

# United States Senate

WASHINGTON, DC 20510

July 21, 2020

COMMITTEES:  
APPROPRIATIONS  
FOREIGN RELATIONS  
SELECT COMMITTEE ON INTELLIGENCE  
SMALL BUSINESS AND ENTREPRENEURSHIP  
SPECIAL COMMITTEE ON AGING

The Honorable Steven Mnuchin  
Secretary  
U.S. Department of Treasury  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

Dear Secretary Mnuchin:

On June 4, 2020, President Trump issued the *Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies*. In this Memorandum, the President notes that Chinese firms access American capital markets without abiding by the same investor protections rules that companies from across the world follow.<sup>1</sup> This creates a two-tiered system within our markets that disadvantages American investors, who expect consistency and equal application of our laws.

I urge you to address the following in your upcoming report to the President, in order to protect American investors and the integrity of U.S. capital markets:

1. **Chinese companies listed on U.S. securities exchanges:** American stock exchanges list Chinese companies, including state-owned enterprises, which are widely shielded by their government from the full oversight of American financial regulators. Most notably, these firms do not have their audits inspected by the Public Company Accounting Oversight Board (PCAOB). As such, Chinese companies listed on American exchanges face a different set of standards than companies headquartered elsewhere. The Chinese government is the only national government to bar PCAOB access to the audits of issuers listed on U.S. exchanges and the consequences are vast. According to data made available by the PCAOB, “In the twelve months ended December 31, 2019, 17 PCAOB-registered firms in mainland China and Hong Kong signed audit reports for 188 public companies with a combined global market capitalization (U.S. and non-U.S. exchanges) of approximately \$1.9 trillion.”<sup>2</sup>

An estimate cited in the 2017 annual report by the U.S. - China Economic and Security Review Commission values the losses to fraud perpetrated by Chinese firms on U.S. exchanges at \$5 billion,<sup>3</sup> a figure that has only grown in light of recent, high profile scandals, such that of Luckin Coffee in April of this year.

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<sup>1</sup> <https://www.whitehouse.gov/presidential-actions/memorandum-protecting-united-states-investors-significant-risks-chinese-companies/>

<sup>2</sup> <https://pcaobus.org/International/Pages/China-Related-Access-Challenges.aspx>

<sup>3</sup> [https://www.uscc.gov/sites/default/files/2019-09/2017\\_Annual\\_Report\\_to\\_Congress.pdf](https://www.uscc.gov/sites/default/files/2019-09/2017_Annual_Report_to_Congress.pdf)

Many Chinese firms list on U.S. stock exchanges using a corporate structure called the variable interest entity (VIE). This arrangement allows investors to engage in complex legal contracts with a company, as opposed to direct ownership. To skirt China's foreign ownership restrictions, these firms operate in a state of contradiction, telling the Chinese government that they are not owned by foreign investors, while effectively telling the foreign investors the opposite.<sup>4</sup> This convoluted state of affairs jeopardizes the rights of American investors. Legal enforceability is questionable and the Chinese government has the power to intervene in a VIE, which it may consider illegal whenever it pleases.

Firms listed on American exchanges whose audits are shielded from inspection by the PCAOB should be deregistered by the SEC subject to a warning period under which such firms can come into compliance. In addition, audit clients of registered accounting firms that the PCAOB is unable to inspect should be barred from Initial Public Offerings on U.S. exchanges. These steps will protect investors from fraudulent foreign firms while upholding the rule of law and integrity of American capital markets. U.S. regulators must also close the VIE loophole by requiring companies to list directly on U.S. exchanges in a manner that complies with all relevant U.S. laws and regulations.

- 2. Inclusion of Chinese equities on securities indexes:** The rise of passive investment funds is reshaping the way Americans invest as well as the structure of capital markets more broadly. From 2007 to 2016, actively managed funds saw roughly \$1.2 trillion in outflows, while index funds saw inflows of over \$1.4 trillion.<sup>5</sup> At its best, this development has meant that everyday Americans face lower barriers to investment in a diverse group of listings, as the job of picking is done by outside professionals, namely the index providers. On the other hand, reliance on a small group of index providers may leave investors with weakened control over their investments. In addition, it has led to market concentration and the ability of index providers to funnel vast sums to markets and individual companies without proper accountability or oversight.

This dynamic, in which index providers act as the gatekeepers to capital markets, has not gone unnoticed. Concerns of bias or unfair manipulation are particularly relevant to the industry, which has the power to move capital without the direct knowledge or consent of the retail investors who own the assets tracking these indexes.

In addition, the Chinese government has begun to use its influence and coercive power to strong-arm index providers into reallocating capital into its national economy, regardless of worthiness. In February 2019, the Wall Street Journal reported that the Chinese government successfully pressured MSCI, a major index provider, to add the Chinese stock market to its popular investment benchmark.<sup>6</sup> The concerns related to the rush of index providers to China extends beyond the threat of

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<sup>4</sup> <https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf>

<sup>5</sup> <https://theconversation.com/these-three-firms-own-corporate-america-77072>

<sup>6</sup> <https://www.wsj.com/articles/how-china-pressured-msci-to-add-its-market-to-major-benchmark-11549195201>

manipulation and conflict of interest. In tying billions of U.S. investors' dollars to the Chinese economy – often unwittingly – index providers are linking U.S. retail investors' fate to China's economic and industrial ambitions; put more starkly, over time, Americans will be rooting for Chinese industrial success to fund their retirement.

In May of this year, the Administration took bold action to protect investors from the risks associated with Chinese firms on securities indexes when it halted the planned move of the Thrift Savings Plan's International Fund to track the MSCI All Country World ex U.S. Investable Market index. According to a letter sent by National Economic Council Director Kudlow and National Security Advisor Robert O'Brien, "Investing in certain Chinese equities based on this latter index poses significant investment risks, which are likely only to increase as China's share of emerging-market investment indexes increases in future years. The financial impact of this risk is significant."<sup>7</sup>

For too long, index providers have acted as de facto fund managers without the associated oversight or disclosure. Investors currently receive insufficient disclosures related to the indexes tracked by passive funds. Index funds should be required to disclose to investors information related to the underlying index, including on index construction and management, fees paid from the fund to the index, and names of individuals who manage the index. Investors must be made aware of the risks associated with Chinese equities that they are invested in through passive funds, including their retirement and pension plans. In addition, decisions to increase funding for Chinese securities by index providers should be subject to the will of investors. Finally, the potential for conflicts of interest is particularly severe for index providers who are unregulated and unaccountable. The SEC should investigate instances of conflict of interest and issue rules to prevent future misconduct.

- 3. Recourse for American investors who have been defrauded by Chinese firms:** As noted in an April 21, 2020 public statement by the SEC and PCAOB, China investments are characterized not only by the risk of fraud and misconduct, but also by the "substantially less access to recourse" that defrauded investors face.<sup>8</sup> Indeed, the risks go beyond the normal challenges associated with investing in emerging markets as they exist both for investors in Chinese equities listed on Chinese exchanges and for those listed right here in the United States. According to the U.S. - China Economic and Security Review Commission, "Meanwhile, the complex listing structures of Chinese issuers, coupled with Chinese authorities' general unwillingness to actively regulate and protect U.S. investors, leave U.S. shareholders with no legal recourse to dispute fraud cases."<sup>9</sup> The Chinese government itself enables these fraudulent companies to avoid justice.

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<sup>7</sup> <https://www.foxbusiness.com/markets/trump-orders-federal-retirement-money-invested-in-chinese-equities-to-be-pulled>

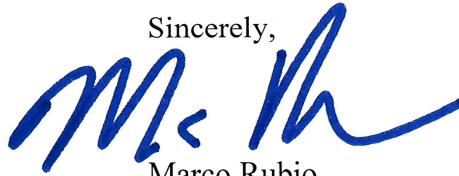
<sup>8</sup> <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting>

<sup>9</sup> [https://www.uscc.gov/sites/default/files/2019-09/2017\\_Annual\\_Report\\_to\\_Congress.pdf](https://www.uscc.gov/sites/default/files/2019-09/2017_Annual_Report_to_Congress.pdf)

Federal regulators should ensure that legal accountability exists for Chinese firms seeking to raise capital in the United States. As noted above, Chinese issuers on American exchanges regularly flout our laws and regulations. This misconduct, along with effective legal impunity creates adverse incentives for these firms to take advantage of American investors. For companies listed in China, comprehensive disclosures must be made to American investors warning them of the unique risks and legal challenges associated with this market.

Thank you for your work to protect American investors and the integrity of U.S. capital markets from the risks associated with Chinese equities. I look forward to working with you to ensure that this important concern is fully addressed.

Sincerely,

A handwritten signature in blue ink, appearing to read 'M. Rubio', with a stylized flourish extending to the right.

Marco Rubio  
U.S. Senator

CC: Board of Governors of the Federal Reserve System Chairman Jerome Powell  
Securities and Exchange Commission Chairman Jay Clayton  
Commodity Futures Trading Commission Chairman Heath Tarbert