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Statement of Nazak Nikakhtar

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China's Quest for Capital: Motivations, Methods, and Implications

Introduction

Vice Chair and Hearing Co-Chair Robin Cleveland, Commissioner and Hearing Co-Chair Michael Wessel, thank you for the opportunity to speak today about the extent to which China's access to U.S. and global capital markets poses risks for U.S. economic, foreign policy, and national security interests.

The International Trade Administration, with its professionals in Washington, across the United States and around the world, is responsible for strengthening the competitiveness of U.S. industry in the United States and global marketplace, increasing investments in America, monitoring compliance with U.S. trade agreements, and enforcing U.S. trade laws.

At Industry and Analysis (I&A), we are, in particular, responsible for developing and implementing international trade and investment strategies for a range of industries from the manufacturing sector to the financial services sector, including industries that are critical to U.S. economic and national security. I&A also leads the Commerce Department's participation in the Committee on Foreign Investment in the United States (CFIUS), a Committee that reviews specific foreign investments in the United States for their impact on U.S. national security.

Today, China is the world's second largest economy and the world's leading exporter. Chinese companies have been intensive users of U.S. capital markets and, from 2013 to the end of 2019, Chinese companies have raised over $48 billion through 119 new listings in the United States. This is more than the total raised by companies from any country, except for the United States.

Further, according to the U.S. China Economic and Security Review Commission, as of September 2019, there were 172 Chinese companies listed on the three largest U.S. exchanges, the NASDAQ, the New York Stock Exchange (NYSE), and the NYSE American, with a total market capitalization of more than $1 trillion. In 2018, Chinese initial public offerings (IPOs) raised more than $9.4 billion on U.S. exchanges – or 51 percent of all cross-border listings in the United States – compared to an aggregate value of $60 billion for all IPOs. Similarly, in 2019, Chinese companies raised $3.8 billion – or 42 percent of all cross-border listings in the United States – compared to an aggregate value of $53.9 billion for all IPOs. As shown by these statistics, Chinese companies have a continuing interest in raising capital on U.S. markets even as Chinese capital markets mature.

But why, if China is now the world's second largest economy, do its companies continue to seek access to U.S. capital markets? And to what extent – if any – are these investments intersecting with U.S. economic, foreign policy, and national security interests?

The 2017 National Security Strategy identifies China as a "strategic competitor," and states that China's "predatory" economic practices are a central part of its global strategic ambitions. A key pillar of the Chinese Communist Party's ambition is the government's emphasis on civil-military integration. This doctrine subordinates the civilian economy to the needs of the Chinese national security apparatus and was formally adopted by the Central Military Commission in December 2015. In essence, this doctrine mandates that the Chinese government or military may direct any civilian sector entity – indeed any commercial corporate entity – to act on behalf of the Chinese government or military. The doctrine has no jurisdictional limits, which means that Chinese businesses operating abroad are also subject to this requirement.

Further, China's economic practices, as enshrined in the One Belt, One Road initiative, encourage the expansion of the country's geopolitical reach globally. Under this initiative, Chinese firms are acquiring stakes in critical industry and supporting infrastructure in many countries, such as key transportation ports in Greece, railways in Ethiopia, and massive steel plants in Indonesia and India. These investments, as noted in the 2017 National Security Strategy, can serve as "persuasion" for nations to follow Beijing's directions.

It is also reported that the Chinese government is implementing this year a nationwide social credit rating system for all corporations to detect misconduct and non-compliance with state and local law. The corporate credit system has implications for companies operating in China with respect to sensitive personal data, surveillance, and proprietary technical information. Companies – including multinationals – could be required to transfer internal data to the Chinese government as part of their obligations. The European Chamber reports this credit rating system as potentially amounting to "life or death" for companies operating in China. Failing to score well, by non-compliance with Chinese government policies or demands, may subject companies to a myriad of sanctions, including higher taxes or permit difficulties, or a blacklisting which could mean financial ruin for that entity.

The foregoing facts demonstrate the Chinese government's efforts to dominate the global economy through data and technological hegemony, as explicitly stated in its Made in China 2025 plan. Key to this effort is its ability to grow corporate champions through access to capital markets. In this context, we need to understand how China has accessed capital markets in the past and how it will participate in the global securities markets in the future.

The NYSE and NASDAQ exchanges' market capitalization accounts for over 40 percent of the world's stock market capitalization. Companies, especially emerging growth companies, choose to list in U.S. capital markets for several reasons. Some companies want greater access to deeper pools of capital. Other companies seek the seal of approval that is achieved by listing in U.S. exchanges with higher disclosure and regulatory requirements, which may enhance a company's reputation in its home markets. The use of dual class shares in the United States is also attractive to companies as a separate class of stock offers its holders the ability to maintain control of their growing companies. In the case of China, this may also allow individuals or entities connected to the Chinese government to maintain significant control of certain companies in which they have a pre-existing vested interest.

For many years, the United States offered faster approval of new IPOs than either Hong Kong or the mainland, and U.S. exchanges also allowed emerging but not yet profitable companies to list. These reasons help explain the three distinct waves of IPOs by Chinese companies.

First was the state-owned enterprises (SOEs), who came in heavily around the time that China entered the World Trade Organization (WTO). They came to raise large amounts of capital and to import corporate governance principles that would make them behave more like for-profit companies.

The second wave included over 500 Chinese companies that entered the U.S. market through reverse mergers. A reverse merger was a cheap and quick way to list a company by essentially merging a foreign company into an already-listed shell in the United States. Unfortunately, many of these reverse mergers had issues with investor protections, particularly with auditing obligations and visibility into the Chinese parent company, and in 2011 the exchanges eliminated the advantage of reverse mergers.

The third wave, which we are discussing today, includes many emerging and technology companies such as Alibaba. Some of the largest and best-known Chinese companies have sought access to U.S. exchanges. Although Hong Kong has traditionally been the venue of choice for Chinese-based companies, U.S. exchanges provide unmatched access to capital, liquidity, and credibility. U.S. exchanges permit weighted voting rights, and the ability to list without having shown profitability. These differences allowed owners in the United States to both list years before showing their profits and to maintain their control after listing.

Some of the corporate governance and regulatory frameworks of U.S. exchanges are being adopted by competing exchanges. Over the last few years, foreign exchanges have competed for listings and, in April 2018, the Hong Kong exchange debuted new regulations allowing companies to list using a weighted-voting share structure. These regulations also allow listing of certain technology companies that do not have a history of profitability. Recent IPO activity reflects these changes; in 2018 Hong Kong's exchange topped the NYSE in both the number and value of new IPOs.

Chinese exchanges are also trying to attract these listings. In November 2018, President Xi announced plans for a NASDAQ-style technology board on the Shanghai Stock Exchange. The new science and technology innovation board – the STAR Market – would allow the listing of companies with weighted voting rights and without having shown profitability. China's STAR Market debuted in the second quarter of 2019 and outperformed other regional exchanges including those in Hong Kong, Australia, and Japan. Of course, the broadening and deepening of Chinese capital markets fuel the growth and expansion of a Chinese ecosystem to fund businesses and facilitate joint ventures between international and Chinese companies that not only compete directly against American firms but may ultimately threaten U.S. national security interests. China's growing securities market, moreover, signals their lowering dependence on foreign markets.

Another indicator of China's desire for a growing share of the global capital markets is the Hong Kong Exchange's failed bid for the London Stock Exchange (LSE). Hong Kong is a Special Administrative Region of China, and in 2019 the Hong Kong Exchange touted its proposed $40 billion acquisition of the LSE as a perfect fit for London to ensure its global prominence post-Brexit. The LSE, however, rejected the deal due to its concern about the Hong Kong Exchange's "unusual board structure and relationship with the Hong Kong government." Government and party influence on the board reduced investor confidence in the exchange's independence.

China's quest for outside capital continues to grow and, as Chinese companies look to other exchanges to fulfill their growing capital needs, it is unclear whether the United States will be as clear a first choice as it was 20, 10 or even five years ago. Reforms to exchanges in Hong Kong, Singapore, and on the mainland have made those exchanges attractive to countries wishing to expedite their companies' growth.

According to the World Federation of Exchange, Shanghai's exchange is, after the NYSE, NASDAQ and the Tokyo exchange, the 4th largest exchange in the world and the Shenzhen exchange is number eight. Together with Hong Kong, at number five, this represents a significant source of capital for new Chinese companies.

Without question, today Chinese companies are growing in prominence as players in the race for capital. According to Hurun Global Unicorn List, at the end of June 2019, China had 206 unicorns – startups valued over $1 billion – compared with 203 for the United States.

Many of these unicorns in China represent technologies in key emerging and foundational sectors that may threaten to undermine the United States both in terms of economic competitiveness and national security. Artificial intelligence, for example, is one of the largest sectors in the listing. Chinese doctrine has stressed AI as a lynchpin of future economic and military power, and of course it is the technology driving China's social and corporate credit systems. China has 15 of the 40 unicorns in this critical sector while the United States has 20. It is also important to note that all of these Chinese unicorns – like all Chinese companies – are subject to a patchwork of national security-oriented laws that allow Chinese security and intelligence services to effectively leverage Chinese firms for espionage and other purposes. For example, per Article Seven of China's 2017 National Intelligence Law, private Chinese companies are compelled to cooperate in "state intelligence work." Furthermore, these laws require data to be housed inside China, as well as require random inspections and black-box security audits.

Here, it should be noted that when U.S. individual and institutional investors invest in Chinese firms, they may not be aware that they are funding companies involved in activities that are contrary to U.S. interests, including companies that appear on the Commerce Department's Entity List – a list of foreign entities subject to significant U.S. trade restrictions due to national security or foreign policy concerns.

Investment in Chinese firms also underscores the importance of audit quality and transparency, but there have been difficulties in achieving these goals with respect to China. The Public Accounting Oversight Board (PCAOB) has noted that it is "prevented from inspecting the U.S.-related audit work and practices of PCAOB-registered firms in . . . China, and, to the extent their audit clients have operations in mainland China, Hong Kong."[1] This means that investors often do not get a true picture of these companies' financial health, and of course bear the resulting risks associated with the lack of disclosure and difficulty in pursuing legal recourse.

In short, China's growth in the international capital markets is expanding and this has significant implications for U.S. economic and national security. It is in this context that we need to reexamine our policies to determine how to prioritize our interests to preserve our nations' economic strength and national security for both today and tomorrow. I look forward to answering your questions on this important topic.

[1] *Public Company Accounting Oversight Board*, "Public Companies that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdiction where the PCAOB is Denied Access to Conduct Inspections," https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx. Accessed 22 January 2020.