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U.S. Capital Markets and China: Issues for Congress

Financial ties between the United States and the People's Republic of China (PRC or China) had been expanding since 2012. They have contracted since 2020 in the context of China's economic slowdown, reinvigorated capital controls, and increased scrutiny from U.S. government officials on U.S. investment in China.

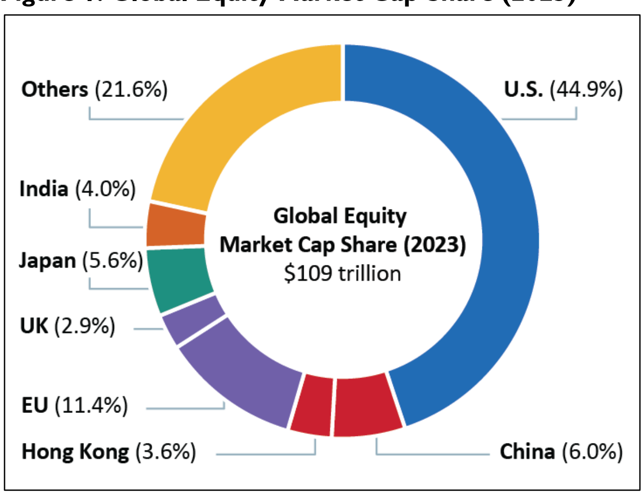
As of December 2023, U.S. investors held $322 billion in PRC (mainland China and Hong Kong) long-term securities (a 13.4% drop over 2022) while PRC holdings of U.S. securities rose by 4.5% to $1.87 trillion, according to the U.S. Treasury Department. Since 2020, U.S. net portfolio investment flows into China have fallen with a sharp drop in 2022 and over $30 billion in net outflows in 2023. This is the first time since 2018 that China has had a net outflow of funds. Investments in China by U.S. private equity (PE) funds fell from $140 billion in 2019 to $93 billion in 2021 and $4 to billion in 2023, according to the data firm Preqin.

Congress is debating whether or not to encourage or restrict financial flows, and is considering efforts to adopt enhanced disclosure and audit requirements. Congress also is considering legislation that would restrict U.S. investments in PRC state and military-tied firms and PRC strategic sectors.

Capital Markets Investments

The United States has the largest capital market in the world, far surpassing Europe, the second largest market. (**Figure 1**). U.S. listings and PE and venture capital (VC) ties offer PRC firms U.S. capital and paths to build brand recognition, and expand in China and overseas.

Figure 1. Global Equity Market Cap Share (2023)



Source: CRS, with data from the Securities Industry and Financial Markets Association (SIFMA)

Investor confidence in China's equity markets has dipped with China's economic slowdown. China's blue-chip index, the CSI 300, had declining returns from 2000 to 2023. Beijing has encouraged firms to buy back shares while tightening margin financing, in which investors borrow from brokers to invest. Similar to efforts in 2012 and 2015, Beijing has directed a "national team" of state firms and China's sovereign wealth fund to buy shares to stabilize the market. Beijing reportedly aims to use $278 billion that state firms hold offshore to boost the market.

Based on SEC filings, CRS estimates that 277 PRC firms were listed on U.S. stock exchanges as of May 2023—up from 248 in May 2021—with market capitalization of about $845 billion, about 1.7 % of the estimated $50 trillion in total U.S. equity market capitalization. One firm (Alibaba) accounts for about one fourth of China's total U.S. market capitalization. PRC firms listed on U.S. exchanges include firms in sectors prioritized in PRC industrial plans. In 2023, the average deal size of U.S. IPOs by PRC firms fell by 93% from 2021 levels, marking the lowest level in 20 years, according to Ernst and Young. In 2023, 24 PRC firms raised about $656 million in U.S. IPOs. Hesai, a PRC LiDAR firm, raised $190 million (29% of the total). Shein, a PRC digital fashion firm, filed in 2023 for a U.S. IPO.

While the PRC government maintains a closed capital account, since 2012 it has accelerated efforts to develop China's capital markets. These efforts include allowing some foreign institutional and retail investors to buy shares in PRC firms listed on China's exchanges through qualified institutional investor programs and stock connect programs via Hong Kong. Domestic and foreign capital markets have become a key source of capital for PRC firms in technology and strategic sectors. Since 2006, the PRC government has adopted a VC model that pools state and foreign monies in state-tied funds and foreign VC and PE activity.

Securing market access in China remains a key concern for U.S. financial firms. To date, Beijing has created limited openings in China's debt and equity markets, and allows a few U.S. firms to operate wholly-owned funds that spur U.S. investment. Morgan Stanley Capital Index (MSCI), a widely followed benchmark, has included PRC stocks since 2017; five major index fund providers include PRC bonds and A-shares of firms listed on PRC exchanges.

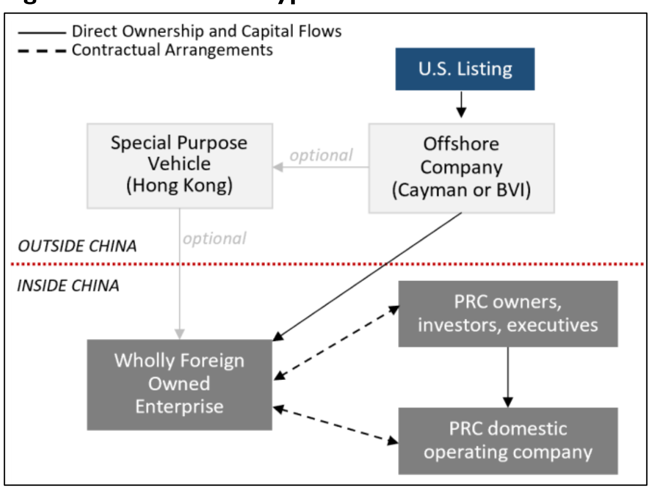
At the same time, China is taking steps that appear aimed at shifting U.S.-PRC investment activity to PRC exchanges. Since 2016, China's securities regulator has directed PRC firms to list on PRC exchanges and in Hong Kong. As of January 2023, all PRC firms managed by China's State Council had de-listed from U.S. exchanges. Since 2021, Beijing has also enhanced controls of overseas listings. In December 2021, Beijing pulled back the U.S. listing of DiDi Global, part of China's largest ride-sharing service, citing the need for a data security review. The PRC government has assumed a new shareholding position in several firms, and, since February 2023, requires a national security review for all PRC firms listing overseas.

Issues for Congress

PRC Corporate Structures

Congressional attention has focused on PRC firms' use of complex structures, such as the variable interest entity (VIE). Some Members have proposed stronger disclosure rules (S. 855 and H.R. 499) to address how these structures may obscure risks and state ties and shield PRC parent firms and core assets from U.S. legal recourse. In a review of filings, CRS estimates that two-thirds of all PRC U.S.-listed firms—including Alibaba, Baidu, and Tencent—use a VIE structure to address PRC restrictions and gain flexibility in operating overseas. A VIE structure involves the owners of a PRC firm creating an offshore holding company in which foreign investors can purchase an equity claim. The holding company is tied to the "parent" through a series of contracts and revenue sharing agreements that mimic ownership arrangements but do not provide the same rights typically afforded to investors in U.S.-listed firms (**Figure 2**). The contracts underpinning the VIE allow the PRC owner(s) to move funds across the business while creating a firewall between the listed entity and the core assets and licenses held by the PRC owner.

Figure 2. Outline of a Typical VIE Structure



Source: CRS, with information from multiple sources.

VIE arrangements have no definitive legal standing in China, which may leave U.S. investors without recourse. SEC 20-F disclosures by some firms acknowledge the risks of VIEs, noting that the VIEs are incorporated offshore, conduct most operations in China, and have executives who reside outside the United States. Use of the VIE structure allows PRC firms to take actions such as shifting business licenses and issuing off-the-books bonds, potentially reducing shareholder value and leaving no clear avenue for legal recourse. In 2010, for example, Alibaba cut out Yahoo (a 43% stake investor) in its spinoff of the online payment firm Alipay to a separate VIE. In February 2021, global investors reportedly had no alternative exit strategy or legal rights for an estimated $10 billion invested in an offshore shell company after the PRC government suspended Ant Financial's $34.5 billion IPO in Shanghai and Hong Kong. U.S. listings of PRC firms often represent a small portion of a firm's shares and do not include core assets of the PRC parent. Some firms use American Depositary Receipts (ADRs), a structure that allows a U.S. financial institution to sponsor a secondary U.S. exchange listing of a foreign firm. The parent firm's stocks are listed in the United States through a contract that bundles the firm's stock certificates. Most PRC firms are required to file an SEC 20-F annual report for foreign issuers, but there are exemptions on specific disclosure requirements. For ADRs, the SEC relies on foreign government reporting and disclosures, and that can create transparency gaps.

U.S. Financial Investment in PRC Strategic Sectors

The Treasury Department and some Members say they are disinclined to restrict financial flows, noting that the United States benefits from an open investment climate. Instead, Treasury has sought restrictions that are "narrowly targeted at investments in highly sensitive technologies and products for the purposes of protecting U.S. national security." Other Members and policymakers say U.S. investments, including passive financial investments, support China's military and strategic sectors. They note that U.S. index funds include PRC military and state-tied firms. In February 2024, the House Select Committee on Strategic Competition with the Chinese Communist Party determined that several U.S. VC firms invested over $3 billion in PRC firms tied to the military, industrial policies, and human rights abuses.

The U.S. government has taken several actions to address risks U.S. investments may pose. In May 2020, U.S. policymakers convinced the U.S. government's Thrift Savings Plan board to defer a decision to tie its international fund to an index that includes PRC firms. A June 2021 Biden Administration Executive Order (E.O.) 14032 prohibits U.S. persons from investing in named PRC military firms. In February 2024, the U.S. Department of Defense listed a PRC investment firm, IDG Capital, as a military firm. Some Members have sought to expand the list of firms and sectors and restrict capital flows. In August 2023, the Biden Administration issued E.O. 14105, directing Treasury to create a program to regulate certain U.S. investments in China's semiconductors, artificial intelligence, and quantum sectors. H.R. 6349 proposes to codify the E.O. in statute and expands the sectors it covers.

U.S. Investor Protections

In 2020, Congress passed the Holding Foreign Companies Accountable Act (HFCAA) (P.L. 116-222) to address PRC firms' noncompliance with U.S. statutory audit requirements. HFCAA requires PRC firms to disclose state and military ties and delist from U.S. exchanges if terms are unmet. In August 2022, PRC officials agreed to an initial auditing framework to allow the U.S. review of the work of PRC-based accounting firms that audit PRC-based firms listed on U.S. exchanges. Since 2021, the SEC has increased scrutiny of PRC firms. In July 2023 it issued guidance on disclosure obligations for PRC firms. Congress could consider whether or not to require the SEC to augment these rules with more details on state ties and beneficial ownership and to verify the completeness and accuracy of PRC filings. Congress also could consider whether or not to require the SEC to make the U.S.-China auditing deal public; report on HFCAA implementation; and issue China investment bulletins.

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