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Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

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

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

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

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

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

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

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

U.S. Economic and Financial Statecraft in Recent Years

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

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

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

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

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

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

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

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

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

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

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

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

Russian Stocks, Index Providers, and Financial Risk

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

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

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

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

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

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

Institutional Investors Face Russia Divestment Obstacles

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

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

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

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

Targeting China with Economic and Financial Sanctions

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

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

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

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

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

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

Passive Investment, Exposure to Risky Corporate Structures

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

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

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

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

Institutional Investors and China Investment Strategy

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

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

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

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

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

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[32] "Comparing benchmark providers," Vanguard, accessed on November 11, 2022, https://institutional.vanguard.com/VGApp/iip/institutional/csa/investments/benchmarks/home.

[33] Zhen Wei, "China A Shares: What Have We Learned?," MSCI, October 30, 2020, https://www.msci.com/www/blog-posts/china-a-shares-what-have-we/02164045217.

[34] "Executive Order on Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," The White House, June 3, 2021, https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/.

[35] "Commerce Department Will Publish the First Military End User List Naming More Than 100 Chinese and Russian Companies," U.S. Department of State, Global Public Affairs, December 21, 2020, https://2017-2021-translations.state.gov/2020/12/21/commerce-department-will-publish-the-first-military-end-user-list-naming-more-than-100-chinese-and-russian-companies/index.html.

[36] "Harbin Z-19 (Black Whirlwind) (WZ-19)," Military Factory, last edited July 6, 2020, https://www.militaryfactory.com/aircraft/detail.php?aircraft_id=992.

[37] "CAIC Z-18," Military Factory, last edited August 12, 2022, https://www.militaryfactory.com/aircraft/detail.php?aircraft_id=2273.

State and Federal Pension Funds

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

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

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

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

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

University Endowment Funds

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

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

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

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[45] "TSP Mutual Fund Window (MFW) — List of all available funds," TSP Folio, accessed November 10, 2022, https://www.tspfolio.com/mfw/mutualfundlist.

[46] Demetri Sevastopulo, "Trump orders federal pension fund not to invest in Chinese stocks," Financial Times, May 12, 2020, https://www.ft.com/content/37ee5097-8ae2-4bc6-9c1f-048a242a4f33.

[47] Collin Binkley, "Colleges secretive about endowment investments," Associated Press via Milwaukee Journal Sentinel, March 17, 2016, http://archive.jsonline.com/news/statepolitics/colleges-secretive-about-endowment-investments-b99689686z1-372399571.html.

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

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

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

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

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

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

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

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

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

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

tax incentives to pressure university endowments on the issue of divestment.[55] In what appears to be an indirect response, the University of California's investment arm stated in September 2022 that it was working to taper its China investment exposure, while sources claim that Harvard University's endowment is considering reducing its holdings in China as well.[56.57]

Alternative Investments: Private Funds

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

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

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

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[55] "Murphy Introduces Bill to Pressure University Endowments to Divest from Dangerous Chinese Entities," Congressman Greg Murphy, July 21, 2022, https://gregmurphy.house.gov/media/press-releases/murphy-introduces-bill-pressure-university-endowments-divest-dangerous-chinese.

[56] David G. Barry, "UC Investments Seeks to Reduce China Holdings," Markets Group, September 22, 2022, https://www.marketsgroup.org/news/UC-Investments-China.

[57] Cathy Chan and Janet Lorin, "Investor pullback shows private equity funds' China struggle," Bloomberg, April 10, 2022, https://www.bloomberg.com/news/articles/2022-04-10/harvard-endowment-s-debate-shows-private-equity-s-china-struggle#xj4y7vzkg.

[58] "Private Fund," U.S. Securities and Exchange Commission, accessed November 12, 2022, https://www.sec.gov/education/capitalraising/building-blocks/private-fund.

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

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

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

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

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

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

Recommendations

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

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[63] Drew Maloney, "America for Sale? An Examination of the Practices of Private Funds," U.S. Congress, Hearing of the House Financial Services Committee, November 19, 2019, https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-maloneyd-20191119.pdf.

[64] "2021 Public Pension Study," American Investment Council, July 2021, https://www.investmentcouncil.org/wp-content/uploads/2021/07/2021_pension_report.pdf.

[65] Heather Gillers, "Retirement Funds Bet Bigger on Private Equity," The Wall Street Journal, January 10, 2022, https://www.wsj.com/articles/retirement-funds-bet-bigger-on-private-equity-11641810604.

[66] "SEC Proposes Amendments to Enhance Private Fund Reporting," U.S. Securities and Exchange Commission, January 26, 2022, https://www.sec.gov/news/press-release/2022-9.

[67] Celia Cohen, "US SEC approves proposal to adopt broad disclosure rules for private investment funds," Norton Rose Fulbright, February 14, 2022, https://www.nortonrosefulbright.com/en/knowledge/publications/bc84e594/us-sec-approves-proposal-to-adopt-broad-disclosure-rules-for-private-investment-funds.

[68] "SEC Proposes to Enhance Private Fund Reporting," U.S. Securities and Exchange Commission, August 10, 2022, https://www.sec.gov/news/press-release/2022-141.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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