CHINA'S PRESENCE IN THE GLOBAL CAPITAL MARKETS

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

APRIL 16, 2004

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I think the primary concern that I want to raise also which was addressed in the previous panel, is that issue of state control. I direct your attention to a 1997 study by World Bank economists on corporate governance in China, showing that ownership structure (both the mix and concentration) has significant effects on the performance of stock companies.

There's a positive and significant correlation between ownership concentration and profitability. That's a good thing. The effect of ownership concentration is stronger for companies dominated by legal person shareholders than for those dominated by the states.

So they raise very significant concerns about the state control and a number of factors, including labor productivity.

The second concern is the ability and independence of the directors. In an article in this new book, *International Corporate Governance*, Professor Viner says, "in no other major economy does there exist such a vast gulf separating corporate governance enshrined as code and regulation from corporate governance as practiced."

I think that's a very telling statement to keep in mind, and so as we talk about caveat emptor and the ability of the market, including investors like Warren Buffett, to make decisions about their investments in China, we want to make sure that they understand not just what is said to be the practice but what is actually the practice.

John Plender, who I think is one of the most thoughtful people writing about business, wrote in *Financial Times*, "the trouble is that enforcement is well nigh impossible as long as the state is still a controlling shareholder in so many companies. Too many independent directors are simply stooges of the state or cronies of the executive directors. They're rarely paid more than their travel expenses and few believe they will escape the egregious related party transactions that disadvantage outside shareholders and mar the Chinese government landscape."

So independence is great. We really appreciate that, but we want to make sure it's genuine independence.

Third, I want to draw your attention to what I call exploitation of loopholes. The current *Forbes* magazine has a very troubling article about Chinese companies exploiting loopholes to list on American exchanges. They mention China Cable and Communication with zero revenues and, as they say, "iffy assets." That's a technical term. *Forbes* said it had no prayer of going public even in China but through a reverse merger that set up another organization in the British Virgin Islands and then made itself a subsidiary of that, and then it merged with a shell U.S. company with no operational history in a decade we've got to plug up the loopholes on our side, people—it was able to list on the Nasdaq and raise $4 million from U.S. investors. Four other Chinese companies have done the same this year, an attractive alternative to the slow and expensive process of going public in China where 1,000 companies are waiting for review by Chinese securities authority and only one in ten are expected to be successful.

I think that's probably a good thing. It shows there is some sorting ability there. CTC Cosmetics did a reverse measure along these lines in 1997 and has been delisted with some scandal attached to

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FRIDAY, APRIL 16, 2004

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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission's full charter is available via the World Wide Web: http://www.uscc.gov.

The Commission's Statutory Mandate begins on page 79.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

MAY 21, 2004

The Honorable TED STEVENS,
President Pro Tempore of the U.S. Senate, Washington, D.C. 20510
The Honorable J. DENNIS HASTERT,
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the record of our April 16, 2004 hearing on "***China's Presence in the Global Capital Markets***."

This hearing addresses the charge in our mandate to examine "Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests." This is a cutting-edge element of our broader look at the U.S.-China economic relationship.

At this hearing the Commission heard testimony from two panels of witnesses on the goals, methods and implications of Chinese firms' use of global debt and equity markets to raise capital. Witnesses expressed particular concern about the governance and transparency of Chinese enterprises listing on U.S. exchanges. Recently, these listings have come under increased scrutiny in light of the Securities and Exchange Commission's investigation into China Life's accounting irregularities and a trade secret theft and patent infringement suit brought in U.S. courts against Semiconductor Manufacturing International Corporation, two Chinese firms listed on the New York Stock Exchange. However, despite mounting investor apprehension, China's outreach to international capital markets continues to grow in size and frequency, with some analysts forecasting the volume of Chinese company initial public offerings (IPOs) in the global markets to be as high as $23 billion for 2004.

Accessing international capital markets is an important component of China's economic development strategy. Notably, despite the fact that Chinese private firms account for roughly 60 percent of the country's GDP, the Chinese government has permitted state-owned enterprises (SOEs) to launch the overwhelming majority of IPOs in global capital markets. Chinese SOEs listing on global capital markets generally remain under the control of the Chinese government whose corporate governance and disclosure practices differ significantly from U.S. norms. With billions of dollars in U.S. investor funds being attracted by these firms, it is vital to understand whether U.S. investors are being provided adequate information about these firms' governance and financial performance, and whether U.S. regulatory requirements are sufficient to capture this concern.

The Commission also heard testimony about potential linkages between listed Chinese firms and China's defense-industrial complex and weapons proliferation activities. Such security-sensitive activities could constitute a material risk to investors because of the possible negative impact on the share value and reputations of these enterprises. More fundamentally, the Commission is concerned about whether the U.S. Government is sufficiently monitoring this nexus and focused on the potential security implications.

The Commission will provide a comprehensive analysis of this issue, along with recommendations for Congressional action, as part of its upcoming report to the Congress.

Sincerely,

Roger W. Robinson, Jr. *Chairman*	C. Richard D'Amato *Vice Chairman*