closely" matched the name of an entity identified under the executive order. Executive Order 14032 leaves no room for ambiguity by removing the "closely matching" prohibition. In addition, Executive Oder 14032 includes the full English-language names of the targeted companies rather than the shorthand English-language names that caused confusion following the issuance of Executive Order 13959. For a full analysis of both executive orders, see: "United States Prohibits Investment in Chinese Companies with Military Ties," *K2 Integrity*, November 19, 2020. (https://www.k2integrity.com/en/knowledge/policy-alerts/united-states-prohibits-investment-in-chinese-companies-with-military-ties); "Biden Revises Ban on U.S. Investors Buying Certain Chinese Securities," *K2 Integrity*, June 7, 2021. (https://www.k2integrity.com/en/knowledge/policy-alerts/biden-revises-ban-on-us-investors-buying-certain-chinese-securities)

[11] See: Executive Order 13818, "Blocking the Property of Persons Involved in Serious Human Rights Abuse or Corruption," December 20, 2017. (https://home.treasury.gov/system/files/126/glomag_eo.pdf). This executive order implements the legislation.

[12] See, for example: Hong Kong Autonomy Act, Pub. L. 116-149, codified as amended at 22 U.S.C. §5701.

For example, in July 2020, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) designated the Xinjiang Production and Construction Corps (XPCC) and two affiliated CCP officials under Executive Order 13818, the implementing executive order for the Global Magnitsky Human Rights Accountability Act.[13] The XPCC is a quasi-governmental paramilitary entity that is instrumental in Beijing's economic development plans for Xinjiang. According to international human rights groups[14] and UN experts,[15] the Chinese government prevents the Uyghurs, ethnic Kazakhs, and ethnic Kyrgyz, among others, from freely exercising their religion and subjects them to arbitrary detention and systematic forced labor, particularly in the Xinjiang region. According to the U.S. government, the XPCC is involved in human rights abuses, including surveillance and detention of ethnic minorities. The XPCC is involved in a variety of economic activities in the region, such as cotton cultivation, and often operates through subsidiaries and front companies.

Likewise, the U.S. government has targeted individuals in Hong Kong under Executive Order 13936, which authorizes the president to impose sanctions on non-U.S. persons involved or complicit in, inter alia, undermining democratic processes or institutions in Hong Kong; threatening the peace, security, stability, or autonomy of Hong Kong; censoring, prohibiting, or limiting the freedom of expression or assembly by citizens of Hong Kong; or limiting access to free media.[16]

On August 7, 2020, the Treasury Department imposed its first set of sanctions under Executive Order 13936, designating Hong Kong Chief Executive Carrie Lam and 10 other high-ranking Hong Kong or CCP officials for their role in implementing China's National Security Law and orchestrating the arrest of demonstrators.[17] Then, on December 7, 2020, the U.S. State Department announced the designation of 14 vice-chairs of China's National People's Congress Standing Committee who voted unanimously to adopt the National Security Law, thereby undermining "the ability of the people of Hong Kong to choose their elected representatives."[18] OFAC simultaneously added these individuals, designated pursuant to EO 13696, to the Specially Designated Nationals and Blocked Persons (SDN) List.

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[13] U.S. Department of the Treasury, Press Release, "Treasury Sanctions Chinese Entity and Officials Pursuant to Global Magnitsky Human Rights Executive Order," July 31, 2020. (https://home.treasury.gov/news/press-releases/sm1073)

[14] "Eradicating Ideological Viruses: China's Campaign of Repression Against Xinjiang's Muslims," *Human Rights Watch*, September 9, 2018. (https://www.hrw.org/report/2018/09/09/eradicating-ideological-viruses/chinas-campaign-repression-against-xinjiangs)

[15] UN News, "Rights Experts Concerned about Alleged Detention, Forced Labour of Uyghurs in China" March 29, 2021. (https://news.un.org/en/story/2021/03/1088612)

[16] Executive Order 13926, "The President's Executive Order on Hong Kong Normalization," July 14, 2020. (https://www.federalregister.gov/documents/2020/07/17/2020-15646/the-presidents-executive-order-on-hong-kong-normalization)

[17] U.S. Department of the Treasury, Press Release, "Treasury Sanctions Individuals for Undermining Hong Kong's Autonomy," August 7, 2020. (https://home.treasury.gov/news/press-releases/sm1088)

[18] Secretary of State Michael R. Pompeo, U.S. Department of State, Press Statement, "Designations of National People's Congress Officials Undermining the Autonomy of Hong Kong," December 7, 2020. (https://2017-2021.state.gov/designations-of-national-peoples-congress-officials-undermining-the-autonomy-of-hong-kong/index.html)

Imposing targeted blocking sanctions against specific Chinese persons could likewise be a way to ensure that companies the United States believes pose national security threats are unable to access U.S. markets, including capital markets.

Guidance for the Private Sector

Beyond sanctions, the U.S. government has published a range of advisories designed to warn the private sector about specific risks of doing business in particular Chinese economic sectors and jurisdictions.

For example, in July 2020, the U.S. departments of State, the Treasury, Commerce, and Homeland Security issued a joint advisory warning U.S. businesses of the reputational, economic, and legal risks arising from their supply chain exposure to the Xinjiang Uyghur Autonomous Region in China.[19]

The advisory recommends that U.S. businesses implement human rights-related due diligence measures to manage their risk exposure. The advisory focuses on three activities of concern: assisting in developing surveillance tools that China could use to monitor and control populations in Xinjiang; buying goods produced by laborers based in Xinjiang or from factories elsewhere in China that use laborers originally from Xinjiang; and aiding in the construction of facilities within Xinjiang that house or employ forced laborers. The advisory links to resources provided by the U.S. departments of Labor, State, and Justice to guide businesses in ensuring supply chain integrity in the face of these risks.[20]

The advisory recommends U.S. businesses be aware of the methods China uses to obfuscate its forced labor practices. According to the advisory, the Chinese government refers to many camps used to forcibly imprison or re-educate Uyghurs as "educational centers" or "vocational training centers." According to the advisory, Chinese firms using this labor also uses shell companies to export the items produced in these camps, which can often obscure the goods' origins in Xinjiang.[21]

Likewise, in July 2020, the U.S. departments of State, Commerce, Treasury, and Homeland Security issued a Hong Kong Business Advisory detailing the risks of continuing to do business in Hong Kong after the implementation of the National Security Law.[22] According to the U.S. government, these risks fall into four primary categories: risks for businesses following the imposition of the National Security Law; data privacy risks; risks regarding transparency and

[19] This advisory was subsequently updated in July 2021. U.S. Department of State, Department of the Treasury, Department of Commerce, Department of Homeland Security, Department of Labor, and the Office of the Trade Representative, "Updated Xinjiang Supply Chain Business Advisory," July 13, 2021. (https://home.treasury.gov/system/files/126/20210713_xinjiang_advisory_0.pdf)
[20] Ibid.
[21] Ibid.
[22] U.S. Department of State, Department of the Treasury, Department of Commerce, and Department of Homeland Security, "Hong Kong Business Advisory," July 16, 2021. (https://home.treasury.gov/system/files/126/20210716_hong_kong_advisory.pdf)

access to critical business information; and risks for businesses with exposure to sanctioned Hong Kong or mainland Chinese entities or individuals. Since the issuance of this advisory, additional risk related to Chinese countersanctions has also increased.

These advisories provide U.S. businesses — including those operating in financial markets — with clear indications of which specific Chinese companies and which sectors of the Chinese and Hong Kong economies pose real and regulatory risks. Providing U.S. companies with additional information, building on prior, high-level guidance issued by the SEC, could be an effective way to allow U.S. investors better understand their risks.

IV. Conclusion

Ensuring U.S. investors have access to relevant, material considerations about Chinese companies is important to ensuring that they have the opportunity to make informed decisions. Likewise, preventing companies that pose national security threats to the United States from accessing our financial markets is critical. While protecting U.S. investors from Chinese issuers who refuse to abide by U.S. standards is an important objective, we must be cautious to ensure we do not inadvertently raise reporting and disclosure obligations too high and chill the attractiveness of those very financial markets we aim to protect and foster.

Narrowly targeted sanctions on certain Chinese companies or Chinese industries that the United States determines pose national security threats can be a way to protect both U.S. investors and U.S. national security. However, Congress and the administration should clearly understand the limits of such sanctions. While they can prevent malign actors from accessing our financial markets, they may be less effective at protecting U.S. investors from non-U.S. issuers who do not provide sufficient material information.

I look forward to your questions and thank you again for the opportunity to testify.