

# CHINA'S STRATEGY AND OBJECTIVES IN GLOBAL CAPITAL MARKETS

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## HEARING BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

—  
AUGUST 11, 2005  
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The Commission's Statutory Mandate begins on page 135.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

DECEMBER 1, 2005

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 this summary of our August 11, 2005 hearing on ***China's Strategy and Objectives in Global Capital Markets***. An electronic copy of the hearing record is available on line at [www.uscc.gov](http://www.uscc.gov). This hearing examined a key element of the Commission's broader mandate to examine the security implications of the U.S.-China economic relationship—specifically “*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.*”

***China's Presence in International Capital Markets***

The Commission heard expert testimony from three panels of witnesses on the goals, methods, and implications of Chinese firms' use of global capital markets to raise funds. Witnesses expressed particular concern about the governance and transparency of China's state-run enterprises that are listing on international exchanges with increasing frequency. They identified specific problems with many of the Chinese companies that are listing, including a lack of minority shareholder rights, improper accounting practices, and corruption. Yet, despite these problems, Chinese initial public offerings (IPOs) generally have fared very well and often have been oversubscribed. These IPOs appear to have benefited from a widespread enthusiasm about and desire to participate in China's economy as a result of its recent history of impressive economic growth.

Chinese IPOs remain largely the domain of the state-owned enterprises (SOEs). China Construction Bank (CCB) and Shenhua Energy Co., China's preeminent coal producer, account for roughly \$11 billion of the total projected proceeds of \$20 billion from Chinese IPOs during 2005. Every firm incorporated in China must first receive central government approval before listing on an exchange. This is especially the case for SOEs, since they often require a “cleaning” process to ready themselves for the public scrutiny an international listing requires. This process combines a host of financial and production-related restructuring and marketing maneuvers to demonstrate management autonomy, transparency, and corporate governance improvements. In an attempt to avoid the political maneuvering that often accompanies efforts to obtain Beijing's approval for IPOs, many private Chinese firms have chosen to incorporate themselves in small island jurisdictions such as

Bermuda and the Cayman Islands, which enables them to avoid the government approval requirement.<sup>1</sup>

China's domestic capital markets in Shanghai and Shenzhen remain weak today. Between June 2001 and June 2005 the Shanghai Stock Exchange lost over half its value and hit an eight-year low.<sup>2</sup> Experts believe this is largely due to the lack of market forces and transparency in the process of pricing listings on that market. Among the problems faced by the two exchanges are a frequent failure to set the IPO price by the time the prospectus is issued, poor regulatory supervision, rampant insider trading, frequent government intervention, inadequate corporate disclosure, and corruption. There have been criminal investigations related to eight listed companies, including an investigation of the chairman of Shanghai-listed jeweler Diamond Co. who transferred \$10 million in company funds into private overseas accounts and disappeared.<sup>3</sup> These developments have led to a widespread lack of confidence in the proper functioning of these exchanges. As a result, both private and state-owned Chinese firms have been increasingly active in international capital markets.

Due to the weakness of China's domestic capital markets and the enhanced reporting requirements under the Sarbanes-Oxley Act of 2002 (SOX), non-technology-related Chinese firms, particularly SOEs, are choosing almost exclusively to list on the Hong Kong Stock Exchange (HKEx). Beijing's influence over the political authorities in Hong Kong may present a conflict of interest, and the HKEx's financial authorities are taking preliminary measures to ward off potential troubles. This concern is particularly appropriate because at present the HKEx has no statutory mechanism set up to inquire into the financial reports of listed companies. For this reason Hong Kong's regulatory authorities are publicly seeking to "maintain investor confidence and uphold Hong Kong's standard of corporate governance" by seeking Legislative Council enactment of legislation establishing a Financial Reporting Council.

To avoid current and future SOX reporting requirements, Chinese SOEs have been utilizing the 144A listing process to raise capital instead of using traditional IPOs. U.S. Securities and Exchange Commission rule 144A allows private placement to institutional investors—e.g., a hedge or private equity fund—after a public listing on the HKEx or another exchange. The ability to raise funds from U.S. institutional investors that this mechanism provides has reduced the need for Chinese issuers to incur the costs associated with meeting the disclosure and governance requirements mandated by SOX. As a result, Chinese issuances on the NYSE have fallen sharply while 144A listings have grown rapidly.

While there has been a drop in Chinese listings on the NYSE, the one category of Chinese companies that has continued to list on U.S. exchanges is Chinese technology firms. These companies tend to list on the NASDAQ Exchange (NASDAQ). During the

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<sup>1</sup>In this context "Chinese company" refers to a company whose primary business operations are conducted within the PRC. This includes those incorporated in the PRC as well as companies domiciled outside the PRC. Despite the fact that they conduct primary operations in the PRC, the majority of internationally listed Chinese companies are domiciled in the Cayman Islands, Bermuda, the British Virgin Islands or similar locations.

<sup>2</sup>"Outlook Dims for China's Stock Markets," *Agence France Press*, June 6, 2005.

<sup>3</sup>Matthew Forney, "China's Market Maladies," *TIME Asia*, February 7, 2005.

“tech bubble” of the late 1990s several Chinese tech firms listed in the United States, but after the bubble burst there were virtually no Chinese technology IPOs in 2001, 2002, or 2003. In 2004, the Chinese technology sector reemerged and eleven companies launched IPOs. At the beginning of 2005, there were few Chinese technology issues, but as the year passed they began to list with increasing frequency. Currently, nine Chinese firms are now seeking to list on the NASDAQ. The Chinese firms listing on the NASDAQ are smaller, more technology-focused, and more entrepreneurial than those that have traditionally listed on the NYSE.

The NASDAQ-listed firms appear to have determined that the benefits of a U.S. listing outweigh the costs. Managers of these firms tend to be familiar with the U.S. capital market environment and their venture capital investors expect U.S. IPOs. This is because the NASDAQ tends to value technology companies at higher price multiples than other markets, including the HKEx; it provides the liquidity necessary for exiting investors; and it offers the most “credibility and cachet.” According to Howard Chao:

*[C]ompanies of this type tend to be more familiar with U.S. disclosure rules, standards of corporate governance, and other market expectations. On average they tend to have higher management standards than many other Chinese companies. They tend to be more market-driven.*

### **Chinese Banks’ Capital Raising Activities**

For some time, China has aspired to list its four leading state-owned banks on international exchanges; CCB led the way, listing on the HKEx on October 19, 2005 (where it raised \$8 billion). Chinese authorities believe pressure to list internationally will spur China’s banks to achieve international standards of capitalization and corporate governance that will help them compete with foreign banks when protectionist government regulations are lifted in 2006.<sup>4</sup> This is a large step for these quasi-government institutions whose leaders are unaccustomed to opening their books to public scrutiny.

An evaluation of the Chinese banking sector provides cause for both optimism and pessimism. Among the reasons for optimism, the Commission heard testimony that while all top officials at China’s financial sector regulatory agencies, the Central Bank, and the major state-owned banks are senior Chinese Communist Party (CCP) members and political considerations are involved in their appointments, the government is trying to reduce the Party’s political influence in those organizations. Efforts are being made to bring large state-owned banks in line with international accounting norms. In 2004, there was a reduction in the percentage of loans by China’s banks that are nonperforming (NPLs). Those NPLs are estimated to have a current aggregate value between \$350 billion and \$550 billion. It is important to note, however, that a massive lending binge temporarily reduced the percentage of Chinese bank loans that are nonperforming, but that binge ironically could lead to a new wave of NPLs in coming years, particularly if the Chinese

<sup>4</sup>Alexis Chui, “Listing of Chinese Banks Delayed,” *Asia Times Online*, June 7, 2005. [www.atimes.com/atimes/China/GF07Ad03.html](http://www.atimes.com/atimes/China/GF07Ad03.html).

economy continues to slow. However, according to Pieter Bottelier, “Ultimate losses associated with absorbing the remaining stock of currently reported NPLs [are] well within the capacity of the Chinese state to finance, even without additional foreign equity participation in state banks.”

Unfortunately a number of reasons for pessimism about Chinese banks remain. While the large state-owned commercial banks are working to improve their lending practices, Dr. Bottelier noted that over 60 percent of incremental lending in China between the last quarter of 2002 and the second quarter of 2004 came from small banks, mostly owned by local governments. Reform efforts at these smaller banks are less well developed or absent altogether. Lending without proper due diligence remains common. Tens of millions of dollars were stolen from Chinese banks last year alone, often by or with the complicity of bank officials.<sup>5</sup>

The Commission heard testimony that China is taking a two-pronged approach to raising capital vis-à-vis its state-owned banks. While it is preparing its largest state-owned banks for overseas stock market listings, it also is selling stakes in these and other banks to Western firms eager to gain a foothold in the Chinese banking sector. Between January and October, foreign banks have agreed to invest more than \$15 billion in Chinese lenders.<sup>6</sup> Bank of America, Royal Bank of Scotland, Deutsche Bank, and HSBC are among those seeking stakes in China’s state-run banks. These transactions likely are more important to the Chinese for the international financial sector relationships they establish and cultivate and the incentives they provide to Chinese banks to improve their corporate governance methods and procedures than they are for the cash they attract. The foreign banks see such investments as a means of entering an expanding and potentially lucrative Chinese market. These investments are subject to essentially the same set of problems for investors to which Chinese bank IPOs are subject, and institutions considering such investments should be as cautious as individuals and institutions considering purchasing the listed stocks of these banks.

### ***Security Related Concerns***

The Commission’s 2004 Annual Report to Congress identified four security-related areas of concern regarding the listing of Chinese companies on U.S. and other international exchanges. These are (1) links between listed Chinese firms and weapons proliferators, (2) links between listed Chinese firms and the People’s Liberation Army (PLA) and other parts of China’s defense-industrial sector, (3) the way in which Chinese state-owned banks have provided subsidized financial support to Chinese defense-industrial firms, and (4) inadequate disclosure of the activities of listed Chinese enterprises in terrorist-supporting states such as Iran and Sudan. The Commission continues to take seriously these concerns.

Inadequate transparency and disclosure by Chinese firms prevent the U.S. Government and investors from fully understanding

<sup>5</sup> “18M Fraud Uncovered at Chinese Bank,” *Agence France Presse*, March 12, 2005.

<sup>6</sup> Kate Linebaugh, “Deutsche Bank Joins the Push into China,” *Wall Street Journal*, September 22, 2005.

the possible nexus between Chinese firms listing on U.S. and international capital markets and support for Chinese and other weapons proliferation activity. However, there is no doubt that some listed Chinese firms are involved in proliferation-related activities.

The U.S. Government has imposed sanctions on a number of Chinese companies, including quasi-governmental companies, for proliferation activities.<sup>7</sup> Some of the sanctioned companies have ties to listed firms, and some of them are subsidiaries of prominent companies that do business in the United States. Examples include Nanjing Chemical Industries Group and Jiangsu Yongli Chemical Engineering and Technology Import/Export Corp. Both these organizations have been cited by the U.S. Government for proliferating dual-use chemical precursors, equipment, and/or technology to Iran and have been under U.S. sanctions since 1997. Both are also subsidiaries of the Chinese oil and chemical giant Sinopec that has conducted joint ventures with U.S. companies and is listed on the NYSE, despite the fact that two subsidiaries were under U.S. sanctions at the time of the listing.<sup>8</sup>

Other Chinese firms sanctioned by the United States for proliferation include quasi-governmental firms such as North China Industries Corp. (NORINCO) and China National Aero-Technology Import and Export Corporation (CATIC).<sup>9</sup> CATIC was sanctioned for proliferation activities relating to its deals with Iran. This year CATIC has been particularly active in Zimbabwe, reporting sales of aircraft there with both civilian and military capabilities.<sup>10</sup> CATIC is listed on the HKEx and the Berlin Stock Exchange. NORINCO is traded on China's Shenzhen Stock Exchange where it is available for purchase by Chinese and Qualified Foreign Institutional Investors.

Disturbingly, U.S. investors and government regulators have little information regarding any proliferation-related activities of U.S.-listed Chinese firms. To address this concern, the Congress established a requirement for an annual report by the Central Intelligence Agency concerning "whether any Chinese or other foreign companies determined to be engaged in the proliferation of weapons of mass destruction (WMD) or their delivery systems have raised, or attempted to raise, funds in the U.S. capital markets."<sup>11</sup> However, this requirement, established under the 2003 Intelligence Authorization Act (P.L. 107-306 sec. 827) was repealed in the 2004 Intelligence Authorization Act (P.L. 108-177 sec. 361e). The persistence of Chinese proliferation coupled with the growing number of Chinese firms entering international capital markets urgently requires the reinstatement of this reporting requirement.

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<sup>7</sup>U.S.-China Economic and Security Review Commission, *Hearing on China's Proliferation Practices and Role in North Korea Crisis*, testimony of Assistant Secretary of Defense Peter W. Rodman, March 10, 2005.

<sup>8</sup>Matthew Godsey and Gary Milhollin, "A Shell Game in the Arms Race," *New York Times*, February 15, 2005, p. A-23.

<sup>9</sup>U.S.-China Economic and Security Review Commission, *Hearing on China's Proliferation Practices and Role in North Korea Crisis*, testimony of Peter W. Rodman, March 10, 2005.

<sup>10</sup>"China Aims to Sell More Aircraft to African Market," *Xinhua*, April 28, 2005.

<sup>11</sup>U.S.-China Economic and Security Review Commission, *2004 Report to Congress of the U.S.-China Economic and Security Review Commission* (Washington, DC: June 2004), p. 88.

### ***Recommendations***

Based on the information presented to the Commission at the August 11 hearing about China's growing presence in international capital markets, we present four recommendations to the Congress for its consideration. We note for your information that, between the date of the hearing and the date the letter is being delivered, the Commission completed and issued its 2005 Annual Report to Congress. A summary of the material provided above is included in Chapter 1 of the Report; that Chapter also includes these recommendations.

1. The Commission recommends that Congress encourage the Administration to use Executive Order 13382 to freeze the assets of Chinese firms involved in WMD or missile-related proliferation, and the assets of Chinese companies or financial institutions that may be assisting or lending to such proliferators. Congress also should encourage the Administration to expand the provisions of Executive Order 13382 so that the U.S. property of a parent company can be frozen if the parent knows or has reason to know the proliferation activities undertaken by its subsidiaries, or so the U.S. property of financial institutions can be frozen if they know or have reason to know of the involvement of their lending customers in proliferation activities.<sup>12</sup>
2. The Commission recommends that Congress urge the Securities and Exchange Commission to work directly with its regulatory counterparts in other nations as well as through the International Organization of Securities Commissions to press for the harmonization and independent and robust enforcement of securities laws, especially as they relate to corporate governance and reporting, transparency, and disclosure requirements.
3. The Commission reiterates the recommendation in its 2004 Annual Report that Congress reinstate the provision of the 2003 Intelligence Authorization Act (P.L. 107-306, sec. 827) directing the Director of Central Intelligence to prepare an annual report identifying Chinese or other foreign companies engaged in proliferation of weapons of mass destruction or their delivery systems that have raised, or attempted to raise, funds in U.S. capital markets.
4. The Commission recommends that Congress instruct the Securities and Exchange Commission to notify the National Security Council (NSC) when any Chinese firm seeks to list on a U.S. capital market, and urge the NSC upon receipt of such a notification to consider carefully all relevant intelligence and determine if the firm is involved in WMD or ballistic missile proliferation, support for terrorism, or other security-related abuses and, if so, to utilize the appropriate provisions of Executive Order 13382.<sup>13</sup>

Thank you for your consideration of this summary of the Commission's hearing and the resulting recommendations the Commission is making to the Congress. We note that the full transcript

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<sup>12</sup> Commissioner Reinsch dissents from this recommendation.

<sup>13</sup> Commissioner Reinsch dissents from this recommendation.




of the hearing plus the prepared statements and supporting documents submitted by the witnesses can be found on the Commission's website at [www.uscc.gov](http://www.uscc.gov), and that these can be searched by computer for particular words or terms. We hope these materials will be helpful as the Congress continues its assessment of China's activities in global capital markets and policies the United States should pursue in response.

Sincerely,



C. Richard D'Amato  
*Chairman*



Roger W. Robinson, Jr.  
*Vice Chairman*



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## **CHINA'S STRATEGY AND OBJECTIVES IN GLOBAL CAPITAL MARKETS**

**THURSDAY, AUGUST 11, 2005**

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION,  
*Washington, D.C.*

The Commission met in Room 124, Dirksen Senate Office Building, Washington, D.C. at 10:00 a.m., Chairman C. Richard D'Amato, Vice Chairman Roger W. Robinson, Jr., and Commissioner Michael R. Wessel (Hearing Cochairs), presiding.

### **OPENING STATEMENT OF CHAIRMAN C. RICHARD D'AMATO**

Chairman D'AMATO. The hearing will come to order. Today, the U.S.-China Economic and Security Review Commission will have a hearing on China's Strategy and Objectives in the Global Capital Markets. I'd like to thank Commissioner Mike Wessel to my right and Vice Chairman Roger Robinson for chairing this hearing and for continuing to focus the Commission's attention on the important topic before us. I also thank today's panelists in advance, for offering their informed perspectives on the issues.

The economic and security challenges for the United States, and particularly from our point of view American investors and holders of mutual funds on China stocks and bonds—firefighters, policemen, teachers, workers—the challenges for the United States and our constituents stemming from the increased incursion of Chinese firms to the global capital market is certainly one of the most unique issues of our mandate from the Congress, and this—to repeat our mandate, Part D of the congressional mandate for this Commission—is that we shall evaluate the extent of Chinese access to and use of United States capital markets, whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets.

These issues have significant implications for U.S. institutional and portfolio investors looking to purchase stock in Chinese firms, as well as financial analysts tasked with unraveling Chinese companies' complex web of relationships and finances.

As Chinese financial institutions prepare today, we understand, for an estimated combined \$15 billion in listings, questions need to be raised regarding the loan portfolios of these institutions. I am concerned that U.S. investors may not have sufficient information to make informed decisions about the risk of these investments.

Furthermore, the possible links between listed state-run firms and banks and China's military industrial complex also requires comprehensive examination.

I might point out—and we'll be talking about this during the hearing—that Wall Street financial ratings for Chinese banks, for 13 Chinese banks, which we have seen, give us some pause as to the intrinsic strength of those banks. None of those banks rise to even average international standards, and we'll be talking about that during the day today.

China's state-run enterprises and financial institutions are not transparent or accountable, making it nearly impossible to know the full extent of their assets and subsidiaries. Now that Congress has enacted comprehensive enhanced disclosure framework known as the Sarbanes-Oxley law, Chinese firms apparently have been bypassing the New York Stock Exchange and listing mainly in Hong Kong, London or Frankfurt.

Given the rush of Chinese IPOs, particularly to the Hong Kong Stock Exchange, the Hong Kong Stock Exchange financial authorities would be wise to recognize the potential consequences of allowing Beijing-managed firms to acquire so much capital under their auspices, and there is some concern that these institutions are going to Hong Kong Stock Exchange with the lower regulation and standards as a way to bypass Sarbanes-Oxley. That's something that we need to discuss.

Taken together, all this suggests that China's need to finance its economic expansion and support its state-owned enterprises with U.S. investors' money demands the full attention of the United States Government. I'd like to turn the podium over now to the Co-chairman, Commissioner Mike Wessel, and then to my Vice Chairman Roger Robinson.

Commissioner Wessel.

[The statement follows:]

**Prepared Statement of Chairman C. Richard D'Amato**

I would like to thank Vice Chairman Robinson for continuing to focus the Commission's attention on the important topic before us, and today's panelists for offering their informed perspectives on this issue. The economic and security challenges for the United States stemming from the increasing incursion of Chinese firms to the global capital markets is certainly one of the most unique issues in our mandate from Congress.

The vast majority of Chinese enterprises listed on international capital markets are owned and operated by the Chinese state. Questionable corporate governance, accounting practices, and minority shareholder rights make this a subject of particular concern to the Congress. These issues have significant implications for U.S. institutional and portfolio investors looking to purchase stock in Chinese firms, as well as financial analysts tasked with unraveling Chinese companies' complex web of relationships and finances.

As Chinese financial institutions prepare for an estimated combined \$15 billion in listings, questions need to be raised regarding the loan portfolios of these institutions. I am concerned that U.S. investors may not have sufficient information to make informed decisions about the risk of these investments. Furthermore, the possible links between listed state-run firms and banks and China's military industrial complex has here-to-for lacked comprehensive examination.

China's state-run enterprises and financial institutions are not transparent or accountable making it nearly impossible to know the full extent of their assets and subsidiaries. And now that Congress has enacted an enhanced disclosure framework in the Sarbanes-Oxley law Chinese firms have been bypassing the New York exchange and listing in Hong Kong, London or Frankfurt. Given the rush of Chinese IPOs to the Hong Kong Stock Exchange (HKSE), the HKSE's financial authorities would be wise to recognize the potential consequences of allowing Beijing-managed firms to acquire so much capital under their auspices. Because in the final estimation, the HKSE's reputation as one of the world's top exchanges hinges on its ability to ensure conflicts of interest do not occur. All international capital markets

need to, at a minimum, shine a spotlight on how to perform proper due diligence on Chinese SOE's, and fast.

Taken together, all this suggests that China's need to finance its economic expansion and support its state-owned enterprises with U.S. investors money demands the full attention of the U.S. Government.

**OPENING STATEMENT OF COMMISSIONER MICHAEL R. WESSEL  
HEARING COCHAIR**

Cochair WESSEL. Thank you, Chairman D'Amato, and thank you Vice Chairman Robinson not only for cochairing today's hearing but your leadership on this issue since the Commission's inception several years ago. It's your leadership that has helped raise real public attention on this issue, and it's appreciated by us and by many others.

Since the Commission's last report in 2004, we've held ten hearings covering a range of topics on U.S.-China trade and security issues. Today's topic helps complete this picture of U.S.-China economic relations with the discussion of a topic that gets relatively little attention: the growing trend of Chinese firms raising capital in U.S. and global markets.

While it is certainly an appropriate step in China's economic development that its firms are now increasingly looking to global capital markets to raise funds, it is also appropriate for U.S. Government and the U.S. investors to want to better understand the nature of these listings.

This Commission has made clear in the past its concern about the lack of transparency of certain Chinese firms listing in the global capital markets. We've asked whether U.S. investors are sufficiently aware of the financial wherewithal of such firms and whether the U.S. Government is sufficiently aware of any military and weapons proliferation ties these firms may have as well as their impact on other vital security interests of the United States.

With regard to transparency, as the Chairman noted just a moment ago, current U.S. securities laws such as Sarbanes-Oxley appear to have decreased the number of Chinese offerings in the U.S. capital markets due to concerns by the firms about the enhanced disclosure requirements for foreign registrants.

Today, we will discuss how this legislation has caused Chinese companies to list in Hong Kong or Tokyo rather than the United States.

Transparency concerns may be heightened with regard to the anticipated listings of major Chinese state-owned banks in the U.S. capital markets. I believe we need to draw attention to the level of due diligence performed by these banks and gain a handle on the true holdings in their loan portfolios.

Are they major sources of capital for Chinese military and defense firms? Moreover, Chinese state-owned banks have been the traditional sources of below market rate capital for China's state-owned industries serving, in my opinion, as a massive form of state subsidy unavailable to U.S. competitors.

Take, for example, the recent CNOOC bid for Unocal. To exceed Chevron's offer for Unocal, CNOOC received six billion in state-owned bank funding in addition to the seven billion in loans at below market or no interest rates from its state-owned parent company.

Deals such as this highlight how the nature of state-owned bank lending practices may be based more on governmental interests than true market forces.

As these banks list publicly, this behavior needs to be monitored and at the very least investors deserve complete disclosure of the non-market forces at work.

The forces that drove Congress to enact Sarbanes-Oxley are no less important here as we look at how to protect the investing public.

Our intention is not to propose unreasonable restrictions on the access of Chinese firms to U.S. capital markets. Our goal instead is to ensure that the U.S. Government and U.S. investors have the most complete information possible on the financial standing and activities of Chinese firms listing in our capital markets. The proper functioning of our capital markets requires broad transparency of the listed entities. We should hold all listings to this important standard.

Thank you.

[The statement follows:]

**Prepared Statement of Commissioner Michael R. Wessel  
Hearing Cochair**

Good morning and welcome to today's hearing on China and the capital markets. Since the Commission's last report in 2004 we've held ten hearings covering a range of topics on U.S.-China trade and security issues. Today's topic helps complete this picture of U.S.-China economic relations with a discussion of a topic that gets relatively little attention—the growing trend of Chinese firms raising capital in U.S. and global markets.

While it is certainly an appropriate step in China's economic development that its firms are now increasingly looking to global capital markets to raise funds, it is also appropriate for the U.S. Government and U.S. investors to want to better understand the nature of these listings. This Commission has made clear in the past its concerns about the lack of transparency of certain Chinese firms listing in the global capital markets. We have asked whether U.S. investors are sufficiently aware of the financial wherewithal of such firms and whether the U.S. Government is sufficiently aware of any military and weapons proliferation ties these firms may have.

With regard to transparency, current U.S. securities laws, such as Sarbanes-Oxley, appear to have decreased the number of Chinese offerings in the U.S. capital markets due to concerns by the firms about the enhanced disclosure requirements for foreign registrants. Today we will discuss how this legislation has caused Chinese companies to list in Hong Kong or Tokyo rather than the United States.

Transparency concerns may be heightened with regard to the anticipated listings of major Chinese state-owned banks in the U.S. capital markets. I believe we need to draw attention to the level of due diligence performed by these banks and gain a handle on the true holdings in their loan portfolios. Are they major sources of capital for Chinese military and defense firms? Moreover, China's state-owned banks have been the traditional sources of below market rate capital for China's state-owned industries, serving in my opinion as a massive form of state subsidy unavailable to U.S. competitors. Take for example the CNOOC bid for Unocal. To exceed Chevron's offer for Unocal, CNOOC received \$6 billion in state-owned bank funding in addition to the \$7 billion in loans at below market or no interest rates from its state-owned parent company. Deals such as this highlight how the nature of state-owned bank lending practices may be based more on governmental interests than true market forces. As these banks list publicly, this behavior needs to be monitored, and at the very least, investors deserve complete disclosure of the non-market forces at work. The forces that drove Congress to enact Sarbanes-Oxley are no less important here as we look at how to protect the investing public.

Our intention is not to propose unreasonable restrictions on the access of Chinese firms to U.S. capital markets. Our goal instead is to ensure that the U.S. Government and U.S. investors have the most complete information possible on the financial standing and activities of Chinese firms listing in our capital markets. The



proper functioning of our capital markets requires broad transparency of the listed entities. We should hold all listings to this important standard.

I look forward to today's panels.

Chairman D'AMATO. Thank you very much, Commissioner Wessel. I'd like to turn the podium over now to our Vice Chairman Roger Robinson who has probably more knowledge and experience in this particular issue, in my judgment, than anyone else I know of in this town or really in the country. So, with pleasure, I turn this over to Vice Chairman Robinson.

**OPENING STATEMENT OF VICE CHAIRMAN ROGER W. ROBINSON, JR.**

Vice Chairman ROBINSON. Thank you, Mr. Chairman. I'd like to join Chairman D'Amato and the Cochairman for today's hearing, Mike Wessel, in welcoming you to today's hearing entitled "China's Strategy and Objectives in Global Capital Markets."

As has already been mentioned, our focus today is on the cutting-edge issue of China's presence in the global capital markets and the implications for U.S. investors, market regulators and more broadly U.S. security interests.

The nexus between financing and security is a topic of growing concern for both the legislative and executive branches of the U.S. Government. This was recently highlighted in the House's overwhelming rejection of CNOOC's bid for Unocal as well as President Bush's June 29 Executive Order which freezes U.S. assets of weapons of mass destruction proliferators.

These developments are a wake-up call that increasing attention will be paid to the national security implications of Chinese and foreign companies in U.S. markets, including our financial markets.

In setting out our mandate, the Congress took a broad view of the economic and security issues associated with the U.S.-China relationship. Our charge to examine, quote, "Chinese access to and use of United States capital markets." This demonstrates congressional recognition that U.S. institutional and individual investors are funding Chinese firms through our equity and debt markets; that this vehicle has become a substantial component of the U.S.-China economic relationship.

Moreover, our mandate to evaluate whether existing disclosure and transparency requirements are adequate to identify for investors any Chinese firms involved in activities harmful to U.S. security interests points to congressional concern about the identities and operations of certain Chinese firms accessing our markets.

In December 2001, the Commission introduced this topic with a hearing that set out the enormous capital requirements of China over the next decade, stemming in part from undercapitalized banks, its underfunded pension systems, and other social security obligations, and the importance that fundraising via the international capital markets will play in meeting these needs.

This hearing also established benchmark assessments of the amounts of money raised in the U.S. and the other international capital markets by Chinese enterprises and the predominance of state-owned enterprises among those approved by the Chinese government for overseas listings.

The Commission's April 2004 hearing on this topic broadened this initial assessment by looking at the corporate governance standards and transparency of Chinese firms listing abroad. The key focus was on how Chinese governance practices compare with Western norms and whether Chinese firms adequately disclose to international investors the nature of their financial and business operations worldwide including any ties to China's military and known weapons proliferators.

This year's hearing will focus primarily on how Chinese companies prepare for listings, the upcoming listings of Chinese banks, and the implications for U.S. investors and U.S. security interests of China's overall capital raising strategy.

Chinese firms preparing for initial public offerings in foreign markets generally undergo an extensive process of "window dressing," as it's called on Wall Street, to improve the appearance of their finances and operations. The extent to which these reforms are cosmetic versus genuine structural changes and the marketing strategy employed by Chinese firms in the U.S. capital markets will be explored by our first panel.

Mr. Howard Chao was to begin the panel, but due to a breakdown in his travel arrangements, he'll not be able to join us until 3:30 this afternoon. He is a partner in charge of O'Melveny & Myers' Asia practice. During his 25 years of practice, he's been responsible for establishing O&M's China offices and was stationed in Shanghai for some seven years.

We do have with us Michael Geczi, Managing Director of The Torrenzano Group, an expert on how Chinese firms market themselves in U.S. capital markets. He has advised numerous Chinese firms on how to approach U.S. institutional and portfolio investors.

Robert G. DeLaMater is a partner at Sullivan & Cromwell. He has worked on dozens of Chinese IPOs from 1997 to 2003, and was also managing partner of Sullivan's offices in Hong Kong and Tokyo.

Our second panel will provide an assessment of the concerns surrounding the listings of Chinese state-owned banks on global capital markets. Over the next year or two, several of China's pre-eminent state-owned banks, including the China Construction Bank and the Bank of China, are expected to list on the U.S. and other international capital markets and potentially raise as much as \$10-15 billion. These banks have been plagued by financial problems including an extraordinary number of nonperforming loans and a lack of transparency.

We will hear from Professor Pieter Bottelier, Adjunct Professor at Johns Hopkins School of Advanced International Studies and Georgetown, and Professor Marshall W. Meyer, Professor of Management and Sociology at the University of Pennsylvania's Wharton School of Business.

Professor Bottelier will review the state of China's financial institutions and their attempts to reduce nonperforming loans. Professor Meyer has just returned from Beijing where he conducted research on how China seeks to list its financial institutions.

The third and final panel will examine China's long-term strategy in global capital markets and the U.S. national security dimensions. Over the past year, Chinese firms have turned toward Hong

Kong. In 2004, companies in Hong Kong raised \$12 billion, up from \$7.5 billion the year before.

By contrast, the New York Stock Exchange temporarily appears to have fallen from favor in the eyes of Chinese firms seeking to raise money in international capital markets, primarily as a result of the strengthened regulatory regimes required by the Sarbanes-Oxley statute.

This dynamic begs the question: Are Chinese firms avoiding exchanges that require greater levels of disclosure, transparency, and corporate governance?

Solomon Tadesse, Assistant Professor of International Finance at the Moore School of Business at the University of South Carolina, and Donald Straszheim, President of Straszheim Global Advisors and formerly Chief Economist for Merrill Lynch, will provide an overview of Chinese strategies and objectives in global capital markets and their implications for U.S. investors.

Frank Gaffney, President of the Center for Security Policy and formerly the Acting Assistant Secretary of Defense for International Security Policy in the Reagan Administration, will address security concerns related to certain Chinese firms listing in the international capital markets.

The Commission remains, to my knowledge, the only U.S. Government body systematically examining this emerging area of financial and security risk associated with the trading and listing of Chinese debt and equity offerings in the U.S. and other international capital markets.

With that introduction, I'd now like to turn to our first panelist, and if we could begin today with Mr. Geczi.

[The statement follows:]

**Prepared Statement of Vice Chairman Roger W. Robinson, Jr.**

On behalf of the Commission, I would like to welcome you to today's public hearing entitled "**China's Strategy and Objectives in Global Capital Markets.**" Our focus today is on the cutting-edge issue of China's presence in the global capital markets, and the implications for U.S. investors, market regulators and, more broadly, U.S. security interests.

The nexus between financing and security is a topic of growing concern for both the legislative and executive branches of the U.S. Government. This was recently highlighted in the House's overwhelming rejection of CNOOC's bid for Unocal as well as President Bush's June 29th Executive Order which freezes U.S. assets of WMD proliferators. These developments are a wake-up call that increasing attention will be paid to the national security implications of Chinese and foreign companies in U.S. markets.

In setting out our mandate, the Congress took a broad view of the economic and security issues associated with the U.S.-China relationship. Our charge to examine "Chinese access to, and use of United States capital markets," demonstrates Congressional recognition that U.S. institutional and individual investors funding Chinese firms through our equity and debt markets has become a substantial component of the U.S.-China economic relationship. Moreover, our mandate to evaluate whether existing disclosure and transparency requirements are adequate to identify for investors any Chinese firms conducting, or involved in, activities harmful to U.S. security interests points to Congressional concern about the identities and operations of certain Chinese firms accessing our markets.

In December 2001, the Commission introduced this topic with a hearing that set out the enormous capital requirements of China over the next decade—stemming, in part, from undercapitalized banks, its underfunded pensions and other social security obligations—and the importance that fundraising via international capital markets will play in meeting these needs. This hearing also established benchmark assessments of the amounts of money raised in the U.S. and other international cap-

ital markets by Chinese enterprises and the predominance of state-owned enterprises among those approved by the Chinese government for overseas listings.

The Commission's April 2004 hearing on this topic broadened this assessment by looking at the corporate governance and transparency of Chinese firms listing abroad. The key focus was on how Chinese governance practices compare with Western norms and whether Chinese firms adequately disclose to international investors the nature of their financial and business operations worldwide, including any ties to China's military and known weapons proliferators.

This year's hearing will focus primarily on how Chinese companies prepare for listings, the upcoming listings of Chinese banks and the implications for U.S. investors and U.S. security interests of China's overall capital raising strategy.

Chinese firms preparing for initial public offerings (IPOs) in foreign markets generally undergo an extensive process of "window dressing" to improve the appearance of their finances and operations. The extent to which these reforms are cosmetic versus genuine structural changes and the marketing strategy employed by Chinese firms in U.S. capital markets will be explored by our first panel.

**Mr. Howard Chao** was to begin the panel but due to a breakdown in his travel arrangements he will not be able to join us until 3:30 p.m. this afternoon. He is the partner in charge of O'Melveny & Myers' (OMM) Asia practice. During his 25 years of practice he has been responsible for establishing OMM's China offices, and was stationed in Shanghai for seven years. **Michael Geczi**, Managing Director of The Torrenzano Group, is an expert on how Chinese firms market themselves in U.S. capital markets. He has advised numerous Chinese firms on how to approach U.S. institutional and portfolio investors. **Robert G. DeLaMater** is a partner at Sullivan & Cromwell LLP. He has worked on dozens of Chinese IPOs and from 1997 to 2003 was the managing partner of Sullivan's offices in Hong Kong and Tokyo.

Our second panel will provide an assessment of the concerns surrounding listings of Chinese state-run banks on global capital markets. Over the next year or two, several of China's preeminent state-owned banks, including the China Construction Bank and the Bank of China, are expected to list on the U.S. and other international capital markets and potentially raise as much as \$15 billion. These banks have been plagued by financial problems including an extraordinary amount of nonperforming loans and a lack of transparency. We will hear from **Professor Pieter Bottelier**, Adjunct Professor at Johns Hopkins School of Advanced International Studies and Georgetown, and **Professor Marshall W. Meyer**, Professor of Management and Sociology at the University of Pennsylvania's Wharton School of Business. Professor Bottelier will review the state of China's financial institutions and their attempts to reduce nonperforming loans. Professor Meyer has just returned from Beijing where he conducted research on how China seeks to list its financial institutions.

The third and final panel, will examine China's long-term strategy in the global capital markets and the U.S. national security dimensions. Over the last year Chinese firms have turned towards Hong Kong. In 2004, companies in Hong Kong raised \$12 billion, up from \$7.5 billion the year before. By contrast, the New York Stock Exchange temporarily appears to have fallen from favor in the eyes of Chinese firms seeking to raise money in international capital markets, primarily as a result of strengthened regulatory regimes required by the Sarbanes-Oxley law. This dynamic begs the question: Are Chinese firms avoiding exchanges that require greater levels of disclosure, transparency and corporate governance?

**Solomon Tadesse**, Assistant Professor of International Finance at the Moore School of Business at the University of South Carolina, and **Donald Straszheim**, President of Straszheim Global Advisors, and formerly Chief Economist for Merrill Lynch, will provide an overview of Chinese strategies and objectives in global capital markets and their implications for U.S. investors. **Frank Gaffney**, President of the Center for Security Policy and formerly the Acting Assistant Secretary of Defense for International Security Policy in the Reagan Administration, will address security concerns related to certain Chinese firms listing in the international capital markets.

The Commission remains to my knowledge the only U.S. Government body systematically examining this emerging area of financial and security risk associated with the trading and listing of Chinese debt and equity offerings in the U.S. and international capital markets. With that introduction, I would like to turn to our first panelist.

## PANEL I: ANALYZING CHINESE IPOs: THE LISTING PROCESS

Mr. GECZI. Good morning and thank you.

Vice Chairman ROBINSON. I would only add, sir, that the way that we typically proceed is that you would have some seven minutes or so for your presentation, at which time the Commissioners will have approximately five minutes each for our question and answer period. With that, thank you very much, and please proceed.

**STATEMENT OF MICHAEL GECZI  
MANAGING DIRECTOR, THE TORRENZANO GROUP**

Mr. GECZI. Understood. Thank you. Thank you. Good morning. My name is Michael Geczi, and I'm a Managing Director at The Torrenzano Group, a New York based strategic communications consulting firm. I am pleased to be part of this morning's public hearing on China and the Global Capital Markets, and I thank the Commission for inviting me to participate.

My views on this important topic are shaped by a number of factors, the most prominent of which is the fact that while living in Hong Kong and working throughout the People's Republic of China between late 2000 and 2003, I regularly provided strategic communications counseling to companies based in the PRC.

This advice, which I've provided to state-owned enterprises as well as smaller entrepreneur-based companies, was designed to assist those companies in developing public profiles and corporate reputations as well as a level of market awareness that would be beneficial to them as they considered their various alternatives for raising capital in the West.

Ideally, the communications strategies would be appropriate irrespective of whether the companies ultimately attempted to raise capital publicly or whether they were to seek a private investment.

Since returning to the U.S. in 2003, I have continued to focus on Asia Pacific in general and China specifically. Accordingly, I regularly discuss positioning strategies and tactics with PRC companies, their legal and financial advisors, and others involved in the global capital raising process.

I also conduct training sessions on media relations, investor relations and message development. These sessions all are intended to assist PRC companies in developing a profile in the West.

Moreover, I've conducted strategic training sessions for certain staff members of the Hong Kong Stock Exchange. My focus on China builds upon my earlier experiences, first as a financial journalist for 16 years, primarily with the Wall Street Journal and Business Week magazine, later as the head of Capital Markets Media Relations at Merrill Lynch, and for the past 15 or so years as an outside communications consultant.

Over the past 12 years, my specialty has been developing and implementing cross-border communication strategies focusing first on the developed markets of Western Europe and then in the mid-1990s building an expertise in Russia and some of the republics formerly part of the Soviet Union, and then ultimately Asia Pacific.

The Russia experience in particular has been very helpful as a context for viewing the emerging PRC developments. There are some very meaningful similarities and differences when looking at how Russian and Chinese companies have approached corporate profile-building activities in the West. I will touch on these briefly in my remarks.

In your communication of August 2, 2005, you noted that the Commission is particularly interested in exploring five specific questions. I would be pleased to share with you some of my thoughts on each of those. Before I do, however, I would like to make a couple of affiliated comments that might be useful as I move through my answers to your direct questions.

Irrespective of the questions or focus of interest, I believe there are several factors that are crucial to remember. First of all, when it comes to the topic of investing in China, it is imperative that we not lose sight of the fact that we are discussing a seller's market and not a buyer's market. As a result, all strategy regarding the marketing of issues or the positioning of companies is colored by the fact that demand sharply outweighs supply.

We are not talking about convincing an investor into buying something he or she does not want to buy. We are talking about letting a prospective investor who is already strongly inclined towards buying know that additional supply soon will be available. Therefore, I believe any look at the capital markets activities of PRC companies also must look at the demand side of the equation, that is the investors, with the same degree of interest and concern as when we look at the supply side, the issuers themselves.

Stated another way, let me quote from the Organization for Economic Cooperation and Development, the OECD, which says: "Unfortunately, capital is rarely patient. In their constant search for investment opportunities, investors will not hesitate to take their money around the globe."

My second point is the following: Many of the questions addressed to this particular panel have gone to the issue of how PRC companies market their issues to investors in the West. While that obviously is an important issue, I believe it is equally important that we look at two other factors: one I just mentioned, which is the demand part of the equation. The second is that we must also remember that PRC companies also are being marketed to by Western advisory firms that help them negotiate the capital markets landscape.

Having said that, I now will address your specific questions. Your first question asked: How do Chinese firms market their equity and debt issuances in the U.S. as compared to Hong Kong and other exchanges?

I believe this question can be answered in a number of ways. First of all, regarding the issue of marketing equity and debt issues, there is an important distinction worth noting, and that is the difference between marketing at the time of a public offering compared with ongoing marketing—better known as investor relations—designed to support and enhance the stock price in open market trading. Obviously, the top line answer is as follows:

Given the precise nature of SEC guidelines, PRC companies market in the U.S. in exactly the same way as companies from other locations including companies in the U.S. They face the same rules and they face the same penalties.

I can tell you from personal experience about a client of mine that in 2002 had to withdraw its planned IPO in the U.S. because it ran afoul of the SEC's rules regarding quiet period preceding an

actual offering. Obviously, the cost to this company and its founders was high. The offering still hasn't taken place.

There also is an interesting sidebar story to this example: the excessive publicity occurred in Asia, not in the U.S., but nevertheless brought about the SEC's negative reaction.

Regarding your question on how the companies market, I believe the answer has important subpoints as PRC companies contemplating a public offering in the West face a unique set of challenges distinct from those of U.S. companies.

Ironically, the biggest challenge and the biggest opportunity for PRC companies generally can be described by the same three words: "the China story."

What do I mean by that? I mean that Western investors are drawn to PRC stocks exactly because they are from China and therefore possess all the explosive growth characteristics one associates with an economy that is growing at eight or nine percent annually.

Conversely, the biggest cautionary advice that one could give a prospective investor in PRC equities is that these stocks possess all the explosive growth characteristics that one associates with a market bubble, and that the stock market's reaction probably is going to hit each end of the spectrum.

The potential reward and the potential risk are both at the top of the list for prospective investors, but because of market multiples, many investors view the risk as more than acceptable given the potential reward. The risk after all is fixed; the reward is seen as being limitless.

Last week's noteworthy IPO by Baidu illustrates this point perfectly. As you know, Baidu's shares rose more 350 percent in their first day of trading on the Nasdaq Stock Market. They have since fallen back, but remain significantly above their offering price.

Clearly, Baidu's founder and other select early investors in this company stand to make a great deal of money. On paper, they already have. But this wealth building isn't only occurring in the PRC. California-based Google, which owns 2.6 percent of Baidu, is part of the crowd. So are a large number of U.S. institutional investors that were fortunate enough to acquire Baidu in the offering.

It is worth noting that Baidu's two founders are veterans of U.S. technology companies and Baidu's top competitor, a company by the name of 3721.com was bought in 2003 by Yahoo. As you also know, there currently are media reports this week that Yahoo will be trying to acquire 35 percent of another PRC company, Alibaba.com, and e-commerce company, for \$1 billion.

Now, according to the media reports that accompanied Baidu's offering, the investment attraction for most investors was that Baidu represents the China story, the combination of technology, economic growth, and enormous potential consumer demand. It is, in fact, the quintessential China story.

If you read the same articles, you will see that almost no one is bold enough to predict that Baidu's share price will remain at its currently lofty level. Why not? The same reason. It is the quintessential China story.

Bottom line, to me the issue isn't how PRC companies are marketing themselves; it is how investors are investing. It goes back

to the OECD statement that I read earlier: “Capital is rarely patient.”

I also have a second point regarding this question of how PRC companies market themselves in the U.S. vis-à-vis other exchanges. Given the globalization of world markets over the past decade, the issue of whether a PRC stock is listed in the U.S. or in Hong Kong has gotten very close to becoming irrelevant. The fact is U.S.-based institutional investors do not limit their investments to shares listed only on U.S. exchanges.

Regarding your second question: Do Chinese firms market their equity and debt issuances differently to individual and institutional investors?

Again, the answer depends. The IPO market in the U.S., as you all know, is heavily geared towards institutional investors. And individuals traditionally have had a difficult time gaining access to the so-called “hot new issues.” The pros and cons of this approach obviously have been debated and documented in the past, and there have been interesting and important steps taken to address them.

However, given this reality about IPOs in the U.S., the fact is that marketing of PRC stocks to U.S. audiences is very much an exercise in creating institutional demand. It is rarely about reaching the average retail investor. Generating demand at the institutional level is achieved through SEC-regulated road shows and by non-regulated word of mouth. It is the same process for PRC companies as it is for companies in Massachusetts or Florida or Montana.

However, within the rules of the SEC, there is opportunity for positioning, especially in the official prospectus and in the road show presentations. In those communications, PRC companies—like companies everywhere—are strongly counseled by their advisors to emphasize those key messages that best shape the company’s prospects and, conversely, best address the concerns that are on the part of the possible investors.

Ideally, these messages are designed to connect the company’s prospects to the powerful dynamics of the PRC economy. One major message that regularly is utilized and proves very effective goes to the issue of building the nation’s infrastructure. This has been especially important for energy and telecommunications issues that benefit from that initiative.

In last week’s Baidu example, the key message, as I said earlier, was tying the company’s prospects to the PRC’s massive population. As a result, here are some of the positive themes that were emphasized to investors: second largest Web site in China; seventh largest Web site in the world; providing users with access to more than 690 million Web pages, 80 million image files and ten million multi-media files; establishing relationships with more than 76,000 third-party Web sites.

Now, as important as these messages were, there also was the powerful message that Baidu had Google as an investor. In fact, you will see that Baidu regularly was referred to in the media as the “Chinese Google” in much of the lead-up to the offering.

Back in Asia meanwhile, especially in Hong Kong and Shanghai, the story is very different. Although there is a significant institu-



tional investor base in those major markets, issuers put a much greater priority on retail investors, and marketing strategies are much more geared toward reaching the “mom and pop” investors.

Hong Kong, in particular, is filled with stories about lengthy lines of individuals extending and wrapping around city blocks as they waited patiently in line to buy a small piece of a new stock issue.

Your next question: What are the most significant expected listings?

My understanding is that several significant offerings are expected in the near to mid-term. Air China, for instance, is expected to attempt a listing possibly in the amount of \$500 million early next year.

Other noteworthy listings probably will be the largest state-owned banks, as you’ve already mentioned. The degree to which these institutions are able to clean up their balance sheets and then accurately articulate progress in doing so to the investing public will be interesting to watch. The Bank of China, the country’s second-largest lender, has made progress in lowering its problem loans ratio, heeding a government prerequisite for proceeding with its initial public offering.

There is also an interesting and important emerging development relating to the way the large banks are positioning themselves for their listings. They’re attempting to enhance their attractiveness by taking in well-known Western companies as investors prior to the IPO process. This is exactly the same model I mentioned earlier in referring to the Google investment in Baidu.

Bank of China, for instance, reportedly is negotiating with several potential investors including Royal Bank of Scotland, UBS and the Asian Development Bank. The Industrial and Commercial Bank of China, the PRC’s largest lender, is said to be in talks with a variety of companies—among them are American Express and Goldman Sachs—to become investors prior to going public after 2006.

The goal not only is to have the better known company’s credibility rub off on them, it is to improve their loan books and to better compete with overseas lenders such as Citigroup which has extensive operations in that part of the world.

Industrial and Commercial Bank is said to be seeking to raise as much as \$10 billion, and then there is China Construction Bank, the nation’s third largest lender. In June 2005, Bank of America announced that it would inject \$3 billion into China Construction Bank, taking an ownership stake of about nine percent, the largest investment by a foreign lender in the PRC.

And it was reported this week that HSBC would like to increase its current 19.9 percent stake in Bank of Communications.

It is important to note that these real and prospective investments by Western financial institutions do not represent a hands-off approach to the market. Says one money manager in a recent article: “Taking a strategic stake will provide the overseas investors with a launching pad into China’s banking market which still is not fully deregulated.”

Your fourth question: How do Chinese firms market themselves differently than firms from other countries?

PRC companies, of course, market themselves differently than firms from other countries. The same can be said for companies based in Eastern Europe, companies based in Latin America, companies based in the European Union, and companies representing various industries and regions in the U.S.

Raising capital requires that companies position themselves in a way that addresses the key questions on the mind of the prospective investors. We all know many of these questions as they have to do with forecasts for sales and profitability and for the likelihood and magnitude of growth in both of those categories.

As I have discussed this issue with PRC companies in the past, the issue of message development and corporate positioning always includes the following issues: the issue of the buying power of the PRC's consumer base; the fact that they have a large and growing educated and skilled workforce; the impact of the WTO; the impact of the improving infrastructure; what is the level of government support to the companies; and the ease of entry for other companies.

Vice Chairman ROBINSON. Excuse me. We'll need to wrap up soon, if you don't mind.

Mr. GECZI. Yes.

Vice Chairman ROBINSON. Thanks.

Mr. GECZI. Additionally, our discussions have always hit on the fact that companies need to address these key questions that have to do with risks such as geopolitical risk, data risk related party risk and the rule of law risk.

Finally, on your fifth question about transparency and corporate governance, I'm not the attorney at this table, so I will let the attorney talk about that. But I will say that there seems to be in the capital markets right now the ability to differentiate between some of the stronger companies and some of the not-so-strong companies, those that are doing better and those that aren't.

The other thing I will do is just briefly touch back on the Russian example, and I can tell you in the mid-to-late '90s, the issue of corporate governance gained some traction with Russian companies and it was very much used as a public relations tool. In fact, it probably was co-opted by many of them as a public relations tool, and at this point I don't see Chinese companies going down the same path.

Since you want me to wrap up, I will wrap up. I thank you very much, and I appreciate your interest.

[The statement follows:]

**Prepared Statement of Michael Geczi  
Managing Director, The Torrenzano Group**

Good morning.

My name is Michael Geczi, and I am a managing director at The Torrenzano Group, a New York-based strategic communications consulting firm. I am pleased to be part of this morning's public hearing on "China and the Global Capital Markets" and I thank the Commission for inviting me to participate.

My views on this important topic are shaped by a number of factors, the most prominent of which is the fact that while living in Hong Kong and working throughout the Peoples Republic of China between late 2000 and 2003 I regularly provided strategic communications counseling to companies based in the PRC. This advice, which I provided to state-owned enterprises (SOEs) and smaller, entrepreneur-based companies, was designed to assist these companies in developing public profiles and corporate reputations—as well as a level of market awareness—that would be bene-

ficial to them as they considered their various alternatives for raising capital in the West. Ideally, the communications strategies would be appropriate irrespective of whether the companies ultimately attempted to raise capital publicly or whether they were to seek a private investment.

Since returning to the U.S. in 2003, I have continued to focus on Asia-Pacific in general, and China specifically. Accordingly, I regularly discuss positioning strategies and tactics with PRC companies, their legal and financial advisors, and others involved in the global capital-raising process.

I also conducted training sessions on media relations, investor relations and message development. In 2004, for instance, I conducted a strategic communications training session for certain staff members of the Hong Kong Stock Exchange. In the preceding two years, I designed and implemented training sessions for several PRC companies, usually on the topic of how to communicate effectively in the West.

This focus on China builds upon my earlier experiences: first as a financial journalist for 16 years, primarily with *The Wall Street Journal* and *BusinessWeek* magazine; later as the head of capital markets media relations at Merrill Lynch, and for the past 15 or so years as an outside communications consultant. Over the past 12 years, my specialty has been developing and implementing cross-border communications strategies, focusing first on the developed markets of western Europe, and then in the mid-1990s building an expertise in Russia and some of the republics formerly part of the Soviet Union, and then ultimately Asia-Pacific.

The Russia experience, in particular, has been very helpful as a context for viewing the emerging PRC developments. There are some very meaningful similarities and differences when looking at how Russian and Chinese companies have approached corporate profile-building activities in the West. I will touch on these briefly in my remarks.

In your communication of August 2, 2005, you noted that the Commission is particularly interested in exploring five specific questions. I would be pleased to share with you some of my thoughts on each of those areas.

Before I do, however, I would like to make a couple of “affiliated comments” that might be useful as I move through my answers to your direct questions. Irrespective of the questions or focus of interest, I believe there are several factors that are crucial to remember:

First of all, when it comes to the topic of investing in China, it is imperative that we not lose sight of the fact that we are discussing a “seller’s market” and not a “buyer’s market.” As a result, all strategy regarding the marketing of issues or the positioning of companies is colored by the fact that demand sharply outweighs supply. We are not talking about convincing an investor into buying something they don’t want. We are talking about letting a prospective investor, who is already strongly inclined toward buying, know that additional supply soon will be available.

Therefore, it seems to me that any concern about the emerging power of the PRC and Chinese companies must look at the demand side of the equation (that is, the investors), with the same degree of interest and concern as when looking at the supply side (that is, the issuers themselves). Stated another way, let me quote from the Organization for Economic Cooperation and Development (OECD), which says: “Unfortunately, capital is rarely ‘patient.’ In their constant search for investment opportunities, investors will not hesitate to take their money around the globe.”

My second point is the following: Many of the questions addressed to this particular panel have gone to the issue of how PRC companies “market” their issues to investors in the West. While that obviously is an important issue, I believe it is important that we remember that PRC companies also are being “marketed to” by Western advisory firms that help them negotiate the capital markets landscape.

Having said that, I now will address your specific questions.

**Question #1: *How do Chinese firms market their equity and debt issuances in the U.S. as compared to Hong Kong and other exchanges?***

This is an interesting question. And I believe it can be answered in a variety of ways.

First of all, regarding the issue of marketing equity and debt issues, there is an important distinction worth noting, and that is the difference between marketing at the time of a public offering (or listing), compared with ongoing marketing—better known as investor relations activities—designed to support and enhance the stock price in open-market trading. Obviously, the top-line answer is as follows: Given the precise nature of Securities and Exchange Commission guidelines, PRC companies market in the U.S. in exactly the same way as companies from other locations, including the U.S.

They face the same rules. And they face the same penalties. I can tell you, from personal experience, about a client of mine that in 2002 had to withdraw its planned IPO in the U.S. because it ran afoul of the SEC's rules regarding the "quiet period" preceding an actual offering. Obviously, the cost to this company and its founders was high; the offering still hasn't taken place. There also is an interesting sidebar story to this example: the excessive publicity occurred in Asia, not the U.S., but nevertheless brought about the SEC's negative reaction.

Returning to your first question: I believe the answer has important sub-points as PRC companies contemplating a public offering in the West face a unique set of challenges distinct from those of U.S. companies.

Ironically, the biggest challenge and the biggest opportunity for PRC companies generally can be described by the same three words: "the China story."

- What do I mean by that? I mean that Western investors are drawn to PRC stocks exactly because they are from China, and therefore possess all the explosive growth characteristics one associates with an economy that is growing at 8% or 9% annually.
- Conversely, the biggest cautionary advice that one could give a prospective investor in PRC equities is that these stocks possess all the explosive growth characteristics that one associates with a market bubble—and that the stock market's reaction probably is going to hit each end of the spectrum.

The potential reward and the potential risk are both at the top of the list but, because of market multiples, many investors view the risk as more than acceptable, given the potential reward. The risk, after all, is fixed. The reward is limitless.

Last week's noteworthy IPO by Baidu illustrates this point perfectly. As you know, Baidu shares rose more than 350% in their first day of trading on the Nasdaq Stock Market. It has since fallen back, but remains significantly above its offering price.

Clearly, Baidu's founders and other select early investors in this company stand to make a great deal of money. On paper, they already have. But this wealth building isn't only occurring in the PRC. California-based Google, which owns 2.6% of Baidu, is part of that crowd. So are a large number of U.S. institutional investors that were fortunate enough to acquire Baidu in the offering.

It also is worth noting that Baidu's two founders are veterans of U.S. technology companies. And that's Baidu's top competitor, a company by the name of 3721.com, which was bought in 2003 by Yahoo. There also are media reports this week that Yahoo may be trying to acquire 35% of Alibaba.com, a PRC e-commerce company, for \$1 billion.

Now, according to the media accounts that accompanied Baidu's offering, the investment attraction for most investors was that Baidu represents the combination of technology, economic growth and enormous potential consumer demand. It is the quintessential China story.

If you read the same articles, you will see that almost no one is bold enough to predict that Baidu's share price will remain at that lofty level. Why not? Same reason: it is the quintessential China story.

Bottom line: To me, the issue isn't how PRC companies are marketing themselves. It is how investors are investing. It goes back to the OECD statement I read earlier. "Capital is rarely patient."

I also have a second point regarding this question of how PRC companies market themselves in the U.S. vis-à-vis other exchanges. Given the globalization of world markets over the past decade, the issue of whether a PRC stock is listed in the U.S. or in Hong Kong has gotten very close to being irrelevant. The fact is, U.S.-based institutional investors do not limit their investments to shares listed only on U.S. exchanges.

**Question #2: Do Chinese firms market their equity and debt issuances differently to individual and institutional investors?**

Again, it depends. The IPO market in the U.S., as you all know, is heavily geared toward institutional investors ... and individuals traditionally have had a difficult time gaining access to the so-called hot new issues. The pros and cons of this approach obviously have been debated and documented in the past and there have been interesting and important steps taken to address them.

Given this reality about IPOs in the U.S., the fact is that the marketing of PRC stocks to U.S. audiences is very much an exercise in creating institutional demand. It is rarely about reaching the average retail investor.

Generating demand at the institutional level is achieved through SEC-regulated road shows and by non-regulated “word of mouth.” This is the same for PRC companies, as well as for companies from Massachusetts or Florida or Montana.

However, within the rules of the SEC, there is opportunity for positioning, especially in the official prospectus and in the road show presentations. In those communications, PRC companies—like companies anywhere—are strongly counseled by their advisors to emphasize those key messages that best shape the company’s prospects . . . and, conversely, best address concerns on the part of possible investors.

Ideally, these messages are designed to connect the company’s prospects to the powerful dynamics of the PRC economy. One major message that regularly is utilized (and proves effective) goes to the issue of building the nation’s infrastructure; this has been especially important for energy and telecommunications issues that benefit from that initiative.

In last week’s Baidu example, the key message, as I said earlier, was tying the company’s prospects to the PRC’s massive population. As a result, here are some of the positive themes that were emphasized to investors:

- Second-largest website in China
- Seventh-largest website in the world
- Providing users with access to more than 690 million web pages, 80 million image files and 10 million multimedia files
- Establishing relationships with more than 76,000 third-party websites

Now, as important as these messages were, there also was a powerful message in the fact that Baidu had Google as an investor. In fact, you will see that Baidu regularly was referred to in the media as the Chinese Google in much of the lead-up to the offering.

Back in Asia, meanwhile—especially in Hong Kong and Shanghai—the story is very different. Although there is a significant institutional base in those major markets, issuers tend to think first about reaching retail investors . . . and marketing strategies are very much geared toward reaching these “mom-and-pop investors.” Hong Kong, in particular, is filled with stories about lengthy lines of individuals extending around city blocks as anxious investors waited patiently to buy a small piece of a new stock issue.

**Question #3: *What are the most significant expected future listings of Chinese firms in the near term, in the U.S. markets and elsewhere?***

My understanding is that several significant offerings are expected in the near to mid-term. Air China, for instance, is expected to attempt a listing, possibly in the amount of \$500 million, early in 2006.

Other noteworthy listings probably will be the largest state-owned banks. The degree to which these institutions are able to clean up their balance sheets—and then accurately articulate progress in doing so to the investing public—will be interesting to watch. The Bank of China, the country’s second-largest lender, has made progress in lowering its bad-loans ratio, heeding a government prerequisite for proceeding with an initial public offering.

There’s also an interesting—and important—emerging development relating to the way the large banks are positioning themselves for their listings: they are attempting to enhance their attractiveness by taking in well-known Western companies as investors prior to the IPO process. This is exactly the same model I mentioned earlier in referring to the Google investment in Baidu.

Bank of China, for instance, reportedly is negotiating with several potential investors, including Royal Bank of Scotland, UBS and the Asian Development Bank. The Industrial & Commercial Bank of China, the PRC’s largest lender, is said to be in talks with a variety of companies—among them American Express and Goldman Sachs—to become investors prior to going public after 2006. The goal not only is to have the better-known company’s credibility “rub off” on them, it is to improve their loan books and to better compete with overseas lenders such as Citigroup. Industrial & Commercial is said to be seeking to raise \$10 billion.

It’s important to note that these real—and prospective—investments by Western financial institutions do not represent a “hand’s-off” approach to the market. Says one money manager in a recent magazine article: “Taking a strategic stake will provide the overseas investors with a launching pad into China’s banking market, which still is not fully deregulated.”

And then there is China Construction Bank, the nation’s third-largest lender. In June 2005, Bank of America announced that it would inject \$3 billion into China Construction Bank, taking an ownership stake of about 9%—the largest investment

by a foreign lender in the PRC. And it was reported this week that HSBC would like to increase its current 19.9% stake in Bank of Communications.

**Question #4: *How do Chinese firms market themselves differently than firms from other countries?***

PRC companies, of course, market themselves differently than firms from other countries. The same can be said for companies based in Eastern Europe; companies based in Latin America, companies based in the European Union . . . and companies representing various industries and regions in the U.S.

Raising capital requires that companies position themselves in a way that addresses the key questions on the minds of prospective investors. We all know many of these questions, as they have to do with forecasts for sales and profitability and for the likelihood and magnitude of growth in both of those categories.

As I have discussed this issue with PRC companies in the past, the issue of message development and corporate positioning always came down to the following issues:

- Consumer buying power
- Education/skilled workforce
- Impact of WTO
- Improving infrastructure
- Government support
- Ease of entry

Additionally, our discussions always hit on the fact that companies needed to address those key questions that have to do with “risk,” such as geopolitical risk, data risk, related party risk, and rule of law risk.

To answer further, let me give you a sense of the conversation I would conduct with a PRC company:

Ideally, we tell the PRC companies they should begin the communications programs early in the process, as far out as 12 to 18 months before they actually would attempt an IPO. This pre-IPO positioning program ideally would include a media outreach program including briefings, roundtables and interviews; a proactive program of industry analyst meetings; the regular dissemination of corporate information through media releases and news bulletins to key stakeholders; active participation in industry discussions; and the contribution of industry opinion articles.

In the instance of an SOE, we would discuss the need to differentiate the company from other SOEs. We would discuss the need to demonstrate management autonomy, transparency and corporate governance advances. We also would develop a program to raise the company’s accessibility to Wall Street securities analysts and influential media.

We also would discuss the need to get beyond what the West sees as SOE stereotypes; that is, whether the company is viewed as government-controlled or government influenced. This message, as we know, was used very extensively—and successfully—in the recent CNOOC/Unocal/Chevron control contest, where CNOOC was portrayed as being an acquisition arm of the PRC government.

We would discuss how the company could articulate and brand its vision and strategy. And how we could create a “public face” for the company, perhaps by leveraging customer and/or partner testimonials to endorse the company’s “brand platform.”

For instance, a PRC company might highlight business milestones with public announcements of deals it is doing with new partners, or new ventures or business opportunities, or even a new business direction. Another strategy is to position the company by announcing its financial performance through results announcements and media and/or analysts briefings . . . even though the company isn’t yet listed and therefore not required to do so. One of the most important and popular strategies/tactics is to initiate the regular flow of information regarding corporate governance from the board to key stakeholders.

**Question #5: *How thorough are the transparency and corporate governance standards of Chinese firms accessing U.S. and international capital markets? How do those standards comport with U.S. disclosure and transparency rules for foreign registrants?***

I am not an attorney, and my two colleagues can speak to the specifics of this question far better than I can. However, I do have a few comments.

It is clear that one important result of the adoption of Sarbanes-Oxley requirements for non-U.S. companies is the following: Because these companies generally

have been required to abide by the same rules, these non-U.S. companies now have every right to assert that prospective investors should have the same degree of confidence in the integrity and accuracy of their financial statements and disclosures as they do in U.S. companies. Moreover, if you look at the Board of Director structures of the companies, many of them also have in place independent directors, audit committee financial experts and corporate governance structures followed in the West.

Secondly, I would say that some of the PRC companies are succeeding in breaking out of the mold. In fact, the "China stock sector" no longer trades en masse as the individual issues no longer share the same characteristics.

*BusinessWeek* recently stated it this way: "investors finally have the information they need to sort out the darlings from the dogs." Now, this of course is in sharp contrast to the example of China Life, which went public with great fanfare in December 2003 with a dual listing on the New York and Hong Kong stock exchanges, but failed to disclose accounting irregularities at the parent company until after the successful IPO.

Indeed, there are problems. The widely followed Corporate Governance Update issued annually by the Asia-based CLSA investment research firm and the Asia Corporate Governance Association stated in 2003 that most of the improvement has been in form, and that the commitment to those statements and obvious actions are not yet clear.

I mentioned earlier that the Russian examples provide an interesting paradigm through which the PRC examples can be viewed. This is especially true in the area of corporate governance. In the late 1990s and early 2000s, for instance, many of the Russian companies achieved great success in utilizing corporate governance as a positioning tool for establishing their corporate reputations.

I don't think it would be unfair to say, in fact, that corporate governance was co-opted by many of the Russian companies as a public relations tool. They made a lot of statements expressing their commitment to good corporate governance. They established all the appropriate board committees. And they appointed independent directors, just as corporate governance "best practices" suggested they do.

At this point, I don't see the PRC companies going down the same path.

In closing, I want to state clearly that investing in PRC companies carries both risk and reward. That is a characteristic of the capital markets. As such, I believe all parties—issuers, advisors, investors, regulators, and exchanges—have an important responsibility to ensure the integrity of the process. But I also believe that the marketplace, despite some missteps, essentially is efficient and self-governing.

I also believe that the barriers have come down, and that we have a 365/24/7 marketplace. U.S. companies are going to continue to seek interesting and appealing opportunities everywhere in the world. We can only expect that non-U.S. companies will view their opportunities the same way.

Thank you very much.

Vice Chairman ROBINSON. Thank you very much, Mr. Geczi. Your full statement will be included in the record of these hearings.

With that, Mr. DeLaMater.

**STATEMENT OF ROBERT G. DELAMATER  
PARTNER, SULLIVAN & CROMWELL LLP**

Mr. DELAMATER. Thank you. Mr. Chairman and Members of the Commission, thank you very much for the opportunity to be with you here today. As is well known, China has assumed an important role both as a user and more recently as a supplier of capital on a global scale.

As part of your mandate to review crucial aspects of the U.S.-China relationship, the Commission has an important role to play in helping to ensure that the United States retains a leading position among the world's capital markets, given the essential role played by these markets in providing investment opportunities for American investors and in supplying capital to businesses that provide jobs and economic opportunities to American workers and their communities.

Your diligence in reviewing developments in this area is vital and I wish you success in your efforts.

I have worked for nearly 20 years as a corporate and securities lawyer and much of my practice has dealt with cross-border securities offerings. My responsibilities in my firm's offices in Tokyo and Hong Kong have enabled me to observe the approaches to U.S. capital markets taken by companies based in China.

Over the past decade, there has been an interesting shift in the practice of these issuers in accessing U.S. markets, a change that has implications for the position of the United States as the world's principal capital market. During the 1990s, there was a sharp rise in securities offerings in the United States by foreign issuers of all nationalities. China was an active participant in these trends and many companies organized in China or having their principal operations there obtained listings of their shares on the New York Stock Exchange or Nasdaq, and thereby became SEC-reporting issuers subject to the full range of U.S. reporting and disclosure obligations for foreign issuers.

However, the level of interest among foreign companies in listing in the United States has changed dramatically in recent years. The significant stock price declines beginning in March 2000 led to reduced interest on the part of U.S. retail investors in investing in initial public offerings.

Also, the enactment of the Sarbanes-Oxley Act in 2002 inhibited many foreign companies from seeking a listing in the United States, not only because of its significant requirements relating to board composition, corporate governance and internal control review, but also due to concerns about what other new U.S. regulatory requirements might be imposed upon short notice in the future.

Moreover, Chinese companies listing on the Hong Kong Stock Exchange increasingly believe that there may be limited value in seeking another international listing in light of the apparent willingness of investors around the globe to invest in Chinese companies listed only in Hong Kong.

Developments in other markets have also contributed to issuers seeking to diversify the markets in which they raise capital and, as a result, to less reliance on the United States. One important feature of some of the recent large Chinese privatizations has been what is known as the public offer without listing, or POWL, in Japan. In some of these offerings, the amount of demand in Japan reportedly has exceeded a few billion dollars and may have accounted for a larger proportion of the offering than that sold in the United States.

Another development has been the increased effort by the London Stock Exchange to solicit listings by Chinese companies by marketing London as an alternative to the increased governance requirements and the risk of securities class action lawsuits claimed to be inherent in listing in New York. Air China last year was convinced to list its shares in London rather than in New York. In recent years, those Chinese companies that have listed in the United States have principally been smaller technology-oriented companies seeking to list on Nasdaq. A very well known cur-



rent example is Baidu.com, famous for rising nearly 400 percent on its opening day of trading last Friday.

But these are not state-owned enterprises. Their principal shareholders are individual founders and management as well as a number of U.S.-based venture capital and private equity funds. Far from being methods for funding the Chinese government, these offerings are rewarding the entrepreneurs who built the company and the early investors, often U.S. investors, who financed them.

In contrast, since 2002, only a handful of Chinese state-owned enterprises have sought U.S. listings and SEC-registered IPOs. The initial public offerings and New York listings by China Netcom in 2004 and China Life in 2003 echoed the Chinese privatizations that commonly were listed on the New York Stock Exchange through 2002.

However, other recent large initial public offerings by state-owned enterprises have listed only in Hong Kong or London and have gained access to U.S. investors by means of a private placement to institutional investors pursuant to Rule 144A. The ability to raise billions of dollars from offerings to U.S. investors by using Rule 144A has led many foreign issuers to conclude that there is no need for the incremental retail demand afforded by SEC registration.

In other words, when even the largest securities offerings can be completed by Chinese and other foreign issuers without SEC registration, to U.S. investors who are willing to accept a foreign market such as the Hong Kong Stock Exchange as the sole listed market trading venue, foreign issuers are less willing to incur the costs and ongoing requirements of SEC registration.

Having spent my entire professional career as a U.S. securities lawyer, my purpose today is not by any means to criticize the Sarbanes-Oxley Act or the other elements of the U.S. securities regulatory scheme that apply to foreign issuers. Those regulations and the manner in which they have been administered by the SEC and its highly professional staff historically have made accommodations that enhance the attractiveness of the U.S. capital markets to foreign issuers by taking into account their specific or unusual needs compared with U.S. domestic issuers.

It should be noted that with the exception of Canada, U.S. Federal securities regulation has generally not made distinctions among foreign issuers on the basis of nationality, but instead has treated all foreign issuers in the same manner.

My point, however, is to emphasize the importance of any single nation's capital market to the global capital market is not something that is fixed and it can fluctuate with changes in relative economic development, changes in regulation and many other factors.

One instructive example is that of Japan, which during the 1980s enjoyed an economic boom that attracted 127 foreign companies to list on the Tokyo Stock Exchange. Today, after over a decade of economic difficulty and many de-listings, the number of foreign companies listed on the Tokyo Stock Exchange has fallen by 80 percent.

This has occurred despite the strong increase in recent years of capital raisings in Japan through the mechanism of the public offer without listing.

Every day investors in the United States buy securities of foreign companies that are not listed in this country, as the United States, like most developed nations, imposes no capital controls on money invested abroad. This is an age of highly mobile capital in which substantial sums can be raised without the need for foreign companies to list their securities in the market in which investors are located.

As many commentators including Chairman Greenspan have noted, there appears to be a global glut of savings and China itself is a major supplier of capital to the United States as a purchaser of U.S. Treasury securities. This global savings glut leads to the phenomenon that those who seek capital are readily able to find it. And those who wish to have attractive investment opportunities may need to compete in order to do so.

There are a number of disadvantages for the United States if it is not the overseas listing venue of choice for Chinese and other foreign companies. Most importantly, to the extent that global accounting, governance and disclosure requirements have not fully converged, the United States loses its ability to apply its own higher requirements if companies do not choose to list their securities in this country.

The desire to diversify investments, which is one of the tenets of modern portfolio management, will strongly encourage U.S. investors to invest in foreign companies, and it is certainly better for our investors if those companies are as engaged as possible in the U.S. securities regulatory and reporting regime.

I suggest that it is vitally in the interest of the United States that our capital markets regulation be shaped and administered in a way that encourages access to U.S. markets by foreign issuers including Chinese issuers while at the same time protecting U.S. investors.

Many of the most attractive investment opportunities in the world today are in Asia in general and China in particular. Always assuming that our regulations meet the threshold requirement to provide appropriate levels of investor protection, we would not be serving the interests of the millions of Americans who depend upon the investment performance of their pension managers, insurance companies, mutual funds and financial advisors if we lead Chinese companies to avoid U.S. capital markets in favor of listings in London, Japanese retail offerings, or other offerings in Europe and the international markets.

As you noted, I've submitted a written statement that extends these remarks, and I'd be happy to take any questions. I thank you again for the opportunity to be here today.

[The statement follows:]

**Prepared Statement of Robert G. DeLaMater  
Partner, Sullivan & Cromwell LLP**

Mr. Chairman and Members of the Commission:

Thank you very much for the opportunity to be with you here today. As is well known, the investment and capital markets relationships between the United States and China have grown substantially in size and complexity over the past decade, as China has assumed an important role as both a user and recently as a supplier of capital on a global scale. As part of your mandate to review crucial aspects of the U.S.-China relationship, the Commission has an important role to play in helping to ensure that the United States retains a leading position among the world's

capital markets, given the essential role played by these markets in providing investment opportunities for American institutional and individual investors and in supplying capital to business enterprises that provide jobs and economic opportunities to American workers and the communities in which they live. Your diligence and care in reviewing developments and in formulating reports and recommendations to Congress in this area is vital, and I wish you success in your efforts.

I have worked for nearly 20 years as a corporate and securities lawyer, and much of my practice has dealt with cross-border securities offerings, investments and acquisitions. In particular, I have worked on many international securities offerings, including offerings by foreign issuers selling securities in public offerings or private placements in the United States. Over the past decade, my responsibilities in my firm's practice in Asia from our offices in Tokyo and Hong Kong have enabled me to observe the approaches to U.S. capital markets taken by various Asian issuers, including companies based in China. Over the past decade, there has been an interesting shift in the practice of these issuers in accessing U.S. capital markets, and it is this change that I wish to discuss today, as it has implications for the position of the United States as the world's principal capital market and as the de facto benchmark for capital markets activity around the world.

During the 1990s there was a sharp rise in securities offerings in the United States by foreign issuers of all nationalities, driven by three significant phenomena: first, a wave of privatization offerings as governments around the world sought to dispose of state-owned enterprises (thereby stimulating private enterprise, improving the focus and governance of the company concerned and raising revenue for the government); second, the technology boom that led to IPOs and other offerings by Internet and telecommunications companies; and third, strong economic growth and the adoption of market-oriented economic policies in emerging markets that generated growing capital needs and a desire to meet those needs through international capital markets.

China was an active participant in these trends, as it exhibited all three of these phenomena. This led to dozens of securities offerings in the United States by companies organized in China or having their principal operations there. Many of these companies sought and obtained listings of their shares on the New York Stock Exchange or Nasdaq, and thereby became SEC-reporting issuers subject to the full range of U.S. reporting and disclosure obligations for foreign issuers. In addition to the practical benefit of being able to raise funds in the large and liquid capital market of our country, many Chinese companies saw an overseas listing in general, and a U.S. listing in particular, as a strategic goal, conferring a seal of approval and accomplishment that could be leveraged into business success beyond mere capital raising. The appeal of a U.S. listing was so great that in the mid-1990s a few Chinese companies listed shares only in New York and did not seek a listing even in Hong Kong.

Even Chinese companies that did not feel immediately ready for the responsibilities of a U.S. listing could raise significant sums in U.S. markets by conducting a private placement under Rule 144A, which offered the opportunity to sell securities to large institutional investors in the United States. Such companies could either continue only with their listings on their home securities market, or could at some opportune time in the future seek a U.S. listing and use the 144A offering as a stepping stone toward full SEC registration.

However, the level of interest among foreign companies in listing in the United States has changed dramatically since 2000, due principally to two developments. First, the significant stock price declines beginning in March 2000 led to reduced interest on the part of U.S. retail investors in investing in initial public offerings. This in turn reduced the benefits to issuers of conducting public offerings and listings of their securities, leading more issuers to choose instead the lower cost, greater speed and increased certainty of a private placement to large institutional investors. Second, the enactment of the Sarbanes-Oxley Act in 2002 inhibited many foreign companies from seeking a listing in the United States, not only because of its significant requirements relating to board composition, corporate governance and internal control review, but also due to concerns about what other new U.S. regulatory requirements might be imposed upon short notice in the future. The various corporate scandals in the United States publicized since 2001 may also have contributed to this, by tarnishing the perceived "seal of approval" effect of listing on a U.S. market.

Moreover, since the early 1990s and particularly in the last few years, other capital markets have been changing and increasing their appeal to companies undertaking cross-border securities offerings and international listings. The Hong Kong Stock Exchange, as the natural listing venue for Chinese companies, has garnered far more of such listings than any other exchange. Companies listing on the Hong

Kong Stock Exchange increasingly believe that there may be limited value in seeking another international listing, in light of the enhancements in disclosure requirements and corporate governance requirements in Hong Kong in recent years and the apparent willingness of investors around the globe to invest in Chinese companies listed only in Hong Kong.

Developments in other markets have also contributed to issuers' seeking to diversify the markets in which they raise capital and as a result to less reliance on the United States. One development that has been an important feature of some of the recent large Chinese privatization offerings has been what is known as the "public offer without listing" or POWL in Japan. This offering structure permits a company to conduct a public offering without being required, following the offering, to assume the burdens of a public listing and the ongoing disclosure and other obligations that a public listing would entail. In some of these offerings the amount of demand in Japan reportedly has exceeded a few billion dollars and may have accounted for a larger proportion of the offering than that sold in the United States. This obviously reduces the importance of the United States market as the key source of incremental demand for these offerings. Another development has been the increased effort by the London Stock Exchange to solicit listings by Chinese companies. The London Stock Exchange has been actively marketing listing in London as an alternative to the increased disclosure and governance requirements, and risk of securities class action lawsuits, claimed to be inherent in listing in New York. Some Chinese issuers, such as Air China last year, have been convinced to list their shares in London rather than in New York. In addition, steps taken by the European Union to harmonize prospectus requirements and to adopt International Financial Reporting Standards have also helped to move the Euromarkets closer to being a more unified capital market and a practical alternative to the United States.

As a result, many Chinese and other foreign companies in the last few years have decided to forego seeking a U.S. listing. For example, there have been no initial public offerings listed in the United States by Japanese companies since the enactment of Sarbanes-Oxley in 2002, and listings by European issuers have been very few. Interestingly, China remains one of the more active sources of companies seeking to list on the New York Stock Exchange or Nasdaq, but this is only by comparison to a dramatic decline from other countries.

It is also noteworthy that in recent years those Chinese companies that have listed in the United States have principally been smaller, technology-oriented companies seeking to list on Nasdaq. There have been over 15 of these IPOs since 2002. A very well-known current example is Baidu.com, famous for rising nearly 400% on its opening day of trading last Friday. This opening day gain was reported to be the largest ever for a foreign company in the U.S. markets, and the largest for any company since 1999. But leaving aside this extraordinary performance, in many respects the company is typical of Chinese technology companies seeking to list in the United States. Although its headquarters and business operations are in China, it is incorporated in an offshore jurisdiction, the Cayman Islands. It is not a state-owned enterprise: its principal shareholders are its individual founders and management as well as a number of U.S.-based venture capital and private equity funds. The offering was also relatively small, raising about \$100 million. Far from being methods for funding the Chinese government, these offerings are rewarding the entrepreneurs who built the company and the early investors, often U.S. investors, who financed them.

In contrast, since 2002 only a handful of Chinese state-owned enterprises have sought U.S. listings and SEC-registered IPOs. The initial public offerings and NYSE listings by China Netcom in 2004 and China Life in 2003 echoed the Chinese privatizations that commonly were listed on the New York Stock Exchange through 2002. The other large initial public offerings by state-owned enterprises that have been completed in recent years have listed only in Hong Kong or London and have gained access to U.S. investors by means of a private placement to institutional investors, including growing numbers of hedge funds and private equity funds, pursuant to Rule 144A.

Reliable and detailed data regarding securities offerings are difficult to assemble, particularly for private placements and other unregistered offerings, because public reporting of the distribution of the offering by jurisdiction is generally not required. Also, there can be problems in properly classifying issuers, because many companies having their principal operations in China are incorporated in Hong Kong or a Caribbean jurisdiction. Nevertheless, such data as are available make clear that offering methods have changed significantly in the nearly five-year period since 2001 compared with the five-year period from 1996 through 2000. My analysis of data gathered by Thomson Financial Corporation indicates clearly that both the number and value of initial public equity offerings by Chinese issuers registered with the

SEC have declined from the first period to the second, while both the number and value of offerings that involved a 144A tranche have increased. For example, these data suggest that from 1996 through 2000, there were 28 SEC-registered IPOs by companies organized in the PRC and Hong Kong. From 2001 to date, there have been only 20. By comparison, there were 10 IPOs by such companies that included offerings pursuant to Rule 144A in the earlier period, and 32 in the latter period. The data based upon offering value are less precise but also clearly show the change.

The ability to raise billions of dollars from offerings to institutional investors in the United States by using Rule 144A has led many foreign issuers to conclude that there is no need for the incremental retail demand afforded by SEC registration. In other words, when even the largest securities offerings can be completed by Chinese and other foreign issuers without SEC registration, to U.S. institutional investors who are willing to accept a foreign market such as the Hong Kong Stock Exchange as the sole listed market trading venue, foreign issuers are less willing to incur the cost and ongoing disclosure and governance requirements of SEC registration and U.S. listing.

Having spent my entire professional career as a U.S. securities lawyer, my purpose today is not by any means to criticize the Sarbanes-Oxley Act or the other elements of the U.S. securities regulatory scheme that apply to foreign issuers. Those regulations, and the manner in which they have been administered by the SEC and its highly professional staff, historically have made accommodations that enhanced the attractiveness of the U.S. capital markets to foreign issuers by taking into account the specific or unusual needs of foreign issuers compared with U.S. domestic issuers. For example, very shortly after the adoption of the Securities Exchange Act of 1934, foreign issuers were exempted from the proxy rules of Section 14 and the insider transaction reporting and short-swing profit disgorgement requirements of Section 16 of that Act. Foreign issuers are entitled to use registration forms different from those that apply to U.S. issuers, which in their disclosure requirements take some account of the differences between U.S. and foreign disclosure regimes and practices (for example, by not requiring foreign companies to disclose individual compensation paid to the top five executive officers, and by limiting the need to report financial information by business segments). The annual reports on Form 20-F required of SEC-reporting foreign issuers are due within six months of year end, as opposed to not more than 90 days for the Form 10-K reports by U.S. issuers.

During the 1990s, the SEC and its staff implemented other accommodations that had the effect of making it easier and more attractive for foreign issuers to make the transition to SEC reporting status. The longstanding requirement that foreign issuers reconcile their home country financial statements to U.S. generally accepted accounting principles was modified to permit foreign issuers upon their initial registration to reconcile only the most recent two fiscal years of financial results rather than the latest five years. The SEC staff made it a routine practice to review foreign issuer registration statements on a confidential basis, rather than requiring that they be publicly filed in order to commence the SEC staff review process, as is the case for U.S. issuers. This was intended to allow foreign issuers to resolve SEC comments privately and to manage the significant change to their home country disclosure that they might face in the initial transition to U.S. GAAP and SEC disclosure requirements. Also, when Regulation FD was adopted, which required full disclosure of information formerly communicated selectively to securities analysts or institutional investors, foreign issuers were exempted from this in recognition of the different regulations or practices in such communications that might exist in overseas markets compared with the U.S. market. The SEC staff also permitted foreign issuers to employ registered exchange offers to give holders of their privately placed equity securities the opportunity to exchange for identical, freely tradable securities in a registered public offering. U.S. issuers are permitted to use this technique only for debt securities. This allowed foreign issuers to take what became known as the "stepping stone" approach to entering U.S. markets, by first issuing equity in a Rule 144A placement to institutions and then following some time later with an SEC registered offering when they were ready to meet all the requirements. Even the Sarbanes-Oxley regime as it has been implemented by the SEC has sought to take account of the particular problems of foreign issuers under their local laws and to reach appropriate accommodations between the burdens faced by foreign issuers and the needs of investor protection in the United States. It should be noted that, with the exception of Canada, due to its proximity and similarity to the United States, U.S. Federal securities regulation has generally not made distinctions among foreign issuers on the basis of nationality, but instead has treated all foreign issuers in the same manner.

My point is, however, to emphasize that the importance of a particular nation's capital market to the global capital market is not something that is fixed, and it can fluctuate with changes in relative economic development, changes in regulation and many other factors. One instructive example is that of Japan, which during the 1980s enjoyed an economic boom that attracted investment interest around the world. By 1991 there were 127 foreign companies listed on the Tokyo Stock Exchange, drawn by the promise of a huge pool of liquid savings in a country that was then challenging the United States for world economic leadership. Today, after over a decade of economic difficulty, during which there were very few new foreign entrants seeking listing on the Tokyo Stock Exchange and a number of delistings, there remain only about two dozen foreign companies still listed on the Tokyo Stock Exchange. This has occurred despite the strong increase in recent years of capital raisings in Japan through the mechanism of the public offer without listing that I described earlier.

When considering the capital markets as providers of capital, it is also important to note that secondary trading of outstanding securities, not merely primary offerings of newly-issued securities, contributes to capital formation. Investors are more apt to purchase newly-issued securities if they expect that there will be a liquid trading market for those securities when they wish to sell. Secondary market purchases by U.S. investors thus can indirectly support capital-raising in overseas markets, by adding incrementally to global trading volume. Every day, investors in the United States invest large sums in the securities of foreign companies that are not listed in this country and may never have completed even a private placement here. Even individual investors are free to invest in securities of foreign companies that they acquire in the secondary market in the issuer's home country, as the United States, like most developed nations today, imposes no capital controls on money invested abroad. In essence, this is an age of highly mobile capital, in which substantial sums can be raised and many large securities offerings completed without the need for foreign companies to list their securities in the market in which investors are located.

This willingness to invest across borders in companies not listed in the investor's home country will only increase as securities and accounting regulators around the world pursue programs to converge accounting standards, governance requirements and disclosure requirements. The substantial progress that has been made to date and undoubtedly will be made in the near future to converge U.S. generally accepted accounting principles and International Financial Reporting Standards is one example. In addition, local securities regulators in various countries are requiring that audit committees comprise independent directors and are imposing greater disclosure requirements. For example, more countries now join the United States in requiring the disclosure of individual compensation of top executives, rather than only aggregate compensation of the management group. Thus U.S. investors, either directly or through mutual funds, pension funds, hedge funds, private equity funds and other collective investment vehicles, are likely to grow even more willing to deploy their capital in securities of issuers listed only outside the United States.

There are a number of disadvantages for the United States if it is not the overseas listing venue of choice for Chinese and other foreign companies. First, to the extent that global accounting, governance and disclosure requirements have not fully converged, the United States loses its ability to apply its own higher requirements if companies do not choose to list their securities in this country. Secondly, there is a benefit to the United States if it is perceived as the global leader and benchmark for sound, consistent, efficient securities market regulation and capital markets activity, as it then enjoys the ability to encourage others to adopt similarly high standards and efficient practices, both as a result of competitive considerations as well as peer pressure. Thirdly, U.S. financial institutions and other intermediaries and advisors who are involved in the capital markets, particularly the securities offering process, benefit significantly from foreign companies accessing U.S. capital markets. This constitutes a significant export of services by U.S. entities that provides American jobs and incrementally helps our trade balance. There is also a more intangible international relations benefit to the United States through the choice of U.S. law and practices to govern international capital markets transactions, which often is the case if a substantial portion of the offering is conducted in the United States. My own experience in Asia suggests that the United Kingdom continues to benefit from the legacy of the British Empire and the widespread use of English law and choice of London as a center for dispute resolution. Finally, the desire to diversify investments, which is one of the tenets of modern portfolio management, will strongly encourage U.S. investors to invest in foreign companies, and it is certainly better for our investors if those companies are as engaged as possible in the U.S. securities regulatory and reporting regime.

In conclusion, I believe that any capital markets regulatory regime, in order to attract participants and capital on an ongoing basis, needs to strive for clear and consistent regulations that are administered on a practical, even-handed and transparent basis. When we consider the regulation of securities offerings in this country by foreign issuers, including Chinese issuers, I believe it is important to keep in mind that these issuers may obtain the capital they need elsewhere. As many commentators, including Chairman Greenspan, have noted, there appears to be a global glut of savings, and China itself is a major supplier of capital to the United States as a purchaser of U.S. Treasury securities. This global savings glut leads to the phenomenon that those who seek capital are readily able to find it, and those who wish to have attractive investment opportunities to which they can provide capital may need to compete in order to do so. As I noted earlier, success in this competition may fluctuate over the years due to changes in relative economic developments as well as changes in regulation. Our ability to control economic movements, particularly those in other countries, is somewhat limited, but we do retain the ability to shape and administer our own regulatory regime.

I suggest that it is vitally in the interest of the United States that our capital markets regulatory regime be shaped and administered in a way that encourages access to U.S. capital markets by foreign issuers, including Chinese issuers, while at the same time protecting U.S. investors. Many of the most attractive investment opportunities in the world today are in Asia in general, and China in particular. Always assuming that our regulations meet the threshold requirement to provide appropriate levels of investor protection, we would not be serving the interests of the millions of Americans who depend upon the investment performance of their pension managers, insurance companies, mutual funds and financial advisors if we lead Chinese and other foreign companies to avoid U.S. capital markets in favor of listings in London, Japanese retail offerings or other offerings in Europe and the international markets.

Thank you again for the opportunity to be here today and for your dedication to careful analysis of the U.S.-China relationship.

#### **Panel I: Discussion, Questions and Answers**

Vice Chairman ROBINSON. Thank you very much, Mr. DeLaMater. I'd now like to move to questions and answers from my fellow Commissioners, beginning with Chairman D'Amato.

Chairman D'AMATO. Thank you very much Vice Chairman Robinson, and I want to thank both of you for very, very interesting testimony. I think it raises a number of issues. I'm mainly concerned here that it looks like, and I'll ask you whether this is valid, that there is a movement away from the American markets because, of course, Sarbanes-Oxley provides a higher standard, which bothers me, because it looks like we're going to have a lot of Chinese IPOs. We're going to have a lot of Chinese banks looking for money. We're told that they don't need the money; they need extra money, walking around money.

We're told by the IMF that it's icing on the cake money. While billions and billions of dollars from American investors are icing on the cake for Chinese banks, the question is what are the standards of disclosure and transparency for investor protection that are going to be involved here?

We've just gone through a period of the high tech bubble. We all remember that. Many, many Americans, billions and billions of dollars were lost in that extravagant rush and stampede to what looked like the nirvana of riches with high tech bubble. Are we on the verge of a China bubble?

You talk about, Mr. Geczi, you talked about the Bank of China and the China Construction Bank, we have a Wall Street rating firm who has rated these banks. The ratings go from A, B, C, D, to E. That's the regular ratings. The average rating for banks in the international market is C plus. No China bank even gets a C

minus. Bank of China gets a D minus. The China Construction Bank gets an E plus. E plus means you better watch out.

So I'm wondering here about this bubble. You say there's no difference between listing on the Hong Kong Exchange and the New York Stock Exchange. I don't understand that statement because it seems to me that they're going to the Hong Kong Exchange to evade the American standard, and then through the trap door, I guess, of what you call the 144A private placement, investors can go and invest in those placements without complying or having the offerer comply with American higher standards.

So I'm just worried about the question of whether or not we're going to a China bubble where we're going to have a lot of puffery and the question of value for the American investor is of question here. Do you see that this rush of IPOs leads to this kind of concern that we may end up with some kind of a bubble that could put investor investments at some risk? And I'd like each of you to address that if you would. Go ahead.

Mr. DELAMATER. Well, there is no question there are certainly fads and fashions in the investment world. Certain types of investments come in and out of fashion, and it is, I think, clear that one of the investment phenomena of our age and of this time is interest in foreign investments in general, Asia more particularly, and China most particularly, for all the reasons that are so widely discussed—population, rapid economic growth and so forth.

I think, however, it's also important to appreciate that securities offerings in this country are highly regulated regardless of who the issuers are. There is an elaborate scheme, as all of you know, for SEC registration. All foreign issuers are required to comply with that if they wish to sell securities publicly. Even in the 144A context, it is the practice of the major participants in that market, the major intermediaries, such as investment banking firms, to insist upon essentially the same type of disclosure in an offering circular for a 144A offering as exists in a prospectus for an SEC registered offering.

Some of the main reasons for choosing the 144A private placement route as opposed to a registered offering relate to some of the more technical requirements of the disclosure forms which may be more difficult for foreign companies to compile, but which do not affect in a material way the total mix of information that's being provided.

Another factor is the timing that can be required in preparing a registered offering and going through the registration review process. Sometimes foreign offerings, if they need to be coordinated with a simultaneous listing in a local market, may find it difficult to meet the timing requirements of the U.S. process.

And I think finally, the Sarbanes-Oxley Act has irritated foreign issuers most because it in many respects goes beyond what has historically been the purview of U.S. Federal securities regulation. Historically, U.S. Federal regulation was directed at disclosure and requiring full disclosure with Justice Douglas' statement that sunshine was the best disinfectant.

What many of the provisions of the Sarbanes-Oxley Act do, however, is go beyond disclosure to require certain types of governance arrangements by listed firms such as a certain number of inde-



pendent directors, independent directors comprising the audit committee, certain relationships between the board, the audit committee, outside auditors, and those are things which many foreign companies found difficult to comply with, not because they resisted the thrust, the general idea of it, but because the specific implementation of it was contrary to their local practices.

Another example which illustrates how the Act took essentially no real account of foreign issuers and their unique needs was the bar on loans to executive officers and directors. As I'm sure you know, U.S. banks were specifically exempted but foreign banks were not, and so that led to the anomalous situation that a foreign bank listed in the United States would be unable to extend a home mortgage loan to one of its own executive officers and directors, and it's things like that, and I should hasten to add that anomaly was corrected by SEC action relatively promptly, but it's things like that that have led many foreign issuers to believe that there is a regulatory risk in listing in this country that goes beyond disclosure requirements and goes into some of the implementation of governance and other requirements.

Mr. GECZI. Yes, thank you. I think I just have three points on this particular issue. On Sarbanes-Oxley and Chinese issuers seeking to avoid the high hurdles of Sarbanes-Oxley, I think it's important to point out that there's a companion activity going on with foreign listed companies in this country that are thinking about withdrawing their listing because of the onerous hurdle. So this is not a situation of Chinese companies trying to avoid something. It's a situation of companies that are already listed, foreign companies that are already listed thinking that the New York Stock Exchange or the U.S. type listing is no longer in their best interests.

Vis-à-vis New York Stock Exchange listing versus Hong Kong listing, I can tell you from personal experience in talking to Chinese companies, at least it's my sense that those decisions are often made as to at what point in the development the company is. These companies would love to list in New York; they would love to have the prestige. They may not be ready for that, but they may have the capital needs at that particular point. Hong Kong presents an alternative for them for whatever point in the maturation their company is in.

I think every conversation I've ever heard with a prospective issuer, they would ideally love to be able to list in the U.S., but if the company is not sufficiently mature, if the books aren't sufficiently worked out properly yet, if they haven't built their business enough, Hong Kong becomes a real alternative for them because it's where their need and the capital supply can come together.

And on the third issue, on the Chinese banks in particular and their ratings, which I don't think anybody would dispute, and I certainly agree, it strikes me that if capital markets investors are going to invest in companies with ratings like that, then they have no one to blame but themselves. I think if banks have ratings like that, they're probably not going to succeed and that suggests to me that the capital market works as a self-governing marketplace and it does what it needs to do.

Chairman D'AMATO. Thank you very much. I hope you're right in what you just said about the Chinese banks, but I detect a kind

of stampede here. I think what we're worried about, is defending some standards as a result of tremendous loss of value to average American investors as a result of the high tech bubble. We're still close to that experience and erring on the side of higher standards I think is what is driving us.

Thank you very much.

Vice Chairman ROBINSON. Thank you, Chairman D'Amato. Co-chairman Wessel.

Cochair WESSEL. Thank you, and thank you both for being here. It's very important testimony, very interesting. Mr. Geczi, I'd like to ask you a question with a quick answer, if I can, and understanding that strategic messaging is a very important industry in this country and certainly in this town. It seems to me that your comments about the CNOOC-Unocal deal were a problem of messaging more than anything else, and I certainly believe that the Chinese government's stepping in and saying don't mess with this transaction probably did more damage than anything else to the view that this was, in fact, not a government-sponsored or government-directed investment. What are your views on that?

Mr. GECZI. I think that was step two. I think step one was the perfect defense strategy that was put together, which was to raise the flag.

Cochair WESSEL. To raise?

Chairman D'AMATO. To raise the American flag?

Mr. GECZI. To raise the American flag.

Cochair WESSEL. Raise the American flag.

Mr. GECZI. That was the perfect defense strategy. It worked very effectively. China then might have made a mistake with their comment, but I think that played out just the way one would expect it to play out and it was done very, very well.

Cochair WESSEL. By one side?

Mr. GECZI. Absolutely.

Cochair WESSEL. By one side. Let me turn and have both of you respond. It seems that what we're also talking about here is another component of the globalization strategy or the globalization issue. It seems that we're looking at some Chinese companies, maybe others, but our focus is on China, who may be shopping the globe for the weakest disclosure standards that give them the requisite amount of capital they need to fill their needs. Certainly, the crown jewel of capitalism is the New York Stock Exchange for the imprint that gives, but Sarbanes-Oxley has deterred some from coming there now.

Yet I think our ultimate goal should be upward harmonization in standards rather than diminution in those standards. When Bank of America that's now purchased 9.1 percent of the Chinese Bank comes for its annual meeting next year, should we expect that their proxy statement will give us some of the disclosure tools that we want to understand what the nature is of their investment since that Bank has yet to come to the U.S. capital markets?

Mr. DELAMATER. Well, I wouldn't presume to speak for them.

Cochair WESSEL. Speaking from a legal perspective, a 9.1 percent, multi-billion, a significant investment, that's a material event for the Bank of America; correct?

Mr. DELAMATER. Well, I'm not sure. It's a very large institution.

Cochair WESSEL. Understand, and it's based on capital standards, et cetera. Assuming it's material, would we be able to gain some disclosure tools as a result of that, meaning that if the Chinese companies aren't going to come to the U.S. market, they're going to go Tokyo or Hong Kong, do we have the secondary review tool now that for U.S. companies, U.S. hedge funds, to the extent that they're disclosing in any way, and I know most aren't, CalPERS, all the other institutional investors?

Mr. DELAMATER. Well, if I could just go perhaps to the premise of your question, which is that foreign requirements are necessarily lower than those in the United States, or that the Hong Kong Stock Exchange in particular, the suggestion is that that is the easy way out for these companies, and I don't think that is actually the case. The Hong Kong Stock Exchange has very detailed disclosure requirements.

Cochair WESSEL. Are they as stringent as New York Stock Exchange?

Mr. DELAMATER. Well, I'll give you one interesting difference between the two regimes. The Hong Kong Stock Exchange will not list a company unless it meets a multi-year track record of profitability. So many high tech companies which by nature of their operations, whether its biotech or Internet related, may never have achieved profitability, the Hong Kong Stock Exchange will not list them, so that's why we see so many Nasdaq listings by these companies. They come to this country because the fact that they've never turned a profit doesn't prevent them from listing here.

Now, there are many good reasons for that. Obviously, in a developing industry—biotech is an excellent example—many of the leaders of biotechnology today did their IPOs and raised substantial capital without profits. Many mainstays of American life today—Amazon, other companies—were not profitable when they did their IPOs.

I think commentators would say that that, however, is a sign of the strength of American capitalism, that it can recognize an opportunity even when a company may not be profitable, when it may be going through very difficult times, or when it's going through a transition from one type of operation to another.

I think that is something that relates very much to the Chinese financial sector. I think even commentators closest to this and even the Chinese authorities themselves would recognize that the Chinese financial sector historically was not operated on strictly commercial lines and that there was a substantial element of policy-based operation.

That is something that they're in the process of changing and seeking to divide policy lending from commercial lending and have those conducted in separate institutions. It's not something that happens overnight. And part of the reason for seeking the substantial investments from foreign financial institutions is to assist in that transition to a modern commercial credit culture with risk management, checks and balances and proper documentation and so forth that we associate with sound banking practice.

But that is a long process and that's why these institutions have been working on this for the last several years. A lot of publicity

is being directed at this now, but these are changes that have been in the works for several years and will continue.

Cochair WESSEL. Thank you.

Vice Chairman ROBINSON. Yes, thank you, Cochairman. Commissioner Wortzel.

Commissioner WORTZEL. Gentlemen, thank you for taking the time to appear today. My questions will relate to what you characterized as maturation and corporate governance. As state-owned firms go public in China, what percentage of ownership and control does the PRC government retain and taking Air China as an example—it's been mentioned by both of you—how was that corporate board restructured? Can you characterize how international or foreign-board members are chosen? And could you also discuss how those companies are restructured?

For instance, when Air China Limited listed in Hong Kong in I think it was 2004, what's the relationship between Air China Limited as in Hong Kong and Air China up there in Beijing?

Mr. DELAMATER. Well, I think that for Chinese companies, they have followed the pattern with respect to their privatizations that's been followed by privatizations around the world. The privatization movement in the modern era really got started in the early '80s with the UK, progressed through a number of European countries and now a number of Asian countries, and it's followed a fairly similar pattern in that the government begins by selling off a portion of its stake but retaining a majority interest.

In many of the European privatizations, the government retained a so-called "golden share," which would allow it to control certain aspects of the company's operations, even if it sold down below a majority of the total equity. And so the model of those privatizations was very much one of maintaining government control over key aspects of the company. That's not something interestingly that the Chinese have ever done. They have not retained golden shares in these companies, and the pattern is expected to be that over time they would continue to sell down their stakes in these companies, and the companies would become more and more privatized.

Just an interesting development in greater China and Asia which is that the government of Taiwan just in the last few days completed the sale of an additional stake in Chunghwa Telecom, taking its stake below 50 percent and allowing it to declare that company privatized.

And so this is a multi-year process, and it's affected substantially by capital market developments and the receptivity of markets to taking these large equity stakes. The government of Australia selling down its stake in Telstra which is the former monopoly telecom operator has taken many years to get to a point where it believes it could sell below the majority level. And so it's not something that the government itself necessarily has control over.

With respect to board composition, generally the board contains some persons appointed by the government with a view toward monitoring the company and taking into account the interests of the majority shareholder as would be the case in any such situation. But there are also independent directors and they are chosen in a variety of ways, but there is an increasing emphasis on choos-

ing persons of standing and credibility who can be looked to by international investors as people who will be more sophisticated in financial matters and who will look out for the interest of public investors.

I'm sure you saw the publicity surrounding the CNOOC bid and the fact that one of the independent directors there was cited as having been influential in the decision whether or not to go ahead with that transaction and the terms on which it would proceed, and so I think it is increasingly the case that independent directors of these companies are persons of standing and experience and they're given influence in the board's deliberations.

Mr. GECZI. I would just briefly add to that, that every experience I had with PRC companies but especially with the SOEs, the very first issue had to do with seeking out this person of standing and the companion issue was what was the best way to aspire to global best practices in doing these kinds of things. And that was always the first conversation I would ever have with somebody initiated on their behalf.

Vice Chairman ROBINSON. Commissioner Dreyer.

Commissioner TEUFEL DREYER. Thank you both for coming. Baidu's headquarters are, I believe, and also its business operations are in China, but it's incorporated in the Cayman Islands; is that correct?

Mr. DELAMATER. That's correct.

Commissioner TEUFEL DREYER. I notice, or we have noticed as a group, from other information, that the Cayman Islands is becoming more and more important as a financial center for Chinese enterprises. Could you characterize how prevalent it is for Chinese operations to headquarter themselves in—to incorporate themselves into the Cayman Islands, and what are the consequences of that for their independence from the Chinese government and for taxation purposes by the Chinese central government?

Mr. DELAMATER. Well, this is an approach that was taken really right from the beginning during the early '90s when Chinese enterprises or enterprises with their principal business operations in China began to seek to do IPOs and list in the United States. A number of those early transactions were companies organized in Bermuda or the Cayman Islands that controlled joint venture interests or operations in China.

And there were a few reasons for that including the fact that by doing so, it would be possible to reduce the delays or requirements of regulatory approval within China that might attend such a listing process. Also, there was an attempt to try to impress investors with the fact that these were companies that would be operated according to Western governance standards. Bermuda law or Cayman law and corporate governance was thought to be widely understood and recognized by the international investment community. And at that time, in the early '90s, there was concern that perhaps Chinese corporate law had not developed to the point where it would be accepted by the international investment community.

And so many of the early listings were done by using those jurisdictions, and it's continued to be the case that, for a number of private companies that operate in China, there are a number of reasons for using an offshore jurisdiction that again relate to smoother

regulatory processes, absence of corporate tax in jurisdictions like the Cayman Islands and Bermuda, and—

Commissioner TEUFEL DREYER. Excuse me. Are you saying that the Chinese central government then gets less tax revenue if the company is incorporated in the Cayman Islands; is that correct?

Mr. DELAMATER. Well, no, the business operations are conducted in China and so tax revenues, the tax regime that applies to the conduct of business in China, remains the same. But the difference is that at the corporate level when shares are sold and capital gains tax might be generated, those jurisdictions don't levy taxes on capital gains.

Commissioner TEUFEL DREYER. So who is losing the revenue then?

Mr. DELAMATER. Well, the country that might otherwise have been chosen. It might have been the United States. It might have been China. It might have been anywhere. But choosing a jurisdiction in which there's no tax on capital gains is something that many entrepreneurs try to do.

Commissioner TEUFEL DREYER. Sure, I understand that. So it is the country such as the United States or France or wherever that is losing the money? The Chinese taxman is not losing the money; is that what you're saying?

Mr. DELAMATER. Well, I guess what I'd say is that in this instance, perhaps the U.S. and China see the situation in the same way, and that it might be more desirable from a fiscal perspective to have more companies organized in one's own country rather than in an offshore jurisdiction. But I don't think it's the case that one could say that tax revenues are really lost in any practical way.

Commissioner TEUFEL DREYER. And what about the independence from the Chinese central government of a company that is incorporated in the Cayman Islands or some other offshore place?

Mr. DELAMATER. Well, I suppose nominally one might say that that company is beyond the reach of the country where the operations are being conducted, in this case China, but still because the business operations, all the revenues, are being generated in China, there is still a wide scope for these companies to be regulated by China.

Commissioner TEUFEL DREYER. Mr. Geczi, have you any thoughts on that?

Mr. GECZI. I think just a couple of points. I think the Cayman type listing in the early days would enable the companies on the positioning standpoint to be able to address one of the concerns of investors, which is rule of law because it provided an adequate answer for rule of law, and I think on this latter point, and I think the independence from the PRC government, I think it's important to note that this is the listed entity that's—

Commissioner TEUFEL DREYER. This is what?

Mr. GECZI. The listed entity that's based in the Cayman's, and as Bob said, the operations are still going on in the PRC. And there's a distinction there.

Commissioner TEUFEL DREYER. Thank you.

Vice Chairman ROBINSON. Commissioner Reinsch.

Commissioner REINSCH. Thank you. Welcome to you both. It's awfully good to have witnesses who really know something about the field, and I appreciate your sharing your expertise with us. Listening and looking at your statements, I've come away with two general conclusions which I'd like you to either validate or disagree with.

One is that in an era of surplus capital, issuers have lots of choices as to where they're going to go, and they're going to seek out those locations that either most meet their needs or might be those that have the least onerous requirements or whatever. But the cards seem to be held by the seller and not the buyer.

The second thing that I come away with is that it sounds from what you're both saying that the Chinese are neither that different from anybody else in terms of how they behave as far as listings and looking for listings, nor are they different from anybody else in terms of how they're treated by the securities authorities in wherever they end up being listed.

Is that a correct conclusion from what you've been saying?

Mr. GECZI. Well, that's my perspective. I think the marketplace treats them the same way and there are those in the marketplace that understand what's going on in China and there are those that do not, and some of those people are going to do very well and some of them aren't going to do very well, but to me that's the marketplace.

But my experience with Chinese companies, whether they're entrepreneurial companies or SOEs, was very much that they wanted to be part of this global marketplace, they wanted to aspire to best practices, they wanted to have Western advisors come in and help teach them and teach their people and learn because they knew they had a long way to go on the learning curve.

Does that mean that in an SOE there isn't still remnants of the government in there? No, it doesn't mean that at all. But it means that there was an intention to try and do things in a way and to meet the best practices in the world and to do it in a way that is consistent with the way everybody else has to act.

Commissioner REINSCH. Mr. DeLaMater?

Mr. DELAMATER. Well, I think that it's economically rational for any business to try to conduct its affairs in a way that results in the most efficient operations and very often that leads any business, including American businesses, to try to operate in ways that minimize their taxes, that minimize regulatory delays or hurdles to efficient operations, and so the fact that Chinese companies take a hard look at different listing venues and try to assess which ones meet their needs and which ones don't is evidence of behaving like capitalists.

It's the same thing that any business anywhere engages in, but having said that, I think there is a strong feeling among these companies that they wish to be perceived as following international best practices, and that they take advice from advisors and they talk to institutional investors around the globe about what are regarded as best practices and take that into account.

Commissioner REINSCH. Thank you. The fact that they're turning out to be capitalists is a point that's been made here frequently by other witnesses and it certainly seems to be true.

Now, Mr. DeLaMater, your written statement had just a wonderful paragraph that unfortunately you truncated in your oral presentation. It talked about the disadvantages to the United States if listings are elsewhere and you provided only a couple of the longer list of disadvantages that you cited here. I'm glad to hear from the Chairman that the full statement will be in the record.

Without asking you to repeat that now because time is short, if one is concerned about that, and thinks that the decline in U.S. listings is a problem, what would you suggest to remedy it? You've already foresworn criticizing Sarbanes-Oxley in your statement. What would you suggest that the United States do?

Mr. DELAMATER. Well, I'm grateful to you for reading that paragraph because I—

Commissioner REINSCH. It's a wonderful paragraph. I commend it to my colleagues.

Mr. DELAMATER. Thank you. I'm grateful for your attention to it because I did regard it as an important point, and I shortened it only to try to stay within my allotted seven minutes, but I think that we do need to be cognizant of many of those factors that I mentioned, and I think in terms of concrete steps that can be taken, I would suggest that more thought be given to whether the current regime that we have, including Sarbanes-Oxley, fully accounts for the unique needs of foreign issuers, and that we remember that the historical conduct of U.S. securities regulation has been to make appropriate accommodations for foreign issuers in these markets.

I didn't set out to criticize Sarbanes-Oxley, but I think some constructive criticism and review of any regulation on a continuing basis is useful because regulations do become outmoded as time goes by or may because of the extreme circumstances under which they need to be adopted. There may not be time to fully consider all the different ramifications, and I think one might say that that was something that happened during the time of Sarbanes-Oxley.

It was a unique set of circumstances, action needed to be taken promptly, but I think in hindsight, there may be changes that can be made, and I should say many of them the SEC and its staff have been making. They have been very open to suggestions about ways in which both U.S. domestic issuers and foreign issuers have problems with the current system and changes are being made.

I noticed that just today there was an announcement from the panel that's looking at the impact on small businesses of Sarbanes-Oxley and a suggestion from that panel that the internal controls requirement be delayed to allow small businesses more time to comply. So these things are happening, but I would encourage those to continue with the particular needs of foreign issuers being accounted for.

Commissioner REINSCH. Thank you.

Vice Chairman ROBINSON. Thank you. Commissioner Mulloy.

Commissioner MULLOY. I second Commissioner Reinsch's thanking you for being here and sharing your expertise. I'm not an expert in any of this, so I'm just trying to understand how it works. You both have talked about the CNOOC transaction in your testimony or in comments, but that's not the thrust of this hearing.



CNOOC was a Chinese company coming here with government subsidized financing to buy an American company. Mr. DeLaMater, you mentioned that they did have a private board or members of their board were private, and indicated that was what they would try and do, put some private sector people. My understanding is that the private sector members of that board were not in favor of that acquisition and, in fact, one of them, the former Ambassador of Switzerland to China, resigned over it. That's my understanding.

That the largest American investor in CNOOC sold its stock because they said this clearly was not a commercial transaction. So just leaving that aside, I did want to get that on the record because I don't want any misapprehension of what that was about, at least from my perspective and from other people's perspective including the private sector investors and members of the board of that company.

I think there are two things we're talking about today: people coming here to raise money—it's too bad that Mr. Chao couldn't have made this panel because he makes a differentiation between non-technology companies, which I think are more government-owned corporations from China, not being as willing now to come to this market and it was discussed that they're going to Hong Kong. I think they're more government-owned corporations which are going to Hong Kong to raise their additional money, and that may be a good thing from Sarbanes-Oxley, that since they are more of a black box, that maybe that's achieving the purpose of Sarbanes-Oxley so people here don't invest in companies that people don't really understand.

But then Mr. Chao tells us there are many Chinese companies coming to the market here and these are the more technology private sector generated companies in China, which are started by, many of them, American venture capitalists find opportunities in China in technology and fund that with American funding to get started, and then come here and raise additional money in U.S. capital markets to help that private sector, private-owned firm raise additional money, and they're willing to undergo all of the scrutiny of Sarbanes-Oxley.

That's what I got from the testimony today. Is that about where you are? Mr. Chao had some very good testimony, and I just wanted to see if that's what you think is going on?

Mr. DELAMATER. I agree with that. I think one can divide into those two different sectors, yes.

Mr. GECZI. Absolutely, and I think it's important at all times in this discussion to talk about both the public capital and the private capital because we're talking about large market of funds going both directions; some of it is private and some of it is public. I totally agree with that.

Commissioner MULLOY. I could conclude then that Sarbanes-Oxley is operating correctly in that those who can undergo the scrutiny that's required under U.S. securities laws can raise money in this market and those that can't, and which we're not sure that the sunshine in shining in, the disinfectant you talked about earlier from Justice Douglas, is really working as well. So those guys are going to Hong Kong to raise their money or London or somewhere else?

Mr. DELAMATER. As I said earlier, I wouldn't necessarily agree with the proposition that these companies stay out of the U.S. because they're fearful of disclosure. I don't think that is really what drives them to stay away.

Disclosure requirements in other markets around the world are increasing, and there is a movement, very strong movement, toward convergence around the world of accounting standards. You're all aware, I'm sure, of the project to converge U.S. GAAP and International Financial Reporting Standards. Disclosure standards are converging through the OECD process.

Commissioner MULLOY. Right.

Mr. DELAMATER. Corporate governance has become a debate in virtually every country and stock exchanges throughout the world conduct seminars on how their listed companies can improve corporate governance. I spoke on such a panel in Singapore, and so there is this movement toward convergence, and so I don't think it's necessarily a fear of disclosure.

In fact, I think I'd say it's a reluctance to have to fit one particular regulatory scheme in all of its many details when one's home market has a different scheme that doesn't fit so comfortably with it, as I said in the comparison between Hong Kong's profit requirement and Nasdaq's willingness to list companies without a history of profitability. One cannot necessarily say that one is bad and one is bad. They are different and they're adopted for different reasons.

Commissioner MULLOY. No, but the non-government-owned companies don't seem to have the reticence to come here and raise their money. That's what I get from reading Mr. Chao's testimony, and that's an important distinction that makes sense in my own head.

Mr. DELAMATER. As I said, in some instances they need to because they could not list in Hong Kong.

Commissioner MULLOY. Because of the fact they didn't show a profit.

Mr. DELAMATER. That's right. The standards are too high in Hong Kong.

Commissioner MULLOY. Let me ask you one other issue and this isn't directly related to this hearing. One of the concerns that the Congress had about CNOOC and was expressed was that this government-owned Chinese company was coming to America to buy a company, but that government-owned Chinese company couldn't be purchased in turn.

Now, these Chinese technology companies that are coming to America to raise funds, ownership and control of those companies can pass from the group that controls it now to some other group. Are these groups that are raising money in the Hong Kong market, these so-called "non-technology" SOEs, control can't be purchased by Americans or non-Chinese-government-owned people?

Mr. DELAMATER. Most of those companies, that's true in the sense that the government has a majority ownership stake.

Commissioner MULLOY. Yes.

Mr. DELAMATER. And so absent a decision by the government to sell control, then a purchase wouldn't be possible, but there are at the level of some smaller companies some transactions that are

now being done where companies that have in the past been controlled by governmental bodies are being sold to private investors.

One example just from the last year is Harbin Brewery which had been controlled in part by the Harbin municipal government and that was recently sold to an international beer manufacturer and distributor, and so some of these companies are——

Commissioner MULLOY. Is that a trend we want to encourage in China?

Mr. DELAMATER. Well, I would think so.

Commissioner MULLOY. Do both of you agree with that?

Mr. GECZI. Absolutely.

Commissioner MULLOY. Do you think it would help us to encourage that trend by saying we want a reciprocal investment policy to say if your company wants to come here, this company owned by the Chinese company wants to come here and buy somebody, we're not too much in favor of that unless somehow it can be in turn purchased by private sector people in this country? A Mr. McGregor who wrote a column in the Outlook Section of the Washington Post. He said that was an important concept that we might want to get from the CNOOC transaction, that we move toward a reciprocal investment policy.

Mr. GECZI. That's taking place now. I mean IMB-Lenovo. I mentioned Yahoo. Those kinds of transactions are taking place.

Commissioner MULLOY. Yes.

Mr. GECZI. Several years ago when the massive bankruptcy of Global Crossing in this country happened, the Asian subsidiary of Global Crossing, Asia Global Crossing, which was filing by bankruptcy, was bought by a Chinese company to rescue that company. So the transactions are going forth in both directions.

Commissioner MULLOY. Yes, I know that, but do you think it should be a policy that if a Chinese company can't be purchased, it shouldn't be purchasing things here?

Mr. GECZI. Whose policy? Policy by who? Government policy?

Commissioner MULLOY. The government?

Mr. GECZI. No.

Commissioner MULLOY. You don't think that would help move the process of opening up the Chinese economy?

Mr. GECZI. I think capital markets make that happen. I think the markets make it happen.

Chairman D'AMATO. Thank you, Commissioner Mulloy. We'll go ahead to Vice Chairman Roger Robinson.

Vice Chairman ROBINSON. Yes. I think that, building off of Commissioner Mulloy's point, I too was struck by the notion that Nasdaq is the venue of choice for what might be termed quasi-private high technology firms, often assisted by venture capital firms. These firms seem to be committed to entrepreneurial activities for their own growth, profitability and so forth. The non-technology state-owned enterprises are steering clear, for the moment at least, of the New York Stock Exchange, although I expect that will soon change.

It's worth noting that I think the Commissioners that have participated in this debate now for some years buy into the notion that the discipline of listing in this country, inherent in the SEC regu-

latory regime, our disclosure standards and accounting standards, are net positive developments for China.

It is the kind of discipline that brings greater integration of China into the world financial system in a positive way. We'd like to see more of the Nasdaq variety of listings frankly because it's the large state-owned enterprises that are more questionable from a number of points of view, and that would include the state-owned banks.

When you're selling off only ten to 15 percent of the equity of such an enterprise with no minority shareholder rights, very little corporate governance, poor disclosure and transparency standards, and where the investor has very little idea about what the company actually does, or its overseas involvements, that's when you get into more dubious territory which can be problematic both for investors as well as for U.S. security interests.

I think it's also encouraging, and I agree with you, that corporate governance has gained a great deal of traction around the world. I've attended many of those international sessions myself and we're anxious to see better harmonization of disclosure, accounting, and other standards.

This is why we need to question whether China is somehow shopping for laxer regulatory regimes.

We're trying to sort this issue out and be more assured that China is not seeking a laxer set of regulatory regimes that could ultimately disadvantage U.S. investors and our security interests.

I just wanted to make those two points. That's more of a statement than it is a question. I'd like to yield the balance of my time to Commissioner Wessel, who I think has a concluding question. Before he does, I'd like to say something I neglected to say in my opening statement. Our Cochairman for today's hearing, Commissioner Michael Wessel, has pursued this particular subject of China's presence in the U.S. and international capital markets with great vigilance since the inception of the Commission, and has contributed mightily to the evolution of the Commission's inquiries that have taken us into the types of inquiries that you've witnessed today.

So we're very grateful to him for that tenacious service. Commissioner Wessel.

Cochair WESSEL. Thank you. As you can tell, it's a mutual admiration society up here. One quick comment on Baidu. If I remember, they've been cited at times in the past for willingness to block pro-democracy and other Web sites in China so the reach of concerns that U.S. investors and the U.S. Government may have is not necessarily absent in this transaction.

Mr. DeLaMater, if I could just ask one or two technical questions. My understanding of Sarbanes-Oxley is materiality is based on net income; is that right?

Mr. DELAMATER. No, well—

Cochair WESSEL. For disclosure?

Mr. DELAMATER. Well, materiality—

Cochair WESSEL. There are many different standards. One of the standards for the disclosure is material transaction is based on net income.

Mr. DELAMATER. That is exactly right—that is one factor that can affect whether something is material.

Cochair WESSEL. While we were sitting here, I Googled and found out that their net income for the second quarter of this year was \$4.2 billion. The purchase of the Chinese bank was \$3 billion, 70 percent roughly of their net income. That I assume under any legal standard would be viewed as a material transaction.

Mr. DELAMATER. I'm sure they will discuss it.

Cochair WESSEL. I'm sure they will discuss it. Let me, though, turn quickly to the Executive Order which the President just announced on June 29, that Chairman Robinson talked about, relating to WMD proliferation. If the bank which Bank of America purchased provides funds to a proliferator, could Bank of America's participation in that transaction, 9.1 percent of the bank is now owned by them, could that be viewed as coming under the ambit of this Executive Order?

Would you as counsel to a firm, hypothetical transaction here, 9.1 percent, they are materially participating in funding a proliferator, would that be something that would be a disclosable fact on their proxy or other statements here, not 144A, but other statements here?

Mr. DELAMATER. Well, as to that fact pattern, I couldn't really say. But certainly I would agree with you that in general any element of a company's operations that gives rise to material regulatory risk, legal risk, that would imperil their ability to conduct operations or that would have an impact to a material extent on net income or revenues, is something that would need to be disclosed and would need to be disclosed in sufficient detail that it could be evaluated by investors.

Cochair WESSEL. Okay. Thank you.

Vice Chairman ROBINSON. I think that would conclude this panel. We're very grateful to both of you gentlemen for your participation. It has greatly enriched our understanding of this highly nuanced business that we're undertaking today.

We'd like to take a five-minute break and then we'd like to convene with our second panel. Many thanks.

[Whereupon, a short break was taken.]

## **PANEL II: UPCOMING CHINESE BANK LISTINGS AND THE BANKING SECTOR**

Cochair WESSEL. Thank you. We're ready to convene our second panel. Introductions were made earlier so I will briefly mention them. This second panel is on the upcoming Chinese bank listings and the banking sector.

Dr. Pieter Bottelier, Adjunct Professor, Johns Hopkins University, SAIS. We're pleased to welcome you back here. The professor will discuss the state of the Chinese banking sector as well as China's current strategy for banking reform. Last year, the professor laid out his baseline assessments and we look forward to his further review and future projections of the Chinese banking industry.

Marshall Meyer is the Richard A. Sapp Professor of Management and Sociology at the Wharton School of Business. Dr. Meyer has just returned from Beijing and will discuss the status of China's at-

tempts to sell equity shares in its banks and the implications for both banks and investors.

As Chairman Robinson noted earlier, your statements will be entered into the record. We hope you can roughly speak within about seven minutes for your oral comments so that the Commissioners can have adequate time to ask their questions.

Mr. Bottelier.

**STATEMENT OF PIETER BOTTELIER  
ASSOCIATE PROFESSOR, JOHNS HOPKINS UNIVERSITY [SAIS]**

Mr. BOTTELIER. Thank you, Commissioner Wessel and thank you, Chairman D'Amato, for inviting me to appear before this Commission. The written statement I prepared for the record is too long to read in seven minutes, so I will limit myself to just a few highlights of that statement.

The Chinese banking system is entering a critical period. The reform process which started slowly in the early '90s, '93-94, and accelerated after the Asian financial crisis, I think is now in high gear. Much of that has to do with the pressure resulting from China's commitment to open fully the banking system to international participation and competition under its WTO accession terms.

I believe that the WTO terms have forcefully pushed the reform process of the banking sector in particular, but the financial system more generally, in the right direction. Much has happened in recent years in terms of the organization and governance standards for the banking sector, and I believe that most of the changes are for the better.

Chinese state banks are still state banks, but they are increasingly beginning to behave like banks and less and less as fiscal agents of the state. It sounds paradoxical but the top managers of many of these large state banks are, although Party members, predominantly technocrats and are making major efforts to impress international peers rather than political supervisors domestically.

The state-owned commercial banks, the four large ones, and the banking system as a whole, though still weak by international standards, I think, are in much better shape today than they were a few years ago. The Central Bank and the main regulatory agency for the banks, the CBRC, are improving their performance, are becoming more effective. The Ministry of Finance, which used to be the owner of these banks, has stopped using the state-owned commercial banks as cash cows for revenue purposes. They used to limit provisioning. Those limits have been lifted, and very soon a new requirement for minimum provisioning will kick in linked to the five-category loan risk classification system that the Chinese banks have adopted in 2001. Therefore, discretion on provisioning will actually be reduced.

The composition of the bank portfolios is rapidly changing. There has been a remarkable shift towards consumer lending in recent years, and much of that is related to the fact that China's urban housing stock has essentially been privatized between '97 and 2003.

This is one of the largest privatizations in history. It has gone largely unnoticed internationally, but that is driving many of the changes in the financial system as well. Mortgage lending, con-

sumer lending is now accounting for about 16 percent of total bank loan portfolios. It was almost zero in the late '90s and this percentage is rapidly increasing.

I believe that the quality of the portfolios, partly as a result of the change in portfolio composition is improving and we see reflections in that in rapidly declining NPL ratios and improving capital adequacy ratios.

Three of the large state-owned commercial banks now have NPL ratios that are within range for preparing international IPOs, and they have a capital adequacy ratio that meets the minimum international Basel standard of 8%.

All banks are rapidly reforming themselves internally and are developing as quickly as they can new sources of income other than just margins on lending, particularly financial services, and they do that in part because competition for the financial services from international banks is just around the corner, when WTO opening kicks in at the end of next year.

Much improvement is also due to the fact that three of the four large state-owned commercial banks have now been incorporated and are now limited liability shareholding companies. Ownership of those banks has shifted from the Ministry of Finance to the Central Bank, which owns these banks through a holding company called Central Huijing Investment Company. That is the company from which international prospective investors will buy shares, because it is currently the sole owner of these banks.

The NPL clean-up process is still going on. The amount of NPLs on the books of the banks and of the asset management companies that were created in '98 in order to help in the recycling process, is still very large, although much lower as a proportion of the total portfolio and of GDP than it was five years ago.

The latest statistics indicate that the aggregate NPL ratio of the four large state commercial banks was down to about ten percent at the end of June 2005 and declining rapidly. But in absolute terms, a total amount of NPLs in the total Chinese banking system including the asset management companies is still very large, and ultimately that will have to be cleaned up. That process will take many more years. I believe that if the current stock of NPLs could be frozen, that the resolution of that problem might cost something of the order of \$300 billion, which is believed to be well within the capacity of the Chinese state, even without foreign equity participation.

Most new problems in the banking system that have accumulated in recent years as a result of a big and I think unprecedented lending binge are believed to have accumulated in the smaller banks, not in the large state-owned banks. Many of the city commercial banks, locally owned banks, are potentially facing more serious problems, I believe, than the large banks.

Finally, in respect to one of the specific questions you raised, subsidies through the banking systems to favorite companies, that is extremely hard to measure. We don't really know to which extent that is still occurring. My impression from discussions with bank managers in China and from general observations is that that is less and less of a problem. To the extent de facto subsidies to favored companies are still occurring, it's probably more in the

form of unintended NPL accumulation than in the form of subsidized loans.

Internal reforms, in conclusion, are in high gear. All three banks that are in line for international listing—the Bank of China, the Construction Bank, and the Industrial and Commercial Bank—are undergoing significant internal reforms. To give you one illustration, Bank of China which is the third largest in balance sheet total and has the lowest number of staff, only about 200,000, has required all managers to resign their positions and has given these managers an opportunity to apply for new positions within the revised and streamlined structure.

If they don't get a new job after three applications, they are out. So very drastic internal reforms, consistent with the objective to improve governance standards, are ongoing.

I would like to leave my remarks at this, Mr. Chairman.  
[The statement follows:]

**Prepared Statement of Pieter Bottelier**  
**Associate Professor, Johns Hopkins University [SAIS]**

*The General Health of China's Banking System*

**Reforms and Risks in the Banking System:**

1. Intermediation through banks remains the dominant form of domestic financial intermediation in China, by far. The local stock exchanges are experiencing serious problems; they accounted for only about 1.3% of domestically intermediated new corporate finance in 2004, even less than in earlier years. Domestic debt markets are dominated by bonds issued by the Ministry of Finance and the China Development Bank. Most bond trading is in the form of repo transactions for liquidity management. The corporate bond market remains very small and underdeveloped. The interbank market has become very large and important in recent years, especially in light of open market operations by China's Central Bank (PBoC) to sterilize M2 resulting from excess foreign exchange accumulation.
2. Serious banking reform in China did not start until after the Asian financial crisis of 1997/8. Reform intensified significantly in recent years, no doubt inspired, at least partly, by China's commitment to open the sector completely to foreign investment and competition by the end of 2006 under its WTO accession terms. WTO-related pressures are forcefully pushing banking reforms in the right direction. Clarity of ownership and management responsibilities has much improved in recent. This is enhancing corporate governance standards. Regulatory agencies are becoming more effective.
3. Though still weak, the major state-owned commercial banks (SOCBs) and the banking system as a whole are in better shape now than only a few years ago; prospects for further improvement appear good. *Indirect* management of the financial system through monetary policy and regulatory agencies is gradually replacing traditional direct controls. Paradoxically, top managers of China's central bank, the regulatory agencies, and big state banks—all senior Party members and highly trained technocrats—are actively trying to reduce the Party's *political* influence on banking operations and on financial policymaking.
4. China's state banks have been gradually shedding their de-facto status as fiscal agents of the state for many years and are slowly becoming real banks, responsible for their own bottom line. It is my impression that subsidized interest rates for favored customers have become rare and that commercial risk management by the four large state-owned commercial banks (controlling about 53% of total bank assets and over 60% of deposits) is rapidly improving. The extent to which de-facto subsidies continue to flow to favored enterprises through the state-controlled financial system (e.g. in the form of NPL accumulation with local banks) is hard to gauge. Although many improvements have been and are being made, the banking system as whole remains largely state-controlled and needs to undergo significant further reform.
5. Reform progress is uneven across the spectrum of banks and continues to be marred from time to time by policy contradictions and corruption scandals. In spite of the scandals, there are many indications that risk management and cor-



porate governance standards for state banks in general are improving. Many smaller local banks—usually owned by local governments—tend to lag in this regard. The trend toward improving governance standards in the big nationally owned state banks (and undoubtedly also in some of the better managed local banks), is reinforced by strategic foreign minority participation and international IPOs (Table 1). In fact, one of the main motivations of China's state banks in seeking strategic foreign minority partners is to strengthen governance standards. "Corporate governance" has become a buzz word in China. The State-owned Assets Supervision and Administration Commission (SASAC) recently announced that it is recruiting 25 private sector managers for top executive positions in SOEs under its supervision.

6. The massive lending binge that lasted from about the last quarter of 2002 through the first half of 2004, may lead to a new wave of NPLs in coming years, especially if the current gradual economic slowdown accelerates, or in the event of a downturn in housing prices in major cities such as Shanghai where housing bubbles have developed in some segments of the market. On the other hand, if China should succeed in maintaining high growth (8–9%) in spite of a necessary slowdown in investment growth,<sup>1</sup> NPL portfolios may only level off or even continue to shrink. Since excess capacity was created in many industries during the recent lending binge, it is to be expected that China will seek external markets for surplus output. This may conflict with the need to allow the exchange rate of the RMB to further appreciate.
7. Well over 60% of reported *incremental lending* between Q4 02 and Q2 04 was accounted for by China's smaller banks, most of which are owned by local governments. These include several joint stock banks, city commercial banks, rural commercial banks and others. Loan risk management and corporate governance standards of many small banks is believed to have lagged considerably behind the large nationally owned state banks. Lending by state-owned non-bank financial institutions, a big problem in the early and mid-1990s, has been largely brought under control. In the meantime, however, informal lending in curb markets and through private credit co-ops is reported to have become important. The government recently initiated measures to try and integrate informal financial markets into the official system.
8. The share in total banking system assets of the big four SOCBs fell from 62.2% in 2000 to about 53% in 2004. Most *incremental deposits*, on the other hand continued to flow into the big four SOCBs, which means that some of the smaller banks had to borrow on the interbank market to fund their rapid loan expansion. Hence, there is a strong possibility that potentially dangerous maturity mismatches have developed on the accounts of some smaller banks. In the event of a sharp downturn in the economy and/or a housing price collapse in big cities, this could become a source of instability in the banking system. China's central bank (PBoC) created a Financial Stability Department which is empowered to intervene to protect system stability in the event of local bank runs. A national banking crisis, though technically possible, seems very unlikely under present circumstances.

#### **Selected Indicators of Change and Progress:**

1. Much has been done to clarify the ownership of state banks and the responsibilities of their managements and boards. This is making it easier to improve corporate governance standards at the level of individual banks.
2. Two of the four large SOCBs, China Construction Bank (CCB) and Bank of China (BOC) received a major capital injection from forex reserves, (\$22.5 bn each) at the end of 2003 and were transformed into limited liability shareholding companies in 2004. CCB announced recently that Bank of America and Temasek of Singapore will purchase strategic minority shareholdings of 9.1% and 5.1% respectively. BofA has an option to increase its share to 19.9%. Many other foreign minority participations in Chinese banks have been negotiated in recent years or are under negotiation (Annex Table 1).
3. The maximum share of a single foreign shareholder in a Chinese state bank under current Chinese regulations is 20%; the maximum share for all foreign shareholders together is at present 25%. The latter ceiling will have to be lifted when the major state banks go forward with their planned international IPOs.

<sup>1</sup>China's gross investment/GDP ratio has reached an all time high of about 46% in the first half of 2005. Economic policymakers agree that this unusually high ratio is not sustainable, but there seems to be no consensus on how much and how quickly investment growth should be reduced.

4. BOC is reported to be negotiating with Royal Bank of Scotland, Morgan Chase, UBS, Temasek and Deutsche Bank for strategic minority participation(s). Both CCB and BOC are preparing international IPOs. CCB is likely to go first, perhaps as early as the fall of 2005. The IPO for CCB may be \$5 bn or more. For BOC's IPO the amount most recently mentioned is \$3–5 bn. CCB is reported to be considering London and Singapore for listing (perhaps to avoid the extra costs for a New York listing associated with Sarbanes Oxley), while BOC is believed to prefer New York. Both will probably also list in Hong Kong and on the domestic stock exchanges. Conditions for listing in the U.S. by Chinese state companies appear unfavorable at the present time.
5. The accounts of BOC and CCB have been audited by international auditing firms since 2003 and 2004 respectively.
6. Industrial and Commercial Bank of China (ICBC), the largest of the four SOCBs was transformed into a limited liability shareholding company during H1 05 after receiving a capital injection of \$15 bn in April—also from forex reserves—and disposing of an additional \$85.2 bn of NPLs (through AMCs and otherwise). As a result, ICBC lowered its NPL ratio from 19% at the end of 2004 to 4.58%, and increased its CAR to 8.07% by the middle of 2005. ICBC also engaged international auditors and is negotiating strategic minority partnership(s) with several international banks (Table 1 and Chart 4) in preparation for an international IPO at a later date.
7. Agricultural Bank of China (ABC), by far the weakest of the big four SOCBs, remains in very poor financial condition (Chart 4). There appears to be no plan at present for conversion to a limited liability shareholding company, but a number of internal reforms are underway.
8. Many *urban* credit co-ops (UCCs) have been consolidated and converted into city commercial banks, while many *rural* credit co-ops (RCCs), traditionally the weakest part of China's financial system, are being consolidated and converted into rural commercial banks, after recapitalization. The financial performance of rural commercial banks so far has been significantly better than that of the RCCs they replaced.
9. The Ministry of Finance stopped using SOCBs as cash cows for fiscal revenue purposes some years ago. Restrictions on provisioning were removed and the onerous Business Tax on state banks is gradually being reduced. Control over the major state banks has shifted from MOF to PBoC (since early 2004 through its newly created holding company for incorporated state banks: Central Huijing Investment Company) and the China Banking Regulatory Commission (CBRC).
10. CBRC, created in 2003 to take over regulatory and bank supervision functions from PBoC, recently introduced minimum provisioning standards for banks, linked to the international loan risk classification system which was adopted by China in 2001. These standards are expected to become effective later this year.
11. The share of non-SOEs in incremental lending in recent years has been over 50%. An important loan-risk-classification bias that used to encourage state banks to lend primarily to SOEs was removed in 2004. Consumer loans to households (mortgages, car loans), together with loans to agricultural households for working capital, have been the most rapidly growing loan categories in recent years. Loans to households accounted for 16% of the aggregate banking sector portfolio at the end of 2004; the number was almost zero in 1997 (Chart 1). As a proportion of total lending, consumer loans are still relatively modest in China (Chart 2).
12. The shift in lending to non-SOE borrowers was reinforced by the enormous boost to the construction industry (public and private) and to consumer loans for mortgages and home improvement that resulted from the privatization of almost all urban housing in China between 1997 and 2003. This was probably one of the largest privatization programs in history and also a huge wealth redistribution program, because transfer prices were generally far below market value. The recent introduction of asset-backed securities on China's domestic capital market is an outflow of the rapid development of mortgage lending in recent years.
13. Special windows for lending to private small and medium sized enterprises (SMEs) are under preparation in several state banks. Much training to equip loan officers with skills for new risk assessment and coaching tasks is being provided. To increase SME access to equity capital, a special board for SMEs was opened at the Shenzhen stock exchange recently.
14. Reported NPL *ratios* have fallen sharply since 2001. Among China's state banks, China Development Bank, one of three "policy banks" created in 1994, has the lowest NPL ratio—1.21% at the end of 2004. CCB and BOC reported to have NPL ratios of 3.7% and 5.1% respectively at that time (Charts 3 and 4).

15. The four state-owned Asset Management Companies (AMCs) created in 1998 to take over part of the NPL portfolio of SOCBs and recycle these assets through auctions, direct sales, debt/equity conversions and debt restructurings, are reported to have disposed of 57.3% of their assets by the end of June 2005. Their average asset recovery rate since the beginning of their operations was 25.6% and their average cash recovery rate 20.7%. The progress of AMCs has been much slower than was originally projected. Their costs are not reflected in the recovery rates cited. MOF is responsible for their ultimate losses.
16. The remaining amount of reported NPLs on the books of state-owned banks and AMCs is still very large, probably of the order of \$350–400 bn (22–25% of GDP). There is no reliable estimate for the amount of unreported NPLs in the system; it could be another \$100–150 bn. The amount of reported NPLs will probably increase in the event of an accelerated economic slowdown or a housing price collapse in major cities. Ultimate losses associated with absorbing the remaining stock of currently reported NPLs would be of the order of \$260–300 bn, which is well within the capacity of the Chinese state to finance, even without additional foreign equity participation in state banks.
17. The capital asset ratios (CAR) of CCB and BOC at the end of 2004 were reported to be 9.4% and 10% respectively, above the minimum international (Basel) standard of 8%. After its reform during H1 05, ICBC also reached a CAR of 8% (Table 2).
18. The liberalization of domestic interest rates is progressing slowly; it may take many more years before all rates are essentially market-determined. Late 2004, the ceiling on lending rates (except for RCCs, UCCs and mortgage loans) was removed for the first time since the start of China's market reforms in 1978. Since state banks are highly liquid and compete for market share, average lending rates have increased more slowly in response to this measure than might otherwise have been expected. Deposit rates remain controlled.
19. China has been a member of the Bank for International Settlements (BIS) in Basel since 1996 and is currently working to adopt and implement the "Revised Framework for International Convergence of Capital Measurement and Capital Standards," known as Basel II (2004). China is adopting international standard in many areas, because it believes that this is in the nation's best interest.
20. To improve operational efficiency, BOC is aggressively downsizing its staff (over 200,000 at the beginning of this year) and reforming its internal management and information systems. All managers were required to resign their old position and were given the opportunity to apply for new positions in a flatter, streamlined organization. Those who do not find a new position after 3 applications are out. CCB (over 300,000 staff) is following a different plan for its internal reorganization.
21. To reduce costs, all four SOCBs have closed numerous redundant branch offices since the late 1990s. At the end of 2003, together they had about 80,000 domestic branches, about half the peak number of 1995. Earlier, in 1997, PBoC had reduced the number of its branches from 33 (one for each province or autonomous region) to 9 regional offices, essentially on the model of the U.S. Federal Reserve system.
22. To better compete with foreign banks and broaden their earnings base, many domestic banks in China are actively developing financial services for their corporate and household customers, including debit cards, credit cards, investment advice, fund management, etc.
23. The American Bankers Association is about to sign a contract with CBRC for a national training and professional certification program for commercial bank managers and staff in China.
24. Cooperation between East and Southeast Asian central banks in the form of automatic forex swap arrangements and periodic consultations under the "Chiang Mai Initiative" of 2000 (originally a Chinese proposal), is intensifying. The objective is to promote regional economic integration and development of common capital markets.

Table 1. Foreign Equity Participation in Chinese Banks

Annex

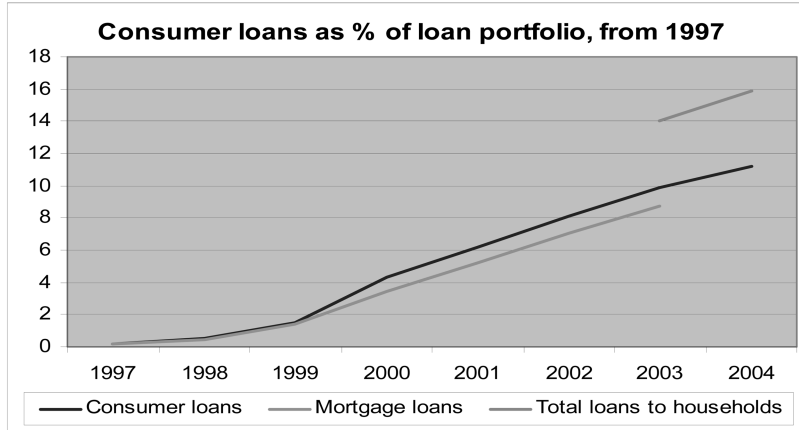
Target bank	Acquiring bank	Stake	Investment in \$mn	Year
China Everbright Bank	ADB	3.03%	?	1996
Bank of Shanghai	IFC	7.0%	50.3	1999
Bank of Shanghai	HSBC	8.0%	63	2001
Nanjing City Commercial Bank	IFC	15.0%	27	2002
Shanghai Pudong Dev. Bank	Citigroup	5.0%	73	2003
Industrial Bank	Hang Seng Bank	16.0%	208	2003
Minsheng Bank	IFC	1.2%	23.5	2003
Minsheng Bank	Hang Seng Bank	8.0%	?	2003
Minsheng Bank	Temasek	?	?	2003
X'ian City Commercial Bank	IFC	12.5%	19.9	2003
X'ian City Commercial Bank	Bank of Nova Scotia	2.5%	3	2004
Bank of Communications	HSBC	19.9%	2,225	2004/5
Shenzhen Development Bank	Newbridge Capital	17.9%	149	2004
Jinan City Commercial Bank	Commonwealth Bank of Australia	11.0%	17	2005
Bohai Bank	Standard Chartered	19.9%	120	2005
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	19.9%	76	2005
Bank of Beijing	ING	19.9%	215	2005
Nanchong Commercial Bank	German Investment and Development Bank	13.0%	4.8	2005*
CCB	Bank of America	9.1%	3,000	2005*
CCB	Temasek (S'pore)	5.1%	1,400	2005
BOC	UBS	?	500 ?	#
BOC	Royal Bank of Scotland	10%	2,500	2005*
BOC	Morgan Chase	?	?	#
BOC	Deutsche Bank	?	?	#
BOC	Temasek	?	1,000 ?	#
BOC	ADB	?	?	#
ICBC	Goldman Sachs & Allianz	?	1,000 ?	#

Sources: press announcements; Federal Reserve Bank of San Francisco

\* Pending.

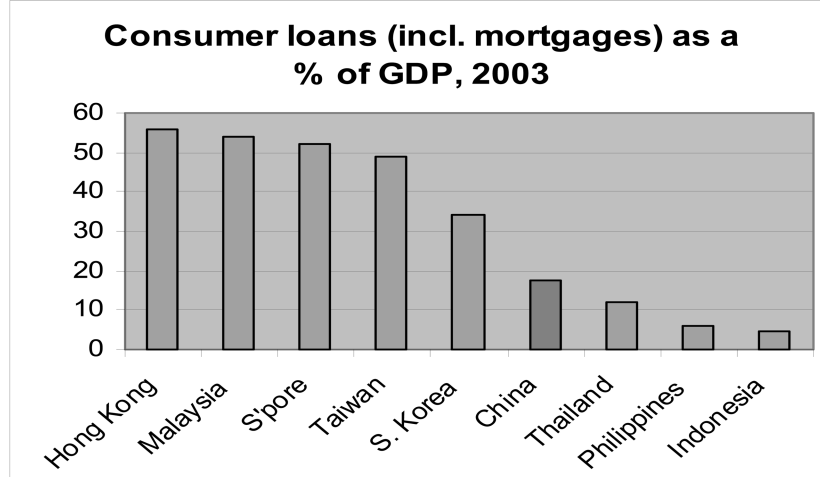
# Reported to be under negotiation; no official announcements have been made.

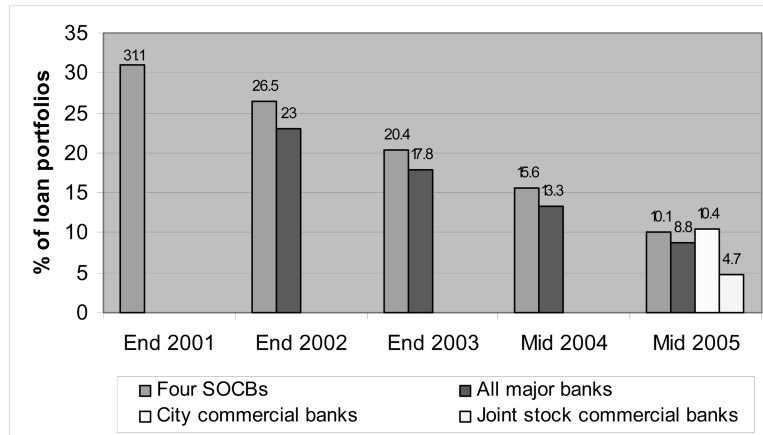
**Chart 1. Consumer lending rose from almost zero 8 years ago to 16% of aggregate bank loan portfolio by the end of 2004**



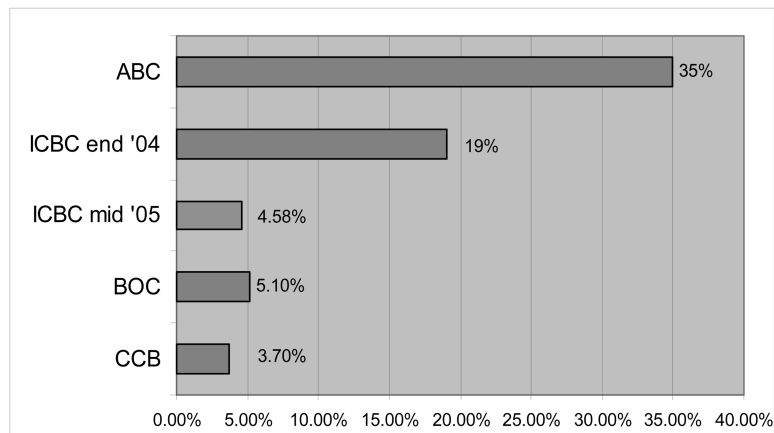
Note: the difference between the green line and the blue line is working capital loans to farm households.

**Chart 2. Consumer lending in China (as % of GDP) is still modest compared to Asian economies with more advanced financial systems**



**Chart 3. Reported NPL ratios for various groups of banks, end 2001 – June 2005**

Source: China Banking Regulatory Commission (CBRC)

**Chart 4. Reported NPL ratios for the four main State-owned commercial banks (SOCBs) end 2004 (incl. ICBC for mid-2005)**

Sources: China Banking Regulatory Commission (CBRC) and individual bank reports. **ABC**: Agricultural Bank of China. **ICBC**: Industrial and Commercial Bank of China.

**BOC**: Bank of China. **CCB**: China Construction Bank.

**Table 2. Capital adequacy and NPL ratios for the three leading SOCBs**

Name of Bank	Date	CAR	NPL ratio	Provisioning ratio
ICBC	June 2005	8.07%	4.58%	
BOC	Dec. 2004	10.04%	5.12%	68.02%
CCB	Dec. 2004	9.4%	3.7%	

Sources: reports of CCB and BOC; press announcements by ICBC and CBRC

Cochair WESSEL. Thank you. We look forward to reading your full statement in the record. Dr. Meyer, please.

**STATEMENT OF MARSHALL W. MEYER  
RICHARD A. SAPP PROFESSOR OF MANAGEMENT AND SOCIOLOGY  
WHARTON SCHOOL OF BUSINESS, UNIVERSITY OF PENNSYLVANIA**

Dr. MEYER. Chairman D'Amato, Commissioners, I really appreciate the opportunity to appear before you this morning. China's banking system and its banking problems are of immense proportion. As you know, China has four large commercial banks, about 14 national commercial banks like Everbright, Huaxia, Minsheng, et cetera, 113 city commercial banks, and about 3,500 rural credit cooperatives. Even in Beijing, there's a rural credit cooperative, I noticed.

As mentioned, these are huge organizations. Bank of China has about 203,000 employees, about 12,000 branches today—the number is coming down—and 1.5 billion active accounts. Until 2003, the banks were extensions of government. They did not have independent legal status which state-owned enterprises have enjoyed since 1988.

Bank personnel were civil servants and not accountable for performance. Their loyalty, not surprisingly, was as much to government officials as it was to the bank's headquarters in Beijing.

Since 1994, many steps have been taken to place the banks on a sound commercial basis. One of the first steps was the creation of the three policy banks—the China Development Bank, the Agricultural Development Bank, and EX-IM Bank—in an effort to remove the policy function from the large commercial banks.

Recently, there have been efforts to centralize control of the large commercial banks. Provincial branch managers, at least in principle, are now appointed by and accountable to headquarters rather than local politicians. Local branch offices have become profit seeking rather than asset seeking. And nonperforming offices in the poorer counties have been closed or shifted to the policy banks.

Importantly, risk management has been consolidated. Today in the Bank of China only 35 provincial level branches as well as the headquarters, of course, can approve loans or credit facilities. The large commercial banks were also recapitalized in 2003, as you know.

Huijin, a holding company created by PBOC, borrowed from Chinese reserves and injected, I believe, \$22.5 billion each into Bank of China and China Construction Bank.

Nonperforming loans were shifted into asset management companies. There's one for each of the large four commercial banks. And the large commercial banks at the same time were separated from the government, reorganized with shareholding companies, and of course given boards of directors. As mentioned, initially there's a single shareholder, Huijin. Ultimately shareholding will be diversified as shares are listed and foreign investors are attracted.

Now, despite these reforms, which have been substantial, many of the people I talk to report that the NPLs remain a problem. How much of a problem is unclear because from time to time loans that are about to be classified as nonperforming are covered by new loans.

The root cause of the persistent NPL problem is also unclear. The simplest and the most common explanation is that banks retain their policy function. Loans are by command despite improvement in and centralization of risk management. However, research on the NPLs by the Development Research Center of the State Council suggests that this is not entirely the case.

The DRC's research finds that about 30 percent of NPLs arise from government intervention in banking decisions. This is the policy function. And additionally, about 30 percent of NPLs are due to corruption, 15 percent due to bankruptcies, mainly of state-owned enterprises, and about 15 percent of NPLs are due simply to poor banking judgment. I've left out ten percent there because the total only added up to 90 percent. Forgive me. There are other and perhaps more fundamental problems as well. The business model of the Chinese banks remains rudimentary: take deposits, make loans, and live on the spread. There are few, if any, fee-based financial products and services, at least today. The performance of the Chinese banks thus is closely tied to the performance of the Chinese economy. The exposure to macroeconomic risk is exacerbated by two other factors:

First, since Chinese capital markets are poorly developed, most household savings go into the bank accounts, and for the same reason the firms, to the extent they are now allowed to borrow, rely on bank loans rather than equity financing.

Second, as the banks constrict credit, the SOEs and local governments tend to sell off real estate to raise cash and this balloons mortgage lending and contributes to the property bubble in China.

The solution that is proffered to these problems is corporate governance; reorganize the banks as shareholding companies, recruit independent directors, seek foreign investors and place board representatives of these investors on risk management committees, recruit seasoned managers and centralize control while introducing innovative and profitable financial products.

The mantra of corporate governance, in other words, envisions top down reform of the banks. Whether top down reform is possible in structures as large and politically embedded as the big four commercial banks is uncertain. Reforming legacy firms in the U.S. or anywhere is very difficult.

Reforming the Chinese banks may prove even more difficult because China, though politically centralized, has been economically decentralized since the beginning of the reform era. Chinese firms are overwhelmingly local and small by global standards. Large centralized firms, save for state-quasi-monopolies in the utility, petrochemical, telecom sectors are quite rare.

Perhaps of greater concern, a gap between the rhetoric and the reality of corporate governance opened last fall. In November of 2004, the executives of the top four Chinese telecoms—China Telecom, China Mobile, China Unicom and China Netcom—were reshuffled by the government. The reshuffling occurred without consultation with the telecoms' boards of directors.

To the best of my knowledge, no independent directors of the telecoms have resigned and none has spoken out publicly.

Despite these issues, the lure for foreign investors is substantial. The size and more importantly the growth potential of the Chinese



market is unmatched anywhere else in the world. Where else can you find 1.3 billion potential customers and eight to ten percent annual growth?

There is also, and very importantly, a substantial advantage afforded foreign banks investing in the big four commercial banks and in the national commercial banks: instant access to markets throughout China.

Foreign banks investing in the smaller city banks gain access only to local markets. Foreign banks seeking to open *de novo* branches in China must negotiate tedious licensing procedures city-by-city or province-by-province. Still, WTO poses huge risks for Chinese banks with or without foreign investors. Their liquidity could be threatened by relaxation of currency controls and a rapid outflow of deposits from China. Their best and potentially most profitable customers, the customers for fee-based services, could be lost to foreign competitors.

There is also an important mitigating factor: China has no choice but to reform its banks. The alternative is nearly unimaginable. The reform of state-owned enterprises has been more rapid and more successful than most people predicted.

It is possible that pragmatism will overcome inertia and that the banks will repeat the performance of the SOEs. As one very senior banker put it: "This is a revolution. If everything is normal, we can overcome the problems. The way is difficult, but the light is ahead."

[The statement follows:]

**Prepared Statement of Marshall W. Meyer  
Richard A. Sapp Professor of Management and Sociology  
Wharton School of Business, University of Pennsylvania**

Thank you for the opportunity to appear before the Commission.

China's banking system and banking problem are of immense proportions. China has four large commercial banks (Agricultural Bank of China, Bank of China, China Construction Bank, Industrial and Commercial Bank of China), fourteen national commercial banks (e.g., Everbright, Huaxia, Minsheng), 113 city commercial banks, and about 3,500 rural credit cooperatives. The big four commercial banks are huge organizations. The Bank of China, for example, has more than 200,000 employees, 12,000 branches, and 1.5 billion active accounts. Until 2003, the banks were extensions of government—both the central and local government. The banks did not have independent legal status, which state-owned enterprises have enjoyed since 1988. Bank personnel were civil servants and not accountable for performance. Their loyalty, not surprisingly, was as much to government officials as it was to the bank's headquarters in Beijing.

Since 1994 steps to place the banks on a sound commercial basis have been taken. The first step was the creation of three policy banks, the National Development Bank, the Agricultural Development Bank, and Export-Import Bank, in an effort to remove the policy function from the commercial banks. Recently there have been efforts to centralize control of the big four commercial banks. Provincial branch managers are now appointed by and accountable to headquarters. Local branch offices have become profit-seeking rather than asset-seeking, and nonperforming offices in poorer counties have been closed or shifted to the policy banks. Importantly, risk management has been consolidated. Today, in the Bank of China, only 35 provincial-level branches can approve loans or credit facilities. The large commercial banks were also recapitalized in 2003. Huijin, a holding company created by the Peoples Bank of China, borrowed from China's foreign reserves and then injected more than US\$20 billion each into the Bank of China and China Construction Bank. Nonperforming loans were shifted into asset management companies. Capital ratios improved and NPLs declined as a consequence. At the same time, the large commercial banks were legally separated from the government and reorganized as shareholding companies with boards of directors. Initially, there was a single shareholder, Huijin. Ultimately, shareholding will be diversified as shares are listed and foreign investors are attracted.

Despite these reforms, challenges remain. NPLs are still a problem. How much of a problem is unclear because loans about to be classified as nonperforming are often covered by new loans. The root cause of the persistent NPL problem is also unclear. The simplest and most common explanation is that the commercial banks retain their policy function: loans are still by command despite improvement in and centralization of risk management. However, research on NPLs by the Development Research Center of the State Council suggests that this is not entirely the case. The DRC's research finds that about 30 percent of NPLs arise due to government intervention in the banking decisions, 30 percent are due to corruption, 15 percent are due to bankruptcies, mainly of state-owned enterprises, and 15 percent are the result of poor banking judgment. There are other and, perhaps, more fundamental problems as well. The business model of Chinese banks is rudimentary: take deposits, make loans, and live on the spread. There are few if any fee-based financial products and services. The performance of the Chinese banks, thus, is closely tied to the performance of the Chinese economy. The exposure to macroeconomic risk is exacerbated by two additional factors. Since Chinese capital markets are poorly developed, most household savings go into bank accounts; for the same reason, firms, to the extent they can borrow, rely on bank loans rather than equity financing. Moreover, as the banks constrict credit, SOEs and local governments sell off real estate to raise cash, ballooning mortgage lending and contributing to the property bubble.

The solution proffered to these problems is corporate governance: reorganize the banks as shareholding companies, recruit independent directors, seek foreign investors and place board representatives of foreign investors on risk management committees, recruit seasoned managers, and centralize control while introducing innovative and profitable financial products. The mantra of corporate governance, in other words, envisions top-down reform. Whether top-down reform is possible in structures as large and embedded as the big four commercial banks is uncertain. Reforming legacy firms in the U.S. has proved difficult; reforming the Chinese banks may prove more difficult because China though politically centralized has been economically decentralized since the beginning of the reform era. Chinese firms are overwhelmingly local and small by global standards. Large centralized firms, save for state quasi-monopolies in the electricity, petrochemical, and telecom sectors, are unusual. Perhaps of greater concern, a gap between the rhetoric and the reality of corporate governance in China opened last year. In November 2004 the executives of the top four Chinese telecoms, China Telecom, China Mobile, China Unicom, and China Netcom, all listed companies, were reshuffled by the central government. The reshuffling occurred without consultation with the telecoms' boards of directors. To the best of my knowledge, no independent directors have resigned and none have spoken out publicly.

Despite these problems, the lure for foreign investors is powerful. The size and, more importantly, growth potential of the Chinese market is unmatched elsewhere in the world: where else can 1.3 billion potential customers and 8–10 percent annual growth be found? There is also a substantial advantage afforded foreign banks investing in the big four and national commercial banks: instant access to markets throughout China. Foreign banks investing in the smaller city banks gain access only to local markets; foreign banks seeking to open *de novo* branches in China must negotiate tedious licensing procedures city by city and province by province. Still, WTO poses huge risks for Chinese banks with or without foreign investors. Their liquidity could be threatened by relaxation of currency controls and a rapid outflow of deposits from China. Their best and potentially most profitable customers, customers for fee-based services, could be lost to foreign competitors.

There is also an important mitigating factor. China has no choice but to reform its banks. The alternative is nearly unimaginable. The reform of state-owned enterprises has been more rapid and more successful than most people predicted. It is possible that pragmatism will overcome inertia and that the banks will repeat the performance of the SOEs. As a senior banker put it, "This is a revolution. If everything is normal we can overcome the problems. The way is difficult but the light is ahead."

## **Panel II: Discussion, Questions and Answers**

Cochair WESSEL. Thank you. Commissioner Mulloy for the first questions.

Commissioner MULLOY. I want to thank you both for your testimony. Dr. Meyer, you've actually presented this in a way that I can

really understand what you're talking about. I want to commend you for that.

I want to raise an issue with you and help me think it through. You talk about the foreign investors wanting to be in China because they get 1.3 billion potential customers and they have eight to ten percent annual growth. Much of that annual growth depends upon exporting.

It seems to me they have more and more export-led growth going on in China. I don't know whether—

Dr. MEYER. That's correct.

Commissioner MULLOY. That's correct. Yes.

Dr. MEYER. Last year I think it was about 600 billion.

Commissioner MULLOY. Okay.

Dr. MEYER. About 60 percent from foreign-invested companies.

Commissioner MULLOY. Now, part of managing an export-led growth economy is the exchange rate issue, which we've been talking about with them. Obviously if the exchange rate—what some people think—is 40 percent undervalued, will reach what some people think it should be, that would have an impact on their export-led growth because there would be less investment flowing in and probably more imports and fewer exports. So I think there is some connection between that and the annual growth rate of ten percent.

Now one of the reasons that people say we can't push them too hard on moving their currency is because they have so many problems in their banking system. They can't float the currency, and you allude to that in your testimony saying this WTO thing would threaten the liquidity because of relaxation of currency controls.

Help me understand. What is the WTO going to do that will interfere with their ability to keep their currency controls? How does that work?

Dr. MEYER. You'll have to forgive me. I'm not an expert on the provisions of WTO, but I believe that there's a commitment ultimately to make the RMB, the capital accounts RMB convertible.

Maybe someone else here knows whether that is the case. But to the extent that convertibility occurs, the deposits are going to flow out of the banks. Why is that? Well, there is ample evidence. First of all, look at the return that the Chinese households are getting on their bank deposits. It's very, very small. I don't know the number, what it is today, but it's very, very small.

Second, if you look in general, the return on capital in China is much, much lower than outside of China. The numbers I don't have at my fingertips, but they're easily accessible. So there are all kinds of pressures for currency to go out of the country. Now, revaluing that currency upward also exacerbates that pressure because it buys more as it goes upward.

There's another element to revaluation. I don't want to go down this track and take a great deal of time on it—

Commissioner MULLOY. Yes.

Dr. MEYER. —which is also I think very significant, and that is Chinese agriculture. Chinese farm prices are actually well above Western farm prices, and the government subsidies to the consumers there are fairly substantial.

Right now, 60 percent of the Chinese population roughly is agriculture, which means 40 percent of the people are actually buying

food; the rest are eating what they grow. And ten percent of that 40 percent is already imported. And that takes quite a whack out of the farmer's income.

I've heard from folks in the Chinese embassy and lots of other folks, that there's grave concern that as the currency goes up, more and more food is imported into the country, and it socks the local farmers—

Commissioner MULLOY. Yes.

Dr. MEYER. —who are already not in great shape right in the pocket.

Commissioner MULLOY. Yes. Let me just finish up by asking Mr. Bottelier, do you have a clear vision on what this WTO commitment, which I think has to be phased in by the end of next year, to let foreign banks into their market and then take deposits, what that would mean to their ability to manage their currency?

Mr. BOTTELIER. There are two things, Mr. Mulloy. China is committed to open its banking sector completely by the end of a five-year adjustment period, which is the 11th of December next year. After that, foreign banks should be able to enter the Chinese market under national treatment conditions, that means that there should be no difference between the way national and international banks are treated.

That's an unusual degree of opening for a developing country. It is completely different from the currency issue you raised; there is no provision in the WTO charter or in China's accession conditions on capital account opening or currency management.

Commissioner MULLOY. But if the banks can get in there and take deposits, that will make it much more difficult to manage their currency, won't it, because they can't keep the capital controls on the way they do now?

Mr. BOTTELIER. No, the capital controls—

Commissioner MULLOY. Is that correct or not?

Mr. BOTTELIER. Excuse me, Commissioner. The capital controls are unaffected by the opening to foreign banks. Foreign banks are indeed, should be able to attract deposits both from families and corporations without any restrictions from December next year onward. That has no effect whatsoever on China's management of the currency or on capital controls.

Commissioner MULLOY. Because the foreign banks won't be able to take the capital out of the country?

Mr. BOTTELIER. That's correct. They're subject to the same capital controls as national banks.

Commissioner MULLOY. Thank you.

Cochair WESSEL. Thank you, Commissioner Mulloy. Has the framework for the transition been set? Have they begun to identify the laws and the legal structure for the full national treatment that will occur next year? Mr. Bottelier?

Mr. BOTTELIER. I cannot answer that in the detail you might expect. The Chinese legal regulatory framework is being adjusted to the WTO requirements. Literally thousands of laws and regulations have been adjusted, newly drafted, in order to make the system consistent with the WTO framework. The particular regulations for the banking system, how far long they are, I cannot answer your question precisely.

Cochair WESSEL. As you gain information on that, if you could share that with us, that would be very helpful.

Mr. BOTTELIER. I will be happy to.

Cochair WESSEL. In your testimony, you talk about the potential, assuming I'm reading this correctly, that there may be a new wave of NPLs in the coming years. Could you elaborate on that, and Dr. Meyer, if you could respond to that question as well?

Mr. BOTTELIER. I put it in my testimony because the NPL picture, as Dr. Meyer, I think, correctly emphasized, is a very complex one. It is not easy to read off the shelf what exactly is happening. The overall indicators suggest NPL ratios have come down sharply for the entire banking system and particularly for the big four.

Having said that, I thought it was important to draw your attention to the fact that from the third or fourth quarter of 2002 through the first half of 2004, there has been another unusual expansion of bank lending in China.

Part of that was, I think, to avoid sharp economic slowdown following the SARS epidemic, but it has led to an unusual increase in the investment ratio, and most of the incremental lending during this period did not come from the big four state-owned commercial banks but from the dozens of smaller banks, most of which are locally owned and not necessarily adhering to same standards. Since most of the deposits have continued to flow to the large four, there is a serious possibility that much of the incremental lending by these smaller banks was financed from short-term borrowing on the inter-bank market, which may have created potentially dangerous maturity mismatches.

Cochair WESSEL. And those banks are not the ones that will be participating in the international markets for—

Mr. BOTTELIER. Well, some of them are.

Cochair WESSEL. The smaller ones?

Mr. BOTTELIER. Some of the smaller city commercial and local development banks, which are incidentally not all that small, are already internationalized. They are incorporated. Some of them already have foreign minority participation.

Cochair WESSEL. Okay. Thank you.

Mr. BOTTELIER. Some are listed, in fact. But the better-managed ones amongst them will not have misbehaved. The majority, however, are not yet listed, and I would not be surprised if at some point, if the economy turns down more sharply than currently expected, or if the property markets in Shanghai and some other city collapses, that we will find that some of these smaller banks find themselves in acute liquidity problems, because they borrowed short and lent long.

So the maturity mismatch on their balance sheets may become a problem. That could lead to isolated banking difficulties and instability here and there. My suggestion was that there may be another wave of NPL coming as a result of the lending binge I referred to. It's uncertain. If the economy slows down on a more orderly pattern, there is a good chance that that will not happen, and that the NPL portfolio will merely stabilize or shrink more slowly than has been the case in recent years.

Cochair WESSEL. Dr. Meyer, do you agree with that assessment?

Dr. MEYER. I'd like to illustrate Mr. Bottelier's point very briefly. To illustrate the cyclical nature of the NPLs, as Mr. Bottelier pointed out, the SARS epidemic opened a wave of lending. There was a lot of lending to households for purchases of automobiles. Folks were a little wealthier; they didn't want to ride the bus during SARS, et cetera.

It turns out in a relatively short period of time about a third of the purchasers and their vehicles simply vanished. And the central government then clamped down severely on auto loans leading to the current tailspin in the auto industry.

One of the big issues in China is the poorly developed state of the consumer credit system. There's some experiments going on in Shanghai, some experiments going on in Beijing, but basically China still has nothing approaching the credit reporting systems that we have in the United States and, hence, household loans, except for real estate loans because real estate does not walk away, are still quite risky.

Cochair WESSEL. Okay. Thank you. Commissioner Wortzel.

Commissioner WORTZEL. Thank you very much. I would like to pursue the comments that you made about Huijing, Dr. Meyer. This holding company borrowed from foreign reserves, as I understand it, and then used that to recapitalize People's Bank of China, or Bank of China and China Construction Bank. How is that transaction or loan carried on the balance sheets of the foreign reserves?

I'll follow that up with a second question for both of you.

Dr. MEYER. I think I'm going to have to defer to Mr. Bottelier on that. I don't know the answer to that.

Commissioner WORTZEL. Okay. I ran into a situation—I think it was about 2000. Shenyang Iron and Steel had thousands of retired workers, 50, 60,000 retired workers, who were ordered to take their savings out of the bank and buy bonds in Shenyang Iron and Steel which wasn't producing, and those bonds were used to capitalize the company because the workers hadn't been paid, the retirees hadn't been paid, and then they were paid.

They put the money that they were paid in part back into the bank and then the bank loaned the money to the company so it could continue to function. Now, it strikes me that that's kind of a shell game. What happens if a bunch of depositors want to life up a shell, in other words, if they want to take their money out of the bank and put it in a foreign bank when a foreign bank can receive those deposits? What's that going to do up in a place like Shenyang to stability, to the viability of the industry?

Dr. MEYER. I think that's the issue of capital controls. Lift those capital controls and I think the scenario you described could occur in many places in China, and hence a high likelihood that the capital controls will be retained for some while in China.

Commissioner WORTZEL. Because they can't afford to open? It would be too unstable to them.

Dr. MEYER. Just a street-level observation. Something new in China starting July 1. They're beginning to enforce seriously the regulation that you can't carry more than I believe 20,000 RMB out of the country. I'm not sure of the exact number because I didn't come anywhere near it, but for the first time, you now have to fill

out paperwork specifying how much currency and whose currency you're carrying out of the country.

Commissioner WORTZEL. The foreign reserves balance?

Mr. BOTTELIER. Well, you raised two very interesting but very different matters, Commissioner. If I may address the first one first on the recapitalization of three of the banks, not two, but three, through Central Huijing. That surprised the financial community. It was an unorthodox transactions, and I'm not sure that we know all the details, but let me describe what I know.

The Central Bank created this new holding company, Central Huijing Investment Company, to which it lent a certain amount of foreign exchange. So on the balance sheet of the Central Bank, forex reserves were replaced by a claim on Central Huijing, still in foreign exchange.

Then Central Huijing invested that money in the form of equity, first in two banks and later in a third; a total amount of \$60 billion has been transferred in that way. That in itself is also unorthodox, because these are local banks and they have been recapitalized, in part with foreign exchange, so that foreign exchange cannot be immediately converted into local currency without causing potential inflationary, so there are restrictions.

So you have a chain of accounting transactions which are genuine. Real resources have been transferred and it is a real capitalization, to my knowledge, it had never been done in this fashion before. So on the specific question you raised, what happened on the balance sheet of the Central Bank, it surrendered forex reserves in lieu of a claim on Central Huijing. Central Huijin will at some point have to compensate the Central Bank.

On what terms that money was made available to Central Huijing, I don't know. That has not, to my knowledge, been made public.

Now, on the question you raised on the Shenyang retirement workers, I'm not familiar with the details, but I believe the implication of your question was what will happen if foreign banks can take deposits locally? Therefore, the capital account restrictions don't really come in here.

I believe that is a serious risk, a risk that China accepted by entering in the WTO on these terms. The experience internationally is that foreign banks do not quickly gain a large proportion of the total deposit base in a country, and it probably will not happen in China either, but if we take a five to ten year horizon, there is a prospect that indeed a lot of local depositors will feel safer putting their money in for example Deutsche Bank or Citibank, rather than keeping their money in a local bank in Shenyang. So that is a real risk and I think that is precisely at the heart of what is going on in China. That is why there is so much pressure on these banks to become banks.

Commissioner WORTZEL. Thank you very much.

Cochair WESSEL. Thank you. Chairman D'Amato.

Chairman D'AMATO. Thank you very much, Mr. Chairman. This is a very, very interesting discussion. I have a lot of trouble understanding how the Chinese are going to, quote, "open" their banking system up by the end of 2006 and retain a Leninist structure of power in China.

To me an open banking system means that—I come from the Senate where the power of the purse is the most important power of the Congress. Clearly, the power of the purse in shifting the structure of power in the banking system away from centralized political control would end this political structure, in my opinion.

I don't know how it could happen otherwise. I don't know how anybody can answer that, but if there's going to be truly an open banking system, there is going to be change in this political structure it seems to me that follows.

Power follows the money. And by the way, I also want to commend you for making a presentation that Commissioner Mulloy understands.

Only kidding. I have one quick question. And that is we have all these banks, all are rated at the bottom by the rating houses, that want to come in with IPOs. I want to understand what IPOs have to do with the bank opening process. To me, these IPOs, and what I understand are not necessarily billions of dollars that are absolutely needed by these banks, but are an opportunity for these banks to grab additional money off the international capital market just to get it.

Maybe I'm wrong in that understanding, but that's what my understanding is. What do the IPOs of these banks have to do with bank opening? Anything at all? Can you tell me, either one of you?

Mr. BOTTELIER. May I address your first question first, on the possible links between financial system reform, banking reform and political reform, I totally agree with you. It is hard to imagine that you cede real power to banks without also ceding political power. And that is a process, in fact, that is going on. One of the paradoxes of the whole Chinese reform process is that this is a one-party state which has created real markets, and markets have real power, and that process is still going on. And they know it.

How they think that through and how that is understood is quite frankly beyond most of us, but this is the reality of the Chinese reforms and is one of its remarkable paradoxes. I know a number of the senior managers in the state banking system; they're all highly trained technocrats, and as I mentioned in my introductory remarks, these people look now to the internationalization of their operations as an opportunity to become internationally peer-reviewed so to speak.

The internal political processes recede into the background, and that leads me to the answer to the second question, the links between IPOs and the opening up of the banking system. I believe that for most of the big state banks, certainly for Bank of China, the money of the IPOs is less important than the international respect and credibility that this whole process conveys on them.

Strictly speaking, the Chinese state does not need the money.

Chairman D'AMATO. Yes.

Mr. BOTTELIER. They have enough money to fully recapitalize those banks, as necessary. But the IPO process is nonetheless very important (a) because it allows foreign minority shareholders to be represented on the boards of those banks and to participate in deliberations at board level. That is precisely what the Chinese want. One of the main motivations of these banks to seek international minority shareholders is to make it easier for them to pursue bet-



ter governance standards internally and to deal more effectively with political processes internally.

This is a very complex process, and I'm not sure I can fully understand it or explain it to you, but this is really what is going on. They seek these IPOs, not in the first place for the money, but to gain respectability and to improve the chances governance standards.

When I discussed these matters with senior manager of Bank of China, for example, they are still, I think, inclined on listing in New York in spite of Sarbanes-Oxley, which imposes significant additional costs on them. They said, oh, we don't mind the costs. They immediately hired the seven or ten additional auditors needed in order to meet all the requirements. No timetable has been set for their listing to my knowledge.

The Construction Bank, I believe, is considering more Singapore and London, and I'm not sure I'm familiar with all their considerations, but the IPO process, to sum up, is very important as a capping stone on the internal reforms in these banks and to separate them as much as possible from Chinese government and from the Party.

Chairman D'AMATO. So an internal revolution is going on here.

Mr. BOTTELIER. Absolutely.

Chairman D'AMATO. We're announcing it today.

Mr. BOTTELIER. Absolutely.

Chairman D'AMATO. Dr. Meyer, do you have any comment on that?

Dr. MEYER. I fully agree with what Mr. Bottelier has said. I think the trade is this: the IPO and the foreign investments are intended to bring discipline into the organization. Now whether that can and will happen is a different question. But that's the theory that's on the table.

Let me give you an analogy if I can. All of you, I'm sure, very aware of the Lenovo acquisition of the IBM PC, the Think\* business. They chose to move their headquarters to Purchase, New York in order to not only acquire but impose Western management, but to impose Western management throughout their system. So there's an analogy here. This is not an IPO situation with Lenovo, but I think the analogy holds.

Now, on the side of the investors, not so much the individual investors but rather the Western bank investors—the foreign bank investors—in the Chinese banks, again, what they're seeking is access, quick access to Chinese markets so by 11/06, they're set to participate in the Chinese market. So I think that's the trade that's going on here.

I agree they don't need the money with 700 billion in foreign reserves. I don't think there's a terrific need for cash over there at this time.

Chairman D'AMATO. Well, I think that's very interesting. From my observation of China, and generally speaking, is that they are incredibly well organized in terms of their goals and how to reach them, given the size of the country and their goals and how quickly they've accomplished many of their goals.

It will be, I think, a challenge to their organizational ability to retain central political control and let this process go forward, as

you've described it, and that will be a huge interesting dynamic to watch. Thank you.

Cochair WESSEL. Vice Chairman Robinson.

Vice Chairman ROBINSON. Yes, thank you, Cochairman. I share Chairman D'Amato's wonderment on this. There's a schizophrenia going on here it seems to me. When I hear the idea that they're going IPO to bring greater discipline to their system, I buy that. Gaining respect, prestige, greater freedom of action, I buy all that.

When it comes to minority shareholder rights and the fact that they're keen to empower minority shareholders, I'm not as sure about that. Whether they really want a voice of independence in the boardroom, it depends on the subject matter. When you look at Bank of China, for example, or the Construction Bank, for that matter, you have the commercial side of their activities, and then you have a very politicized set of activities that involve such things as Chinese energy acquisitions in oil producing, terrorist-sponsoring states.

China's military modernization program is also implicated in these banking transactions. You've got customers of the bank that are known proliferators of weapons of mass destruction. In other words, one would find a number of dubious activities that are part of this mix.

So I'm not sure that the Chinese leadership has sorted this out. I think that many of the Chinese executives working for the banks want them to be peers with their counterparts worldwide, and that there's a good deal of momentum in that direction. I just wonder how it's going to square with China's other priorities, geopolitically and militarily, for example, just to name two. These tend to run at cross-purposes with the kind of openness, with the kind of good governance, with the kind of minority shareholder rights that we're talking about promoting.

I'd like your comment on that question.

Second, a question along the following lines. If a state-owned enterprise is going to list on the New York Stock Exchange, and it has one or two subsidiaries that have been sanctioned by the United States for the proliferation of weapons of mass destruction, do you feel that that is a material risk to investors that should be properly disclosed in the prospectus and SEC filings with respect to that IPO? That's a straightforward question as to whether you think that a parent company with two subs that have been charged with proliferation offenses, is the kind of thing that an American or other investor should know about going into an IPO?

Does that strike you as a sensible proposition?

Mr. BOTTELIER. In light of the Presidential directive, the recent one, I think that sounds to me like a reasonable proposition.

I would not make this a China-specific requirement. I would make this an international requirement—

Vice Chairman ROBINSON. No. Clearly.

Mr. BOTTELIER. —for anyone who wants to list here—yeah.

Vice Chairman ROBINSON. And Dr. Meyer, does that sound right to you or?

Dr. MEYER. I think that's correct. I also think that, again, given the size and the scope of the four large state-owned banks in China, some of what you describe is inevitable.

Vice Chairman ROBINSON. If you were to invest in the Bank of China or the China Construction Bank, would you find it helpful as an investor to have available a breakdown of the loan portfolios of these institutions? I mean the loans of a bank are its assets and asset quality is important. You probably also want to look at other things, too. I mean who are their customers?

We have some idea of who some of their customers are. It goes to the point you just made. Some of them are, shall we say, colorful. Do you think that they should be required to disclose their loan portfolios before coming to market or should U.S. investors be content to invest in a black box in terms of these loan portfolios?

Dr. MEYER. The way the question is posed, I think the answer is foregone. However, there is a particular issue in China, and that is the firms such as they are are organized as parent-subsidiary system. Because a loan goes to Firm X does not mean that its ultimate beneficiary is Firm X, because Firm X most likely has interests in 200 other firms, and what full disclosure would entail would be to delightful for scholars like Mr. Bottelier and me. We could study this forever. Whether investors could make sense of it quickly I don't know, but that's one of the aspects of doing business in China: you don't always know who you're doing business with.

Vice Chairman ROBINSON. And Professor Bottelier?

Mr. BOTTELIER. As a potential investor, I would certainly like to know that the accounts of the company and I would look at the auditing report. As an individual investor, I'm not sure I'd like to see the list of borrowers of the bank, certainly not at Chinese state bank, because there are likely to be hundreds of thousands of accounts, and I do not have the wherewithal to actually scrutinize those for the purposes that you have in mind.

I think in light of the Presidential directive, and if there is a serious security concerns here, I believe that that aspect has to be dealt with in a different way. I think here the regulatory authorities would have to shield the nation's investors from getting into situations that are inconsistent with national security objectives, but how you do that is beyond my competence.

Vice Chairman ROBINSON. Thank you. Your reaction to my first point would indicate that there may be some cross-purposes in the way China is managing its bank operations. Is that something you'd agree is the case?

Mr. BOTTELIER. Well, I think the way you put it, the question about schizophrenia and the lack of protection for minority rights are real questions and there is no question in my mind that this whole process in China is hard to understand and hard to put your arms around.

What I was saying earlier is that it is remarkable in a way that this one-party state is, in fact, creating a market economy which by definition means that it is surrendering power to forces outside the immediate control of the Party, and that process has gone quite far, and I think will go a lot further.

Whether that ultimately signals an inconsistency between the political system and the economic system is another question. I believe there is. So I believe that the economic reforms that are going on will increasingly put pressure on the political system as well.

I cannot really see a totally reformed market economy with a one-party state quite frankly, but that's a personal observation. What is happening in China has not happened in the world before, certainly not on this scale. Nobody knows the outcome of this process.

All we can say is that they've come a long way in 25 years, and that remarkable and rather paradoxical things have happened in the process.

Vice Chairman ROBINSON. Thank you. Thank you.

Cochair WESSEL. Commissioner Dreyer.

Commissioner TEUFEL DREYER. I have a more micro-level question. I'd like to ask you gentlemen to address the issue of what level of confidence the average Chinese who puts her or his savings into the bank has in those banks? We have heard that NPLs are still a matter of concern, and also that interest rates are low. There have been predictions that some day there will be a run on the banks that could cause the financial system to collapse.

Is this even remotely conceivable? And if so, under what circumstances might you expect it to happen? We have definitely heard of small-scale runs on banks in certain areas. Gentlemen?

Mr. BOTTELIER. I believe the banking system is no where near completion in its reforms, but I do also believe that it is better shape today than it was five years ago.

The risk of a serious banking crisis in China today is lower, I think, than it has been for a long time. And that's partly because the quality of the portfolios of these banks has improved, NPL ratios have declined, and capital adequacy ratios have improved. But the quality of management of these banks has also improved. The technical capability, the management information systems is not comparable to what it was ten years ago.

In addition to that, the Central Bank being aware of the risks you were referring to, has created a financial stability department as part of the Central Bank. The managers of that department are watchdogs of the system, in parallel with the banking supervisory agency; they are empowered to intervene in the event of local bank runs.

So there is a low probability, in the event of a local bank run, as has happened from time to time, that it would quickly spread to affect the entire system. I believe that barring major catastrophes, the system is essentially stable and that the Chinese depositors have the confidence in the state banks where they keep about 63 percent of their deposits, because they're not seriously concerned that the system will unravel.

Commissioner TEUFEL DREYER. Thank you. Dr. Meyer?

Dr. MEYER. Well, my information comes from a survey of about nine people whom I've asked this question to: Do you have confidence in the bank? Does your family have confidence in the bank? And uniformly the answer is yes.

So at this point, and this is mainly in Beijing, at this point my guess is—and this is a guess—is that consumer confidence in the state banks is pretty high. The likelihood of a panic I would guess is also fairly low, if only because the kind of information that's needed to create a panic could be bottled up pretty darn quickly in China.

Increasingly with Internet, that risk might go up a little bit, but people would not necessarily hear of a run on the bank in the next community in China as they would immediately hear in other countries.

Commissioner TEUFEL DREYER. Thank you.

Cochair WESSEL. Commissioner Reinsch.

Commissioner REINSCH. Thank you. I just have a short question. I gather from what you're both saying is that the process of reform seems to be underway with some success so far. Assuming the absence of a macroeconomic crisis, and assuming that the government continues its policies of reform, how long is it going to take the banks to get to the point where they would be competent and healthy in a Western sense, either one of you?

Mr. BOTTELIER. Some are already. I think that some of the smaller publicly owned banks, such as the Bank of Communications in Shanghai, actually are pretty modern banks already. The Bank of Communications is small by Chinese standards, but still it has a \$50–\$60 billion balance sheet total. It is a relatively old bank, with preexisting roots and is developing acceptable standards of management and governance quite rapidly.

Of the big four state-owned commercial banks which are owned by the central government, now through the Central Huijing, I think Bank of China is probably advancing more rapidly than the others towards acceptable international standards, but is not close to it yet.

A close second I would say is the Construction Bank. The third one the Industrial and Commercial Bank with the Agriculture Bank lagging the field by several years. The most serious problems in terms of governance standards, management information standards, I think are no longer in three of the big four, but in the multitude of relatively small banks, which are usually owned by local governments or public agencies, but not necessarily incorporated.

It is in some of the local banks where, I believe, bad things are still going on.

Commissioner REINSCH. And that's going to take a lot longer presumably?

Mr. BOTTELIER. Much longer, yes. But I think at the top level, the progress that has been made in terms of governance standards and internal discipline has actually moved quite fast in the last five years.

Commissioner REINSCH. Dr. Meyer, do you agree with that?

Dr. MEYER. For the most part. Two comments. First comment is that big banks, big organizations anywhere, are very difficult to change. I was interested in the phrase just spoken by Mr. Bottelier. He said at the top level the reforms in the large banks are deeply embedded.

I think the question, an important question, is to what extent the reforms undertaken at the top level of the very large Chinese banks have penetrated to the level of provinces almost certainly and beyond the provinces to the counties and the townships because it's at that level, even within the large banks, that the problems can occur.

As to the smaller banks, the only comment would be this—a lot of variance. For example, I've watched very casually Pudong Devel-

opment Bank because of Citibank's investment in it and that seems to be moving along rather nicely.

On the other hand, there is some local banks which seem to be very recalcitrant to change and the time horizon there who knows, so I would say just to summarize, top to bottom in the large banks will take time. We need more data about what's happening at the bottom. A lot of variance occurs across local banks because Chinese localities, the local economies, are dramatically different from one another.

Commissioner REINSCH. Is there anything that the United States Government can or should do to facilitate this process?

Dr. MEYER. Perhaps. I've often thought that investment in a bank is one act but reforming a bank is something else. The current mantra of corporate governance suggests that the two go hand in hand. If you take a position in a bank, you're in a position to influence that bank, and bring it along the reform process.

But again, to go back to my prepared remarks, that assumes that top down can work. I question whether that's a safe assumption in China because SOE reform was definitely not top down. It was bottom up. And it was very experimental. So the question is what other steps can we take to encourage bottom up reform whether it's in the smaller local banks or at the lower levels of the large Chinese banks? I'm not sure what those steps are, but I think it could be worthwhile investing some thought as to what those steps might be and what agencies might promote those steps?

Commissioner REINSCH. Thank you. Mr. Bottelier, do you have any?

Mr. BOTTELIER. I'm not sure that there is much the United States Government, the Federal Government, can do to help or facilitate this process, but I believe it is very important that individual agencies such as Justice, Treasury Department, maintain intensive links with their counterpart agencies in China, including the Central Bank, to accompany that whole process of technical and system transformation.

One important detail that is in my written statement which I did not mention for lack of time, but is nonetheless important, is that the American Bankers Association is about to sign a contract with the banking supervisory agency for a national training program in the Chinese banking system combined with a new locally designed certification system.

ABA has had that system in the United States for a long time and has one of the largest banking training programs in the world domestically in this country. That entire system will now be made available, to train Chinese bankers to become better bankers and to insert in the system professional certification standards which they currently do not have.

Right now if a banker applies for a banking job in the United States, he is normally required to meet certain certification standards. The Chinese have come to the conclusion that that is a useful way to improve their own standards and they have requested the ABA to help them to develop such a certification system.

Now, that's outside the Federal Government, but this is the level where, I think, cooperation which is very important.

Commissioner REINSCH. Thank you.

Cochair WESSEL. Commissioner Mulloy for a quick closing question.

Commissioner MULLOY. Thank you. The question that you mentioned the consumer lending on automobiles. I've read, I remember reading something that the effect of this, the government put easier consumer credit for purchasing automobiles, and you mentioned that this might have been—and the people didn't want to ride public transportation. I don't know whether that was part of it. But as a consequence, more investment flowed from the foreigners into helping China build its automobile industry because there was more demand for automobiles during that period of time.

And now that demand for automobiles has not been as great in China, so this money that now is there and built this capacity is now looking for export markets for these automobiles. And so somebody here or somebody in some other country is going to lose a job because of the way this system is working.

Do you have any policy prescription to deal with things like this? Something is wrong with the system when it can behave that way. You are real experts on this. What do you think about we ought to be doing or what can be done? I turn to both of you.

Mr. BOTTELIER. I think Commissioner Mulloy puts his finger on a very real issue and a very serious problem. I think it is in the nature of the unreformed system in China that you get these crazy credit binges as the one I referred to earlier. That could lead to a lot of excess capacity in the manufacturing sector, some of which will come on international markets, in part because the Chinese have slowed down domestic credit expansion in order to get the excess investment under control.

In the case of automobiles, and that's an excellent example, that's precisely what appears to be happening. Tremendous capacity was built in China in the anticipation of very rapid further domestic market growth, which is not materializing right now in part because they've clamped down on uncontrolled investment expansion. They've told the banks no longer consumer credit for cars. Mortgage loans were also restricted, but much less than car loans, because they are better secured. Car loan security is very difficult.

Some of the big motor companies, like Ford and GM are pushing the Chinese government to get the right to provide car financing themselves, outside the banking system, which they should be allowed under WTO, and that may help to stimulate domestic demand.

But the generic issue you raise, namely, how do we deal with this tendency of Chinese manufacturing to develop excess capacity and then export the surplus, that's a major issue, and I don't belittle that. I think the problem will not go away until the Chinese economy is more truly reformed.

Dr. MEYER. The first two people to lose their jobs were Phil Murtaugh, the head of GM China, and I think I have the name straight—I'll look in my file here—I think Bernd Leissner, Dr. Leissner, who is the head of Volkswagen in China. Both lost their jobs this year in a very short period of time. Indeed, it was quite awkward. I happened to attend the Boao Forum, which is, as you know, China's equivalent to Davos. Obviously the format and the

security are very different. There was a session on the automotive industry there, but as you walked in the door, you were informed in no uncertain terms that the discussion would be focused only on the industry and not on specific companies, most of which are in bad shape. I think the real threat to jobs, as mentioned, comes from manufacturing surplus in China, and the manufacturing surplus is partly a function of the fragmentation of the economy in which every provincial governor is seeking economic growth, encourages investment and encourages bank loans to support manufacturing in all industries, and as a result, the domestic markets in China are hypercompetitive and in many instances not sustainable, and the excess goes abroad quite rapidly. But that's a much larger issue.

Commissioner MULLOY. Thank you. Thank you, both.

Cochair WESSEL. The Commission will recess until 2:00 p.m., and we look forward to seeing you at that time.

[Whereupon, at 1:00 p.m., the hearing recessed, to reconvene at 2:10 p.m., this same day.]

**AFTERNOON SESSION, 2:10 P.M.  
THURSDAY, AUGUST 11, 2005**

**PANEL III: CHINA'S STRATEGY IN INTERNATIONAL  
CAPITAL MARKETS AND IMPLICATIONS FOR THE U.S.**

Cochair WESSEL. Good afternoon. We appreciate everyone coming back and having our third panel here this afternoon, "China's Strategy in International Capital Markets and the Implications for the U.S."

We're honored to have three distinguished panelists with us this afternoon. Frank Gaffney is President and Founder of the Center for Security Policy and former Assistant Secretary of Defense for International Security Policy in the Reagan Administration. He'll address the security concerns that have emerged from China's growing role in the international capital markets.

Dr. Solomon Tadesse is an Assistant Professor of International Finance at the Moore School of Business. Professor Tadesse has published numerous books and articles on these topics and will provide an overview of Chinese strategies and objectives in global capital markets and their implications for those markets.

Mr. Donald Straszheim is Chairman and CEO, Straszheim Global Advisors, LLC, and former Chief Economist for Merrill Lynch. Mr. Straszheim will discuss Chinese strategies and objectives in global capital markets and their implications for U.S. investors.

As an expert in the field for over two decades, we hope Mr. Straszheim's conclusions will help the Commission better understand how industry experts perceive China's strategy in the international capital markets.

As is our normal process, we will give each of our witnesses about seven minutes to present their oral comments. Their prepared testimony will be made part of the record, and then we'll open it up for questions from the Commissioners. Mr. Gaffney, if you could start.



**STATEMENT OF FRANK J. GAFFNEY, JR.  
PRESIDENT AND CEO, CENTER FOR SECURITY POLICY**

Mr. GAFFNEY. Mr. Chairman, and I guess I should say Mr. Chairman, Mr. Chairman and Mr. Chairman, thank you very much for including me. I have a lengthy prepared statement, which I would appreciate having in the record. I will try to do it justice in seven minutes.

I wanted to say before getting into the meat of this meeting how much I personally appreciate the Members of this Commission and the work that you're doing. I think the fact that we as a nation have a second opinion on China from an independent, all-source informed, and official vehicle is of incalculable importance, particularly at a time when I think the sorts of insights that you all have come up with over the four or so years that you've been in business are not given nearly enough attention elsewhere in our government.

Secondly, I think it's fair to say from your record of hearings and reports that China is systematically pursuing a strategy, one that I think should alarm freedom-loving peoples in this country and around the world. As Chairman D'Amato knows from our joint appearance before the House Armed Services Committee recently, I believe that strategy's purpose can be summarized as follows:

To displace the United States as the world's preeminent economic power and if necessary to defeat us militarily.

And I believe that the subject of today's hearing is very much part of and a critically important ingredient in the implementation of that strategy.

I can't let the opportunity pass to say a particular word of appreciation for a long-time friend and colleague of mine, your Vice Chairman, Roger Robinson, who frankly has taught me most of what I know about this subject, so I think I'm probably today going to be reduced to trying to amplify, augment, and reinforce findings and recommendations adopted by this Commission under his leadership.

We have, as I mentioned, recently gone through what I think is a very important and hopefully instructive exercise in the ultimate defeat of a state-owned Chinese enterprise known as the Chinese National Overseas Oil Company's efforts to take over an American energy company, Unocal.

Indeed, it was heartening as I was putting these remarks together yesterday to have Unocal's shareholders reject that idea in favor of Chevron. We should be under no illusions, however, that China as long as it is governed by the Communist Party will continue to both exercise dictatorial control over the country and its resources, not least the immense wealth that is being accumulated as a result of America's record trade deficits with China, and those resources will be put to the various purposes described in that strategy.

These will include among other things efforts to acquire or purchase, to gain by theft, if necessary, strategic energy resources, minerals, materials and technologies. You will see a continuing and I think accelerating and increasingly offensively oriented military build up, including something I think this Commission is familiar with, a concept the Chinese call the "assassin's mace," evidently a

program for decisively defeating the United States military, and I hope if you haven't done so already that the Commission will take an opportunity to receive a briefing by another blue ribbon commission that looked at one way that might be accomplished, namely through an electromagnetic pulse attack against this country delivered by ballistic missiles.

The Chinese will also, I think, continue to seek to dominate strategic chokepoints around the world and other pivotal regions from Africa, Siberia, the Middle East, Central Asia, and Latin America, to of course the United States as well.

I hope that your findings in this area and recommendations will be translated this session of Congress into legislation, and we look forward to working with you at the Center for Security Policy in doing that.

Turning now to the matter at hand, China's deliberate systematic effort to use the U.S. and foreign capital markets to sustain many of its state-owned enterprises and to underwrite their activities is, as I said, I think, an important part of the strategy I mentioned a moment ago.

I think that they have understood that instead of having the Chinese Treasury support these enterprises, some of which are frankly not in very good shape financially, by bringing them to market in the form of IPOs, they can get American and other investors to capitalize them.

The question before us today is what are the financial and strategic implications of such transactions? And I think that they are, in short, not good for the investors and certainly not good for this country, especially since it appears that in doing such underwriting of these state-owned enterprises, we are likely to be underwriting such things as the manufacture of intercontinental range ballistic missiles, space-based and other weapons designed to blind our satellites, the proliferation of weapons of mass destruction, the suppression, in conjunction with police units and regional and level governments, of human rights, the despoiling of the environment, the crushing of Tibetan freedom and various business dealings with terrorist sponsoring states.

I don't believe that American investors would want any part of doing such things if they knew that that was the practical effect of their investments, but of course they don't know. And this is one of the really extraordinary things that I would commend this Commission to make an intensive effort to correct.

It is unimaginable that American investors would be making similar investments in companies that are black boxes, but offered by American concerns, and yet that is by and large what seems to be happening, especially with respect to banks, that China now evidently has in mind bringing to our capital markets.

These are—let's be clear—foreign owned, foreign government-owned entities, not private firms, and whether in the hands of investment bankers in the West, these banks and other concerns are dressed up to make them look a little bit more financially attractive, a model perhaps being adopted from the American experience with the savings and loan fiasco, in which bad debts were simply offloaded onto asset managers and the books somehow miraculously get cleaned up, it's still not in our interests to be subsidizing

activities that banks are making loans to and in other cases companies that are doing such activities directly.

There is a very interesting and important precedent with which I think this Commission is familiar, certainly Vice Chairman Robinson, in dealing with such entities, namely the effort that the Chinese National Petroleum Corporation made in 1999 and 2000 to come to the market with a major IPO. I think it was intended initially to be something on the order of \$10 billion.

A coalition, an unlikely political coalition of Americans across the political spectrum came together to oppose and to educate the public, and particularly the investors about what was really going on in CNPC. It prompted CNPC's again investor managers to come up with a subterfuge. They called it PetroChina, a subsidiary that ostensibly had nothing to do with the parent company but, of course, was part and parcel of it, and did not in the end mislead I think investors into believing that CNPC was not active in Sudan.

Indeed, CNPC is today, we're told, in a position to own a 40 percent equity share in the Greater Nile Petroleum Operating Company of Sudan, and reportedly takes 50 percent of its oil production. I mention this only because I think that this is an important precedent. The shareholder activism and the other efforts to educate investors about what this company was about prompted approximately a 70 percent cut in the value of this transaction from about \$10 billion I believe to something on the order of 2.8 billion.

I would suggest to you that this Commission could very usefully help focus attention on similar transactions not only of those that are coming to market or coming into the United States as CNOOC tried to, but also those that are coming into our bond and equities markets, especially those that we have reason to believe are actively involved in one way or another directly or indirectly in the kind of activities that I mentioned before that are clearly contrary to our interests.

In my testimony, I identify a number a steps that I would recommend this Commission take on, building on your legislative mandate, building on your past record and findings. I also have made some suggestions about the importance, as I know Roger Robinson did in today's Financial Times, of getting the newly ensconced Chairman of the Securities and Exchange Commission to get that institution actively engaged in increasing the transparency, the accountability, the good governance, the due diligence associated with Chinese activities in our markets every bit as much as we do, or at least we pay lip service to doing with American and other enterprises.

This is particularly important because I believe the Chinese have figured out a way to improve from their point of view on the old Leninist, putatively at least Leninist, line about the capitalists will sell us the rope with which we'll hang them. Indeed, I think the Chinese figure the kinds of strategies that they're pursuing now will enable them to sell us the rope with which we will be hung.

So I will just conclude by saying I think if all else fails, if you don't do your job, and I hope that will not be the case, if the SEC under Chairman Cox, who for crying out loud ran in 1999 a commission of his own, a congressional commission that identified this as among the major problems we had with China, the patina, I

think he put it, of regularity that you will see being used to try to garner funds for some very dubious entities and activities in China.

If the SEC fails to do its job, and again I hope that will not be the case, I certainly hope that Congress will take up the cudgel as it did in the CNOOC deal and both ensure that the people, the investing community of this country, and for that matter the Chinese, will from now on be assured that those companies that are coming to the U.S. market, whether they're banks, whether they're businesses of other kinds, will meet the same standards of accountability, transparency, due diligence and so on that American companies are expected to perform at.

The alternative, I must tell you, is not free trade. It is to give China a free pass, and that is not in our interests especially in light of the strategy it's pursuing, and the implications for our security associated therewith.

Thank you, sir.

[The statement follows:]

**Prepared Statement of Frank J. Gaffney, Jr.  
President and CEO, Center for Security Policy**

***Chinese Penetration of the Global Capital Markets:  
Are American Investors Unwittingly Buying the Rope  
To Be Used for Their 'Hanging'?***

**Introduction**

Cochairmen Wessel and Robinson, let me begin by expressing my gratitude for several things: First, for including me in this panel on the People's Republic of China's penetration of the world's capital markets. Second, for recognizing—as this Commission has from its inception—the security implications of Chinese and other actual or potential adversaries' access to U.S. and foreign capital markets.

Third, for the enormous contribution that you and your colleagues are making to official and public awareness of the PRC's increasingly ominous strategy. I believe that the record compiled in your impressive series of hearings and annual reports offers convincing evidence of:

- (a) the real value of the “second opinion” on China that you provide as our government's only independent, all-source-informed, official vehicle for such advice and
- (b) that China is systematically pursuing a strategy that should alarm freedom-loving people in this country and around the world. Its aim is, I believe, to displace the United States as the world's preeminent economic power and, if necessary, to defeat us militarily.

It is in the context of such a strategy that we must address China's access to and use of American and other foreign capital, a subject to which I will return momentarily.

Finally, I would like to express particular appreciation to Roger Robinson, with whom I have had the pleasure of working for the past eighteen years. I have benefited greatly from his expertise and mentoring on economic and financial security matters. In my estimation, he is truly the preeminent thinker in the country on the intersection of traditional national security concerns with economic, financial, energy and technology security developments. Like many others here and abroad, I can honestly say he has taught me practically everything I know about the latter subjects and I hope today to amplify, augment and reinforce findings and recommendations adopted by this Commission under his leadership.

**The CNOOC-Unocal Precedent**

As Members of this Commission know, I was privileged to appear last month alongside Chairman D'Amato in a hearing convened by the House Armed Services Committee. We both testified against the then-pending effort by the Chinese National Overseas Oil Company (CNOOC) to acquire Unocal. It is very gratifying that just yesterday, Unocal's shareholders voted to sell their company to another American concern, Chevron, instead of Communist China's state-owned CNOOC.

We should be under no illusions, though. As long as China's Communist Party continues to exercise dictatorial control over the country and its resources—not least, the immense wealth being accumulated as a result of America's record trade deficits—the PRC will be pursuing various means of advancing its strategy at our expense. Those will include, among other initiatives, the following:

- Further efforts to purchase or otherwise acquire (including, where possible, by theft) strategic energy resources, minerals, materials and technologies;
- Rapidly accelerating and increasingly offensively-oriented military modernization efforts, including a focus on techniques given the name “Assassin's Mace” evidently intended to defeat decisively the U.S. military. (In this connection, I would urge this Commission to receive a briefing from one of your counterpart panels that reported last year on the possibility such a “catastrophic” attack against our country might be carried out by ballistic missile-delivered electromagnetic pulse weapons);
- Expanded attempts to obtain access to and, ultimately, control over strategic choke points around the world; and
- Money-enabled influence operations in pivotal regions from Africa, Siberia, the Middle East, Central Asia and Latin America to here in the United States itself (the last not least in the form of the purchase of vast quantities of U.S. Government debt instruments).

Again, I applaud the U.S.-China Economic and Security Review Commission's sustained effort to document and warn about these developments. I very much hope that before this session of Congress is concluded that your findings and recommendations will be translated into much-needed legislative initiatives. We at the Center for Security Policy look forward to working with you in that connection.

#### **China and the Capital Markets**

For the moment, let me focus on a microcosm of the larger problem we confront from Communist China and its strategy: The PRC's deliberate, systematic effort to use the U.S. and other foreign capital markets to sustain its many state-owned enterprises (SOEs) and to underwrite their activities. At least some of these entities (notably, several government-owned banks) are believed to be in serious economic difficulty. In fact, but for the past support of the Chinese treasury—*support the Communist regime has established can be transferred to American and other investors via Initial Public Offerings (IPOs) on foreign capital exchanges*—these SOEs would almost certainly be unsustainable.

The question before us today is: **What are the financial and strategic implications of the Chinese bringing to market, both here and overseas, companies that are effectively agencies of the state, SOEs whose true financial conditions and activities are not fully disclosed to investors?**

I believe that it is neither in the interest of American investors nor of the country as a whole to be underwriting Communist China's state-owned enterprises engaged in such activities as: the manufacture of intercontinental-range ballistic missiles and space-based weapons designed to blind our satellites; the proliferation of weapons of mass destruction; the suppression, in conjunction with police units and regional and national level governments, of human rights; the despoiling of the environment; the crushing of Tibetan freedom; and various business dealings with terrorist-sponsoring states.

My guess is that most U.S. investors would feel the same way—*provided they knew* that the Chinese SOEs whose stocks are often the object of glitzy road-shows and enthusiastic sales pitches by leading investment bankers are engaged in such activities and/or that the companies' books have been “window-dressed” to conceal their actual financial condition.

Take, for example, the prospective IPOs of Chinese government-owned banks that are each said to be hoping to raise billions of dollars when listed in Hong Kong and perhaps New York later this year or early next year: China Construction Bank (expected to garner some \$5 billion) and Bank of China (also an estimated \$5 billion). Yet another of these financial SOEs, the Bank of Communications recently issued an IPO in Hong Kong worth \$1.9 billion.

Let us be clear. These are *foreign government-owned entities*, not private firms. The Chinese government appears to be actively working with leading international banking houses to shape the appearance, assets, liabilities, profit margins and public relations tactics of these state-owned enterprises.

Despite such efforts, the PRC seems simply to be dressing-up what were, until recently, insolvent banks in the hope that international capital markets will contribute to bailing them out. This process involves the off-loading of non-performing loans onto asset management companies in a fashion very reminiscent of the U.S.

savings and loan crisis. Indeed, the PRC appears, in fact, to have modeled its strategy on the American experience.

The Communist regime is also publicizing measures being taken to track down and apprehend high-profile embezzlers, gangsters and other criminals so as to convey an image of rigor, discipline, accountability and the rule of law. These steps are clearly meant to counteract the growing body of experience of American and other foreign companies doing business with China—namely, that it is corruption and “connections,” rather than an enforceable legal code, that determines how one fares.

I would suggest that a far more accurate indicator of Chinese intentions to foster a free market economy, one in which American businesses and investors can safely and constructively participate, would be if *private sector* Chinese companies were coming to the U.S. capital markets. Instead, reportedly some 90% of those being listed in overseas exchanges are state-owned enterprises—despite the fact that, according to some estimates, SOEs only comprise 40–50% of today’s Chinese economy.

One must ask: Where are the *private* Chinese companies that could be coming to overseas markets? Does the PRC really want them—and the private sector of the Chinese economy—to prosper and grow? Or is their exclusion, by and large (with the exception of some high technology enterprises), from access to the foreign exchanges an indication that the government is determined to perpetuate its SOE dinosaurs at the expense of its private enterprises. In other words, is this gambit really little more than a disingenuous fund-raising device of epic proportions intended to prop up the remains of China’s socialist economy?

Concerns on this score are only further heightened by the fact that China is confining sales of its state-owned entities’ stock to U.S. public pension funds, mutual funds and other investors to only about 10–15% of the total. In exchange for giving the Communist regime what can amount to billions of dollars, will these new investors enjoy any shareholder rights? The answer is decidedly “No.” Nor will they be assured adequate disclosure, transparency, accountability or corporate governance. The playing field remains as uneven as it was in the case of the SOE CNOOC’s fraudulent portrayal of its bid for Unocal as a “purely commercial venture” and paragon of “free trade.”

**The truth of the matter is that U.S. investors wouldn’t accept for a single day the “black box” nature of many of these Chinese transactions on foreign capital markets if the company in question were an American one. Neither would the Securities and Exchange Commission.**

#### **A Useful Precedent: Financial Penalties for Abetting Sudanese Genocide**

The fact is that Chinese SOE’s use the same production facilities to make not only consumer items like refrigerators but components for ICBMs. They are also in unsavory places like Iran, Syria and Sudan. In fact the PRC’s largest oil company, China National Petroleum Corp. (CNPC) has a 40% equity share in the Greater Nile Petroleum Operating Company and reportedly takes 50% of Sudan’s oil production. There are hundreds, if not thousands, of Chinese on the ground providing arms and training to the genocidal government in Khartoum, fueling the killing fields of that country and clearing areas of interest for oil exploitation.

Yet, PetroChina—an artificially created subsidiary manifestly designed to enable CNPC to finesse strenuous opposition to the parent company’s IPO when it was first announced in 1999—is today listed on the U.S. and other foreign exchanges. Fortunately, Harvard University’s endowment recently decided to divest its holdings of Petrochina stock in light of CNPC’s reprehensible activities in Sudan and the fact that there is no difference between CNPC and Petrochina (despite investment bankers’ efforts to help China portray the two as bifurcated). Other universities are following suit.

In addition, the State of Illinois recently passed a statute requiring divestment from their public pension fund portfolios of all companies doing business with Sudan. New Jersey is following suit. And, I am pleased to report, **other states—led by Louisiana—are creating new reporting requirements that may lead to divestment of companies doing business not only with Sudan but with other terrorist-sponsoring states (with whom China generally has close ties).**

This activity is the most important development in the financial security field since the divestment campaign that helped force the South African regime to abandon apartheid, resulting in its subsequent fall from power. Of necessity, the divestment campaign on behalf of Sudan involves taking a stand against China more than any other nation. China is, after all, the most indifferent of any country in the world to the suffering in Sudan. Indeed, it is systematically aiding and abetting it.

As this Commission knows, the groundwork for such actions against attempts by Chinese “black box” SOEs to penetrate U.S. capital markets—and, thereby, to raise

money for odious activities like the rape of Sudan—was laid in 1999 and 2000 by an informal, ad hoc group known as the Petrochina Coalition. Involving an array of organizations (including the AFL–CIO, Friends of the Earth, Freedom House, the Center for Security Policy, the International Campaign for Tibet, the American Anti-Slavery Group and the International Rivers Network), the Coalition created sufficient controversy about and opposition to CNPC/Petrochina’s U.S. IPO through a counter-road show and other means as to reduce the offer’s expected value by some 70% (i.e., from \$10 billion to just \$2.89 billion).

I would argue that the Petrochina Coalition’s success in opposing one of China’s premier SOEs as it sought to underwrite unsavory Chinese behavior with help from U.S. investors is anything but old news. It is a story that is very much in play today as universities, city and state legislatures and officials and other public-spirited organizations become alive to this phenomenon—and adopt strategies for countering it.

### Sinopec and Proliferation

That more can and urgently needs to be done is clear from the recent actions of another Chinese SOE, Sinopec: Last October, Sinopec signed a \$70 billion deal with the Islamofascist regime in Tehran to develop Iran’s oil and natural gas fields. Sinopec is also in Sudan, a fact its representatives tried to deny when they took \$3.4 billion from U.S. and other investors in June of 2000.

In addition, as Gary Milhollin told this Commission last March:

Among Sinopec’s many subsidiaries are two that have been sanctioned a total of four times since 1997 for selling chemical weapons equipment and technology to Iran. These companies, Nanjing Chemical Industries Group and Jiangsu Yongli Chemical Engineering and Technology Import/Export Corporation, are fully-owned subsidiaries of the Sinopec Group, which holds decisionmaking authority over them.

Mr. Milhollin noted, however, that, “The Sinopec Group has never been sanctioned or even mentioned in sanctions announcements.” In fact, it is a virtual certainty that none of the U.S. investors in Sinopec have any idea that the company they partly own is involved in such activities.

### The U.S.-China Commission’s Role

Given this Commission’s legislatively established mandate to “evaluate the extent of 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,” I respectfully submit that you have an obligation to determine several things:

- What steps are being taken to ensure that American investors are aware of the true nature of the Chinese companies in which they are being asked to invest?
- Are such companies’ proliferation-, terrorism- and military production-related activities—or, in the case of Chinese banks, those of the PRC companies to which they lend—listed in the risk section of the prospectus or elsewhere in their disclosure-related filings?
- If not, is that because such activities are not to be considered material risks to investors? **Or, is it simply that we are supposed to accept that the Chinese can do as they wish with our money—and that, despite “transparency,” “accountability,” “due diligence” and “good governance” being the watchwords of the American capital markets these days—such principles do not apply when China wants to conduct businesses in those markets? If so, this arrangement would amount less to “free trade” than a “free pass” for Beijing.**

In particular, with respect to Chinese state-owned banks coming to our capital markets, this Commission would be well-advised to insist that investors be able to review such banks’ loan portfolios. After all, these are the banks’ *assets*. I strongly suspect that the borrowers include: the People’s Liberation Army’s vast array of enterprises, SOEs and front companies involved in technology theft (the *Wall Street Journal* reminded us yesterday that PetroChina has been part of Communist China’s unprecedentedly comprehensive effort to obtain U.S. secrets and proprietary information); slave-labor and other human rights abusing concerns; companies responsible for widespread environmental deprivations; and businesses helping to crush Tibetan aspirations for renewed freedom and independence. If such assets are in the banks’ portfolio, American investors have a need-to-know before they are invited to underwrite—and, thereby, to enable—such conduct in the future.

Similar scrutiny is no less in order with respect to Chinese companies already in the global capital markets such as China International Trust and Investment Corp. (CITIC) and China Ocean Shipping Company (COSCO). The former is chaired by Wang Jun, who also chairs Poly Technologies—a state-owned arms manufacturing conglomerate. The latter amounts to the Chinese merchant marine.

Then, there is Northern Industries (Norinco), another huge Chinese arms-producing concern. Norinco is arguably the most famous serial proliferator in China, yet its stocks trade on the “A-share” market of China’s Shenzhen exchange, to which American portfolios have access only via what Beijing dubs “qualified foreign institutional investors” (QFIIs) such as Goldman Sachs and Morgan Stanley. Even though Norinco has been subjected to import controls and other U.S. sanctions for its proliferation-related activities (among other things, Norinco was caught in a sting operation in March 1996 trying to sell purported American drug-dealers AK-47s, shoulder-fired “Red Parakeet” anti-aircraft missiles and grenade-launchers), it is still possible for U.S. investors unwittingly to help fund such activities through QFIIs.

### **Buying the Rope**

I am concerned that the PRC’s efforts to bring its dubious state-owned enterprises to the world’s capital markets is not evidence of a Communist Chinese commitment to free trade. Rather, it is a reflection of Beijing’s refinement of the quote attributed to Lenin: They want the capitalists to *buy* the rope with which China ultimately will hang them.

The PRC’s play for American investors is more than an effort to raise fresh capital for unsavory—and, at least in some cases, highly *dangerous*—purposes. It is a particularly insidious part of the ominous, overarching strategy described above: **If millions of American investors can be induced to have a vested interest in the physical and financial viability of Chinese firms engaged in such behavior around the world, Beijing stands to create a “China Lobby” even more formidable than that represented to date by co-opted American business interests.** It can reasonably expect to be able to prevent future sanctions and suppress opposition to transactions like CNOOC’s acquisition of Unocal.

This prospect is made all the more appalling by the fact that among those whose funds will be invested in such a fashion are *millions of Americans who would never knowingly want to be put in such a position as having their pensions tied to the success of Chinese arms manufacturers, proliferators, etc.* **Think of the outrage veterans, firefighters, policemen and women, teachers and other patriotic government employees would feel—if only they were aware of what the Communist Chinese and their helpers have in mind.**

This reality makes it all the more scandalous that a highly relevant provision contained in the 2003 Intelligence Authorization Act (P.L. 107–306, Sec. 827) was repealed under circumstances that are far from clear. **As a result, there is no longer a statutory requirement for annual reports by the Director of Central Intelligence identifying Chinese or other foreign companies determined to be engaged or involved in the proliferation of weapons of mass destruction or their delivery systems that have raised, or attempted to raise, funds in U.S. capital markets.**

### **A Job for the Cox Securities and Exchange Commission**

I would, consequently, recommend that this Commission make a priority of seeking the reenactment of such a requirement. In the meantime, I would strongly second a suggestion Vice Chairman Robinson made in the *Financial Times* today. Specifically, the new **Chairman of the Securities and Exchange Commission, Chris Cox**, should be strongly encouraged to make an “enhanced effort” to ensure that U.S. investors are afforded the same transparency with respect to Chinese offerings in the American capital markets as is required of U.S. companies. In fact, **particularly with respect to PRC-owned banks, even greater transparency is in order, since Chinese government ownership and state-owned borrowers puts them in a different class than their American counterparts.**

This Commission should encourage the SEC to conduct an urgent review of the Chinese presence in our debt and equity markets for all kinds of concerns raised by PRC SOEs that already here—notably: disclosure, transparency, governance, do they have any history of proliferation or other security-related abuses (arms smuggling, tech theft, intelligence front companies), etc.

**Given the material risk such security-related activities would obviously represent to share-holders, how could this information possibly be withheld?** If the information is classified, the SEC and the Treasury should be urged



to identify other means to ensure that investors are able to make informed decisions about the true nature of the company in question.

It is hard to imagine a better person to accomplish this vital contribution to transparency and accountability than Chairman Cox. After all, in his previous incarnation, Rep. Cox chaired a congressional commission that concluded in 1999:

The Securities and Exchange Commission collects little information helpful in monitoring PRC commercial activities in the United States. This lack of information is due only in part to the fact that many PRC front companies are privately held and ultimately—if indirectly—wholly-owned by the PRC and the Chinese Communist Party itself. **Increasingly, the PRC is using U.S. capital markets both as a source of central government funding for military and commercial development and as a means of cloaking U.S. technology acquisition efforts by its front companies with a patina of regularity and respectability.** (Emphasis added.)

What the Cox Commission found to be true in 1999 is even more true today. In fact, it is even more true than it was when a second, independent commission chaired by former CIA Director John Deutch determined that:

Because there is currently no national security-based review of entities seeking to gain access to our capital markets, **investors are unlikely to know that they may be assisting in the proliferation of weapons of mass destruction by providing funds to known proliferators.** Aside from the moral implications, there are potential financial consequences of proliferation activity—such as the possible imposition of trade and financial sanctions—which could negatively impact investors.

The Deutch panel felt so strongly about the need to address this problem that it went on to recommend that:

[The U.S. Government] assess options for denying proliferators access to U.S. capital markets. **Options considered should include ways to enhance transparency, such as requiring more detailed reporting on the individuals or companies seeking access or disclosure of proliferation-related activity, as well as mechanisms to bar entry of such entities into the U.S. capital markets.** Along with the possible costs and benefits of various options, this review should consider the potential effectiveness of unilateral actions and the impact of those options on the health and viability of the global capital market in general and U.S. capital markets in particular. (Emphasis added.)

### **The Congress' Role**

If all else fails, I would urge that Congress take up the cudgel as it did so usefully in the CNOOC-Unocal case. In particular, until such time as state-owned entities like the Bank of China and the China Construction Bank, along with their investment banks, list these Chinese enterprises' entire loan portfolios, the legislative branch should act to block the initial public offerings of such banks in the U.S. equity markets.

This is only reasonable. After all, just as the loans of a bank are its assets, asset quality is a fundamental calculation for would-be American investors prepared to conduct serious pre-investment due diligence.

Even though one can be confident that these Chinese banks, and their U.S. and possibly foreign investment bank advisors, labored hard to “window dress” those institutions by removing a myriad of non-performing and controversial loans (particularly to other state-owned enterprises), I would bet the ranch that such loan portfolios will still include defense-related industries, known proliferators, arms smugglers and producers, human rights abusers, environmental despoilers and enterprises associated with the repression of Tibet and human liberties more generally.

We must stop confusing free trade with China with a free pass for some of its most worrisome activities—and the state-owned enterprises who engage in them.

Cochair WESSEL. Thank you, and thank you for your kind comments about the work of the Commission. We appreciate it. Dr. Tadesse.

**STATEMENT OF SOLOMON TADESSE, PH.D., CMA, CFM  
ASSISTANT PROFESSOR OF INTERNATIONAL FINANCE  
MOORE SCHOOL OF BUSINESS, UNIVERSITY OF SOUTH CAROLINA**

Dr. TADESSE. Mr. Chairman and Commissioners, thank you for inviting me to express my views on this important matter. I have put my prepared statement for the record. In addition, I will have probably ten minutes worth of introductory remarks. The broad questions posed for us in the panel today involve assessing the role of China's capital raising in the U.S. to the economic strategy of China and its implications to U.S. economic interests.

What is the financing strategy of China to fund its economic development? What is the importance of capital raising in global capital markets, particularly from the U.S., for the funding strategy?

While Chinese firms are getting increasingly visible in the international capital markets, at this point, the role of external capital raising, including from even the Chinese domestic markets to the Chinese economy is negligible.

Rather, the dominant strategy for funding economic development is the marshalling of financial resources through an actively repressed financial system or domestic banking system. Domestic bank financing accounts for as much as 50 percent of enterprise investment in China. The remaining being sourced, mainly, from internal funding and capital transfers from government.

Mr. Chairman, the relatively negligible role of cross-listing in the U.S. in the larger context of funding economic development in China, however, does not insulate U.S. economic interests from China's financial activities.

While what a nation's banking system does, to a large extent, is an internal affair, with China's increasing economic integration with the global economy, the institutional arrangement of the banking sector, and the manner it channels from the household to the enterprise sectors has significant implications, some harmful, to other countries.

I would like to introduce the notion of financial repression here. Financial repression refers to undue interference by governments in financial systems. A financially repressed system is a state-dominated system. In such a system, the financial sector is viewed a mere extension of the government treasury.

The Chinese financial system is a severely repressed financial system, with the government strictly controlling the channeling of savings to government-connected enterprises through its ownership of banks, entry barriers, and restrictions of capital markets.

Ninety percent of household savings are in the form of bank savings that pay little to savers. The banking sector is dominated by the big four state-owned banks, among which they represent about 60 to 80 percent of the banking business.

The Chinese government owns about 99 percent of the ten largest commercial banks in China. Under the government's guidance, the state-owned banks direct their funds to the state-owned enterprises and other connected firms at interest rates way below the market.

The consequence of such financial repression to China itself is self-evident. It leads to gross misallocation of resources, resulting in economic inefficiency and retardation in the long run. In addi-

tion, financial repression transfers wealth from the citizenry to the government and its connected cronies.

But the question for us here is why should we worry about financial repression in China? What are the implications to the U.S. interests? Traditionally, the consequences of financial repression have been viewed as internal. With the severity of repression in China and its increasing involvement in the global economy, the state of Chinese financial system poses serious risks to the security and economic interests of other countries, particularly the U.S.

The implications are numerous. But I will focus on two serious implications here: namely, (1) the cost advantages financial repression endows the Chinese government; and (2) the breakdown of basic governance mechanisms financial repression entails.

First, the competitive implication. China has been developing unfair advantages in costs of capital that was made possible through the active financial repression it has pursued. Through direct control of household savings via its state-owned banks, the government has amassed massive amounts of financial capital at virtually no cost for the benefit of SOEs and government-connected enterprises.

The state is providing subsidized financing through its state-owned financial institutions to its state-owned enterprises, in effect, agencies of the government, providing unfair cost advantage that can be utilized, for example, has happened recently to acquire strategic assets around the world.

This is very much analogous to the unfair trade practices countries commonly engage in international trade. In effect, therefore, active financial repression can be utilized to develop unfair competitive advantages and China's actions are consistent with this practice.

If recent examples are good indicators of the future, Chinese state-owned enterprises with massive capital channeled through the state-owned banks, under the direction of the government, appear to be posed for high finance acquisitions.

In essence, China could be thought of as using financial repression as a strategic tool to build competitive advantages in its real sectors at the expense of others, including the U.S.

The U.S. should recognize financial repression in partner countries as a potential harm that can erode its competitive advantage. The key implication is that financial development, i.e., the undoing of financial repression, has to be pursued as a national foreign/trade policy priority in engaging partner countries.

The second implication of financial repression in China involves the severe governance risk it poses to the U.S. As one of their important functions, financial systems provide valuable governance services. Banks, for example, screen potential borrowers, collect and generate information about financed projects, and continually monitor to ensure appropriate use of funds.

Government-directed banks, however, do not perform these functions adequately. In addition, China's repressed financial system does not have the institutional infrastructure to provide adequate governance to the companies and businesses it supports.

China's financial system suffers from poor investor protection, lack of rule of law, as evidenced by its pervasive corruption, even

by developing country standards, and a highly underrepresented legal profession by some accounts, only 150,000 lawyers in the whole of China). There is a complete lack of transparency with poor accounting standards and practices, and a critical shortage—this is very important—a critical shortage of independent auditors, accountants, analysts, other agents and institutions of information.

Inadequate governance has severe economic and social consequences as was evident in the recent corporate scandals such as that of Enron, even in the most advanced countries. The consequences are doubly severe in emerging markets such as China.

With the importance of China in the global economy, the lack of governance mechanisms in China's financial system has important implications to the U.S. economy and other trading partners.

These are the following. First, with increasing reliance on China in international trade, systemic failure of governance at Chinese companies could disrupt the provision of strategic products and services, endangering U.S.'s economic security. And here I would like to underline the fact that the governance problem in China is system-wide. It's not just company-specific.

Second, to the extent that Chinese companies become global employers via cross-border acquisitions, failure of governance endangers the welfare of employees from potential layoffs.

Third, in the increasingly integrated world, system-wide failure of governance could adversely affect customers and U.S. firms interconnected to Chinese companies through the supply chain.

Finally, the potential failure of governance also raises significant financial risk and security related concerns to U.S. investors in China today.

As a summary, I would like to emphasize a couple of points. China is an ally and a valuable economic partner. It should be noted that although, due to the focus of this testimony, I focus on the potential risks and threats of China's financial system to the economic interests of the U.S., the benefits of economic engagement with China cannot be overemphasized.

Thus, it is paramount to continue to engage China to reform its institutions including its financial system, both to strengthen mutually beneficial economic partnerships and to protect U.S. national economic interests.

As I pointed out earlier, financial repression provides the basis for the government's power and unparalleled influence. As a result, the government has no incentive for financial development. It is better off with financial repression rather than without it.

Hence, it is naive to presume that governments will reform their financial sectors by their own. External pressure has to be exerted to effect financial development.

These pressures may take the following forms: it could be the natural course of globalization and competition, or it could be pressures by international organizations such as the IMF and the World Bank. For example, through its strategic adjustment programs, the IMF requires borrowing countries in the developing world to reform their financial sectors.

China, however, is a different case. China is a rich and powerful country and does not rely on IMF's conditionalities for its financing. International pressures of this type will not, therefore, be ef-

fective. The WTO agreements do not adequately cover areas of investments and financing, although China's commitments under its WTO agreement to open up its financial sector starting 2007 could be historic opportunity for the desired reforms and remains to be seen.

Hence, appropriate pressure has to be exerted from bilateral partners such as the U.S. It is also important to note that it is to China's interest to reform and develop its financial system. The severe misallocation of capital that breeds in economic inefficiency would pose a serious threat to China's economy in the long run.

Hence, financial reform should be viewed as a win-win strategy for both China and the U.S. Thank you.

[The statement follows:]

**Prepared Statement of Solomon Tadesse, Ph.D., CMA, CFM**  
**Assistant Professor of International Finance**  
**Moore School of Business, University of South Carolina**

Mr. Chairman and Commissioners, thank you for inviting me to share with you my views on the growing presence of Chinese firms in the international capital markets, and Chinese use of the global capital markets for its economic development strategy. The broad questions posed for us in the panel today involve assessing, in particular, the role of U.S. capital markets to the economic development strategy of China. I organize my statement in the following order. In Section (1) below, I first provide an assessment of the role of capital-raising in the global capital markets, including the U.S. markets, as part of the economic development strategy of China. I show that global capital markets and external financing via issuance of stocks and bonds is very marginal in funding Chinese enterprises today. I identify rather the marshalling of financial resources through an actively repressed domestic banking system as a dominant strategy for funding economic development in China. I expound, in Section (2), on the notion of financial repression and its general implications, characterizing the Chinese financial system as a prototype of severely repressed financial system. The report would then outline the potential implications of China's repressed financial system to the economic interests of the U.S., suggesting some policy prescriptions. In Section (3), I focus on the harmful effects on U.S.'s competitive position, and in Section (4), I explore the implications of the lack of governance mechanisms in Chinese financial system. Section (5) provides concluding remarks, underscoring some policy options available to U.S. policymakers.

**(1) *China's Strategy in Financing its Economic Development***

What is the financing strategy of China to fund its economic development? What is the importance of capital-raising in global capital markets, particularly from the U.S. for the funding strategy? These are some of the questions posed to me in preparing for this testimony.

While Chinese firms are getting increasingly visible in international capital markets, at this point, the role of external capital-raising (including from Chinese domestic markets) to the Chinese economy is very negligible. In China, investments of non-financial enterprises are financed through four main sources: (i) self-fundraising including retained earnings, (ii) government capital transfer to State Owned Enterprises, (iii) bank loans channeled from the household sectors, and (iv) foreign direct investment. The predominant source of funding investment in the non-financial enterprise sector, as is common in other countries is internal funds. In year 1999, for example, the amount of enterprise investments that was funded through "self-fundraising and internal sources" amount to 67.6% (Allen, Qian and Qian (2002)). This estimate is only for Chinese locally listed companies. However, the figure compares well with Chen (2003) who reports the share of self-fundraising to be 69.6% in 2001 for the entire enterprise sector in China (see Figure 1 in the Appendix). Self-fundraising includes proceeds from capital raised from local government and communities and internal financing from retained earnings. External capital raised in stock and corporate bond markets was a mere 3.7% in 1999 for listed companies. This figure is significantly lower for the enterprise sector as a whole. The total capital raised over the period 2000 through 2004 in international IPOs (including Hong Kong) amounts to approximately \$30 billion which is a fraction of the yearly total investment needs of the enterprise sector. In contrast, the share of domestic bank loans was a significant 19.2% in 1999 that compares well with the

19.1% for the entire enterprise sector in 2001 (Chen (2003)). **Bank loans**, hence, constitutes the **largest source** of **external** capital.

Domestic loans have also been increasingly substituting state budget appropriations as a primary external source of financing capital investments. State budget appropriations declined from 28% in 1981 to just 6.7% of capital investment in 2001 while, in parallel, domestic loans jumped from 13% to 19% of capital investment during the period. In addition, Chen (2003) suggests that about half of the so called “self fundraising” could actually be forms of loans that are not authorized by regulations; thus **bank loans** that channel household savings could **account for as much as 50% of enterprise investment** in China.

Household savings is one of the highest with around 25 percent of disposable income since 2000, accounting for about 16% of GDP in 2001. The amount of household savings in excess of investments (i.e., the saving surplus) is between 10 and 14% of GDP. About **90%** of this **excess saving** is in the form of **bank saving deposits**. This is because of the limited financial investment opportunities available to Chinese investors.

The role of capital-raising in global capital markets is expected to increase with China’s integration into the global economy and the expected needed reforms, including the opening of its banking sector to competition. However, the relatively negligible role of cross-listing in the U.S. in the larger context of funding economic development in China does not insulate U.S.’s economic interest from China’s financial activities.

As I pointed out, the domestic banking system is the main source of external finance for enterprises in China. While what a nation’s banking system does, to a large extent, is an internal affair, with China’s increasing economic integration with the global economy, the institutional arrangement of the banking sector and the manner it channels from the household to enterprise sectors, has significant implications, some harmful, to other countries. The Chinese financial system is a severely repressed financial system, with the government strictly controlling the channeling of savings to government-connected enterprises through its ownership of banks, entry barriers, and restrictions of capital markets. Such institutional arrangement in the banking sector entails severe repercussions both to the country and its trading partners, and it will be the subject of my testimony in the rest of the statement.

## (2) *Financial Repression and China’s Financial System*

### 2.1 Financial Repression

Financial repression (or financial underdevelopment) refers to the prevalence of undue interference by governments in financial systems. A financially repressed system is a state-dominated financial system. In highly repressed financial systems, the financial sector is viewed as mere extension of the government treasury.

State interference in financial systems takes many forms. These include, in increasing order of scope, the following:

- Imposition of interest rate controls (such as deposit interest rate cap);
- Excessive bank reserve requirements;
- Government credits and government direction of bank credits;
- Restrictions on entry of foreign banks and domestic non-bank entities;
- Imposition of barriers to foreign capital inflows and *active underdevelopment* of competing domestic *capital markets*; and finally
- Outright government ownership and micromanagement of banks.

The consequences of financial repression are many, but the main ones are the following:

- Financial repression leads to gross misallocation of resources, resulting in economic inefficiency and retardation.
- Financial repression transfers wealth from the citizenry to the state and its connected cronies. Regardless of the form of repression, **savers** and **private-sector borrowers** will be **worse off**, and the **government** and **government-connected borrowers** will be **better off**.

### 2.2 The Chinese Financial Sector as a Severely Repressed Financial System

The current Chinese financial system is concentrated around the banking sector.

- The dominant source of funding for Chinese companies is bank loans.
  - as much as 80% of funding is sourced in bank loans.
- There is no real corporate debt market.
- Capital markets are very small, fragmented, and excessively controlled.

China's **banking sector is dominated** by the big 4 **State-Owned Banks (SOBs)**, among which they represent about **60–80% of the banking business**.

At the end of 2001, the 4 state-owned banks had a 62% share of the savings and lending business and about 80% of the payment business (see Figure 2 in the Appendix).

Other State Banks, Private credit agencies, and Community Banks such as the 40,000 Rural Credit Cooperatives, the 3500 Urban Credit Cooperatives, and the 80 or so City Commercial Banks account for the rest of the domestic banking business.

The Chinese **government owns 99.45%** of the 10 **largest commercial banks** in China in 1995 (La Porta, et al. (2002)).

Under the government's guidance, the **State-Owned Banks (SOBs) direct their funds to the State-Owned Enterprises (SOEs) and to other enterprises connected to the state via ownership, through 'policy loans'**, at interest rates far below market.

The **private sector's access** to bank loans is **extremely limited**. In 1999, private enterprises received only **0.62% of the loans from all banks**, and less than **0.5% of all loans from state banks**.

**Why** should we worry about financial repression in **China**? What are the implications to the U.S.? Traditionally, the consequences of financial repression have been viewed solely as internal: financial repression distorts resource allocation and leads to economic retardation. With the severity of the repression in China, and its increasing involvement in the global economic relations, the state of Chinese financial system poses serious risks to the security and economic interests of other countries, including the U.S. The implications are numerous; I would, therefore, summarize the discussion under two organizing themes, namely (i) **the cost advantages financial repression endows the Chinese government**, and (ii) **the breakdown of basic governance mechanisms** financial repression entails.

### (3) *Implications of Chinese Financial System Repression to U.S.'s Competitive Position*

#### a. **China has been developing unfair advantages in costs of capital that was made possible through its ACTIVE financial repression.**

- Through direct control of household savings via its state-owned banks, the government has amassed massive amount of financial capital, at virtually no cost, at its disposal for the benefit of its SOEs and government-connected enterprises. 90% of net household savings (e.g., one of the largest in the world with 10% of GDP in 2001) is in the form of bank saving deposits.
- The state is providing **subsidized financing through its state-owned** or directed financial institutions **to its state-owned companies** (in effect, agencies of the government), providing unfair cost advantage that can be utilized, for example, as is happening recently, **to acquire strategic assets** around the world.
- This is very analogous to the UNFAIR trade practices countries commonly engage in international trade.
  - e.g., Agricultural products dumped in the international markets made possible through government subsidy of their farmers; China's dumping of steel products in international markets made possible through export rebates and tax subsidies to gain competitive advantage in the industry.
- In effect, therefore, **active financial repression can be utilized to develop unfair competitive advantage**, and China's actions are consistent with this practice.
- Countries have developed various mechanisms to retaliate or contain UNFAIR TRADE practices over time, including protectionism.
- The **U.S.** should **recognize financial repression** in partner countries as a potential **harm that can erode** its competitive position.
- It should look into ways to protect itself from the harmful effects of financial underdevelopment.
  - Over the long term, **financial development should be considered a foreign/trade policy** priority item.
  - In the short to medium term, the U.S. has to be aware of the harm it can cause U.S.'s interest, and devise ways to protect itself.

#### b. **China's Financial Repression as a New Challenge**

- Traditionally, financial underdevelopment/repression was considered a domestic affair,
  - through misallocation of resources, it retards domestic economic growth

- and, involves a transfer of wealth from the countries' citizens to the State
  - Examples of regions with significant financial repression used to include much of the developing world, and the Soviet block of countries. Financial underdevelopment in the **developing world did not directly affect other countries**, simply because these are poor countries. Financial repression in the **Soviet bloc countries had the potential to harm others, but its effects were contained via the cold war.**
  - China, however, is a different case:
    - Financial repression has endowed the government with cheap capital, redistributed from its citizenry.
    - Financial repression, combined with state control of its foreign exchange mechanisms, is providing China with a competitive advantage to undertake **cross-border acquisitions** of strategic assets.
    - If recent examples are good indicators, Chinese state-owned enterprises (in essence, arms of the government), with massive capital channeled through the state-owned banks, under the direction of the government, appear to be posed for high finance acquisitions.
    - In essence, China could be thought of as using financial repression as a **strategic tool** to build competitive advantages **in its real-sectors** at the expense of others, including the U.S.
    - The reluctance of policymakers to respond to such threats is partly because this represents a different type of challenge compared to the open and shut cases of unfair trade practices, and *also* because China is an ally.
  - It is, therefore, **imperative**, to recognize the new threat emerging from financial repression. Financial underdevelopment is no longer a domestic malaise, which nations have to deal with in their own. It can be used as a **strategic tool** by rich, otherwise financially underdeveloped countries, to the detriment of others.
  - The implication is that, **FINANCIAL DEVELOPMENT** (i.e., financial liberalization and the undoing of financial repression) **has to be pursued as a NATIONAL FOREIGN/TRADE POLICY** priority in engaging partner countries.
- (4) ***Inadequate Governance Mechanisms in China's Financial System and Their Implications***
- Financial systems serve **two broad functions**: (a) channeling of capital from savers to enterprises and other users of capital (i.e., the **capital mobilization** function) and (b) provision of good **corporate governance** through facilitating information flows and monitoring of corporate insiders by external stakeholders (i.e., the **governance** function).
  - As their governance function, banks screen potential borrowers, collect and generate information about financed projects, and continually monitor to ensure appropriate use of the funds. Similarly, financial markets provide venues (through, for example, facilitating corporate takeovers) for external shareholders to influence corporate policies.
  - The financial system **accomplishes** these important **governance** functions through its various **institutions**, which include investor protection laws, regulations, legal enforcement mechanisms and a strong legal profession; as well as such institutions of information as accounting standards, company disclosure rules, a strong auditing profession, independent credit rating agencies, a financial analyst community, and a vibrant financial press.
  - China's repressed financial system does **not have** the **institutional infrastructure** to provide **adequate governance** to the companies and businesses it supports.
    - China's financial system suffers from poor investor protection, lack of rule of law as evidenced by its pervasive corruption even by developing countries standard, and a highly underrepresented legal profession (with an estimate of 150,000 lawyers in the whole of China). Among the more than five million business enterprises in China, only 4% of them have regular legal advisers. There is a complete lack of transparency with poor accounting standards and practices, and a critical shortage of independent auditors, analysts, other agents and institutions of information.
  - As a result, such repressed financial systems **fail grossly** in providing appropriate governance. In such systems like that of China's, bank credits are, for example, channeled under government direction to connected borrowers without screening and further monitoring.
  - Inadequate governance has severe economic and social consequences** as was evident in the recent corporate scandals (e.g., the case of Enron) even in



the most advanced countries. The consequences are doubly severe in emerging economies such as China.

- With the importance of China in the global economy, the **lack of governance mechanisms in China's financial system** has important **implications to the U.S. economy** and its other trading partners. These are:
  - With the increasing reliance on China in international trade, **systemic failure** of governance at Chinese companies could disrupt the provision of strategic products and services, endangering U.S.'s economic security.
  - To the extent that Chinese companies become global employers (via cross-border acquisitions), failure of governance endangers the welfare of employees from potential layoffs.
  - In the increasingly integrated world, system-wide failure of governance could adversely affect customers and U.S. firms interconnected to Chinese companies through the supply chain.
  - The potential failure of governance also raises significant financial risk and security-related concerns to U.S. investors in Chinese companies.
- An example of an immediate implication to U.S. policymakers is in the context of recent attempts by Chinese companies to acquire U.S. firms. Understandably, policymakers raise such governance issues of concern as the consequences to U.S. employees and the sustainability of service provision under the potential Chinese acquirers. The Chinese companies appear to be ready to provide assurances in all such areas of concern on governance.
- It is, however, **imperative** to realize that individual **company assurances** have **no significance** so long as the governance infrastructure is virtually lacking in the system. The potential **governance problem in China is system-wide**. Hence, policymakers should go beyond the case-by-case assurances and look into the system-wide lack of adequate corporate governance in China, which has **significant adverse implications** to the U.S. economy.
- Another implication has to do with the extent to which U.S. investors as well as regulators could **credibly rely** on Chinese company **financial representations** and **disclosures** made in the context of such a gross failure of corporate governance and a breakdown of information institutions as I outlined above. One of the main problems in Chinese corporate governance is a dearth of qualified independent accountants and auditors (Allen et al. (2003)). There has been a number of cases in the U.S. of financial misrepresentations by crosslisted Chinese companies, including the cases of China Life, and Sina. Data on disclosure malpractices is not widely available. It would not, however, be farfetched to speculate that the scope of the problem is much larger. China is a command economy where economic agents, including agents of information, operate under guidance from above. The lack of professional independent accounting and poor transparency in general, combined with rampant corruption is a breeding ground for disclosure impropriety.
- Furthermore, despite lower registration costs and less stringent disclosure rules in European stock exchanges, Chinese firms prefer to cross-list in the U.S. For example, more than 70 Chinese firms are cross-listed in the U.S., while only 6 firms from Mainland China are in the London Stock Exchange. With the poor disclosure environment in China, one would expect that the much stringent disclosure regulations in the U.S. may discourage Chinese firms from crosslisting in the U.S. This has been the reason for the success of the London stock exchange in attracting firms from many other emerging economies. It might be that the motive of Chinese firms to attract capital and increase their investor base in the deep U.S. capital markets is so strong to justify their presence. It is also possible that the disclosure adjustments to the higher standard may not be that costly to these companies for the reasons I outlined above.
- In this regard, U.S. regulators need to go beyond a checklist of required disclosure, and look into the manner in which financial disclosure has been produced. I should point also out that the Sarbanes-Oxley Act of 2002 appears to be of help along this line. Although the full implications of the Act remain to be seen in the years to come, it is interesting to note the dramatic decline in Chinese cross-listings in the U.S. after the passage of the Act.

##### (5) **Concluding Remarks**

- China is an ally and a valuable economic partner. It should be noted that although, due to the focus of this testimony, I focus on the potential risks and threats of China's financial system to the economic interest of the U.S., the benefits of economic engagement with China can not be overemphasized. Thus, it is paramount to continue to engage China to reform its institutions, including

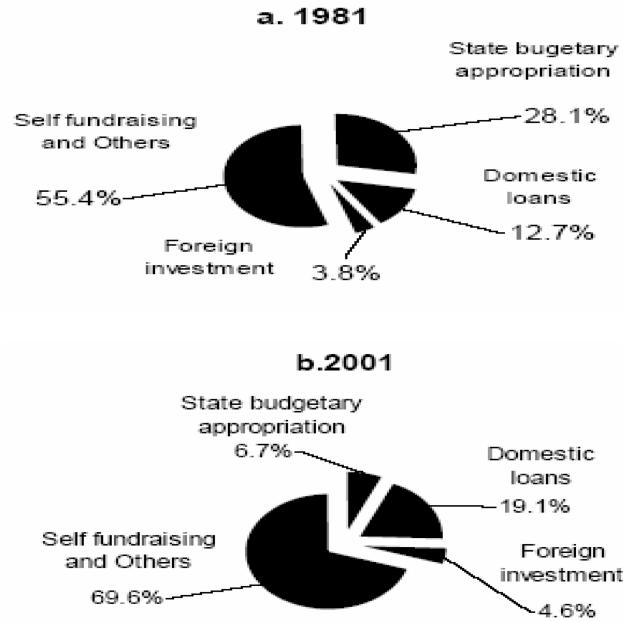
- its financial system, both to strengthen mutually beneficial economic partnerships and to protect U.S.'s national economic interest.
- As noted, financial repression provides the government with a source of cheap capital, which it can direct through central planning to SOEs and other government-connected cronies. Financial repression provides the basis for the government's power and unparalleled influence.
  - As a result, the state has **no** incentive for financial development. It is better off with financial repression rather than without it. Hence, it is naïve to presume that governments will reform their financial sectors by their own.
  - External pressure has to be exerted to effect financial development. These pressures may include:
    - The natural course of globalization and competition, and
    - Pressures by international organizations such as the IMF, the World Bank, and the WTO
      - e.g., via strategic adjustment packages (SAP), the IMF requires borrowing countries in the developing world to reform their financial sectors.
  - China is, however, a different case. China is a rich and powerful country, and does not rely on IMF's conditionalities for its financing. International pressure of this type will not, therefore, be effective. The WTO agreements do not adequately cover areas of investments and financing, although China's commitment under its **WTO agreement** to open up its financial sector starting 2007 could be a **historic opportunity** for the desired reforms, and remains to be seen.
  - Hence, **appropriate pressure has to be exerted from bilateral partners, such as the U.S.**
  - It is also important to note that it is **to China's interest** to reform and **develop its financial system**. The severe misallocation of capital that breeds in economic inefficiency would pose a serious threat to China's economy in the long run. Hence, **financial reform** should be viewed as a **win-win strategy** for **both China and the U.S.**

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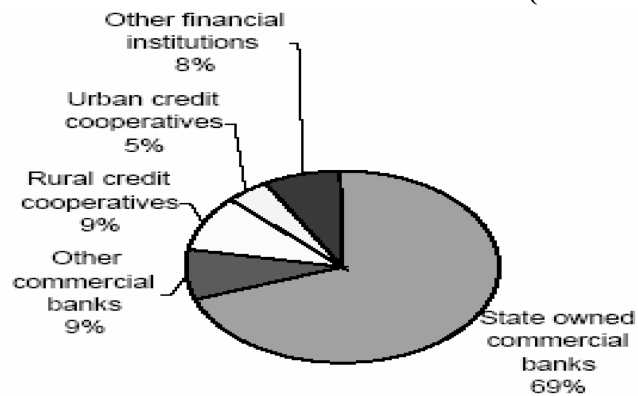
Appendix

**FIGURE 1: Financial Sources of Fixed Asset Investment**



Source: Chen, H. (2003)

**FIGURE 2: Asset Distribution of Financial Institutions (end of 1999)**



Source: Ligang S. (2001)

Cochair WESSEL. Thank you. Dr. Straszheim.

**STATEMENT OF DONALD H. STRASZHEIM  
PRESIDENT AND CEO, STRASZHEIM GLOBAL ADVISORS, LLC  
[FORMER CHIEF ECONOMIST FOR MERRILL LYNCH]**

Dr. STRASZHEIM. Thank you, Mr. Chairman. Our firm focuses on China and what China's economy and what China means to the U.S. and global economy and financial markets. So I come with a very different perspective than the two prior witnesses.

China is I think the global agent of change. It's the engine of growth. China is a growing, changing, complicated and in many ways confusing economy. They come from a different starting point than we do, and I think it is very easy for us to apply our historical experience and expectations to China and come to misleading in some cases conclusions.

I want to focus on the financial markets and the capital markets today which is the real purpose, I think, of the hearings. Their capital markets, their whole financial system is frail and I think in a word "primitive." They are in the process of reforming their economy and their financial markets. We have a great deal to teach them, and I think in fact China is ready to learn from us in many different ways.

Before I talk about the banks and the equity markets, which is what I want to focus on, let me just say something about the condition right now in China. China's economy has been advertised as overheated over the last 18 months. China's economy is not overheated. It wasn't last year, it's not now. It's unbalanced and those imbalances, those places in the economy which are overheated have arisen because of decisions in the command and controlled economy, and if, in fact, they followed more market rules, those imbalances would not be there.

I think their nine percent growth or whatever number you want to use, eight, nine, ten, is really quite sustainable for a long period of time. China is long on labor and short on capital. In our view, Beijing is not leading this process of economic reform that began in 1978. They're increasingly following it. There's a parade toward capitalism in China. Beijing figured out that there was a parade going on and decided they might as well get out in front of the parade.

And there is no turning back. Beijing will be in trouble when the music stops, and I think Beijing knows that full well. Accordingly, I believe they will do anything they can to continue this path of economic growth, to continue to bring in foreign capital, and to become increasingly engaged with us and other countries around the world. I am a believer that economic interdependence, the more the better, and so I think there is a great opportunity, and I am pleased that the committee has focused now on the capital markets because they are so important.

With respect to commercial banking, there shouldn't be any mistake. China's big four banks aren't banks. They're lending arms of the government. They were created state-owned. They were created as lending arms of the government. That has been their role. That is their role. They dominate about two-thirds of all of commercial banking and they have an enormous lack of talent and of technology and of experience in most all of the dimensions that you and

I think of when we think of commercial banks from a Western perspective.

You could walk the halls of one of these big four banks and you'd be hard-pressed to find a member of a loan committee. The record-keeping is difficult at best. They don't have a monetary policy that is a real tool to help manage their economy, and so without that tool, and without the flex up and down in interest rates, both borrowing and deposit rates, their banking system is just utterly unlike what we think a banking system is and should be and that's just the condition that exists in China.

As a consequence of the way they've run their banking system in the past, they have an enormous nonperforming loan problem, and they've done a couple of different bailouts in the last few years which were hailed as important steps toward reform. Nonsense. These, China's banking system and banking problems won't be improved until they make the requisite changes in procedures.

You take \$45 billion of bad loans off the books, which is what they did in December of 2003, 22.5 from China Construction Bank and 22.5 from Bank of China, put those in one of the asset management committee companies which they created for that purpose, the so-called "bad bank," and until you change the procedures, they're going to write \$45 billion of new loans which won't be bad because they're still just new.

But until they change the procedure, they're going to become bad just like the older ones. So we just need to be careful when we think about the banking system in China and realize that it is not at all like ours. China's entry into WTO, as you well know, in December of 2001 established a schedule of different dates for which different industries had to open up to one degree or another. The banking sector was a five-year window, December 11, 2006.

They have no chance to be ready in December 11, 2006, to compete with the Citigroups and the Deutsche Banks. Those big Western banks know that full well. So does China. I also suspect—and it is nobody's best interests for these banks to go into China aggressively and to take market share. That's a negative sum game. Both sides know it. I think they'll accordingly move cautiously and carefully rather than abruptly.

Let me turn to the equity markets. The Shanghai and the Shenzhen, the domestic equity markets are a joke. Everybody knows they're a joke that has ever really looked at these markets to any extent. 90 percent of all of the issues on the Shanghai and Shenzhen exchanges are state-owned enterprises. The Shanghai and Shenzhen exchanges were created in November of 1990, not in the image that you and I think of an equity market, which is to find a place where sources of funds and uses of funds can meet, but these equity markets were created as policy tools of the government to increase the value of the existing state-owned enterprises that they initially listed. They have worked hard to assure that not only would that value increase, but that they would not lose control of those enterprises.

So now you've got this 70 percent or thereabouts overhang of these so-called non-tradable shares which remains and any investor that's had any experience with real equity markets around the world avoids these markets. It's no accident that last year in 2004,

the Shanghai Exchange was down 15 percent and the Shenzhen Exchange was down 16 percent, the two worst performing equity markets in the world, whereas China had the best performing economy in the world.

The reason for that is simply that the word is out and people know. So this brings us to the point of IPOs coming here. No one wants to play in the minor leagues if you can play in the majors. There have been 23 IPOs of China companies in the last five years that have listed on Nasdaq.

The most recent one was Baidu and yet another one again yesterday. These are young companies, basically formed, started by native Chinese who came to the West, got an education, learned about our system, and have gone home to make their fortune. They know better than to list on Shanghai or Shenzhen. They want to play in the majors and that's exactly what they're doing, and you'll see that continue.

Those who can't play in the majors will play in AAA ball which is Hong Kong. Now, the Hong Kong markets are real markets. Quite good listing standards and protections. Outside directors, non-executive directors are real outside directors in Hong Kong. Disclosure, Internationally Accepted Accounting Practices. These characterize American markets. These characterize the Hong Kong markets, but they don't characterize Shanghai and Shenzhen.

So from our perspective, we think you will see a continuation of the best and the brightest from China coming to list in America.

Let me make one last comment about the currency and trade issue although I know that's not the primary focus here, because I think it's quite relevant. I think there is a potential ruckus, a storm brewing, over the recent revaluation of the currency, and the reason I say that is China used in the revaluation, they called this change a managed floating exchange rate regime.

That was their phrase and they adopted the phraseology of the international capital markets, reference to a basket of currencies and to flex the currency up and down by as much as .3 of a percent on any given day. We've looked at this quite extensively, and while yesterday they announced that they have a basket, we've asked ourselves what basket?

If you look at any rational formulation of a basket in the way that other countries around the world have formed these kinds of exchange rate regimes, you come to a conclusion that they should have made various other steps in the last few weeks and they have not.

As the financial markets increasingly realize that China has announced that they were going to do one thing with respect to the currency and, in fact, is doing something different, they will interpret that as misdirection at best or perhaps something worse, and that's counterproductive.

But, Mr. Chairman, let me stop there. I'd be happy to answer any questions you might have.

[The statement follows:]

**Prepared Statement of Donald H. Straszheim  
President and CEO, Straszheim Global Advisors, LLC  
[Former Chief Economist for Merrill Lynch]**

***“China and the Global Capital Markets”***

**Executive Summary**

***Introduction***

My name is Donald Straszheim. I am the CEO of Straszheim Global Advisors, LLC, an independent economics and financial markets research firm which focuses on China and how China affects the U.S. and global economy and financial markets. We have offices in Los Angeles and Beijing. Prior to founding my own firm, I was global Chief Economist for Merrill Lynch, the securities firm, and President of the Milken Institute, a not-for-profit economic and public policy think tank. I have been a regular visitor to China since the mid-1980s and a student of her economy and financial markets for many years.

This statement briefly addresses the current economic situation in China followed by some thoughts on the banking system and China’s equity markets. A brief comment on the debt and the currency markets is at the end.

**China’s Economic Ascent Since 1978**

A brief review of China’s current condition is necessary to understand the role, condition and prospects of China’s capital markets and financial system.

***Careening toward a market economy***

China is careening down the path toward a market economy, with a long way to go, but with, in my view, no turning back. China remains a mixed, dare I say jumbled, economy of the modern and the archaic. China has elements of the old command-and-control system established by the Communists in 1949 alongside, and mingled with, entrepreneurial enthusiasm and market forces of great strength. Applying our perspectives and background to China’s different setup is dangerous. Beijing is enthusiastic to embrace the market economy and let the “invisible hand” take over in some sectors. But she is also as yet utterly unwilling to let go in other portions, still insistent on decisionmaking by committees and bureaucrats in secrecy and without account to others.

***Threat or opportunity or both***

Every company in the world now that is not totally asleep sees China as a threat or an opportunity, or, usually, as both. Since 1978, when China launched the “reforms and opening up,” real GDP growth has averaged 9.4% annually, 3 times the U.S. record. Our analysis suggests these figures are realistic, not exaggerated. With intermittent interruptions, we also believe 9% growth is sustainable for many years—1% labor force growth and productivity. However, China needs to modernize her capital markets, precisely the focus of these hearings, if these growth figures are to be attained. China, America and the world will be better off if China attends to these matters promptly. In a phrase, China has gone from interesting to important over the last 5–10 years.

***Economy unbalanced, not overheated***

It has been entirely inaccurate over the last year to describe China’s economy as overheated, as has been the general description of the business press. Unbalanced, yes; overheated, no. Overheated suggests a general condition of “too much money chasing too few goods.” That is not China. Rather, China is awash in goods, produced for both domestic consumption and export. There are sectors which are overheated, and they are largely the result of decisions made in the command and control portion of the economy. China’s mass of economic managers in the still-dominant public sector remain more comfortable with decisions made by the governing committee around the conference table rather than leaving such decisions to the consensus judgment of the marketplace—the “iron fist” rather than the “invisible hand.”

***1% labor force and 8% productivity is sustainable***

China is an underdeveloped country still in many ways, and is long on labor and short on capital. Give China a continuing flow of new capital to combine with her quite well educated labor force and entrepreneurial inclination and a stable government and society and China will become ever more powerful and significant. China’s populace has come to enjoy the economic gains of the last quarter century. They associate these gains with economic and social reform. Beijing will be in trouble if and when the advances stop. It is no exaggeration to say that the reform process in

China is being lead by the people. Beijing has figured out that there is a parade of economic reform going on and that they need to get in front of that parade. The people are pushing the reforms; Beijing is not. The government's claim to legitimacy rides on a continuation of these gains. Accordingly, China's leadership is very much interested in making the requisite reforms. All of the market economies of the world, most of all the U.S., need to foster this reform movement in any way possible.

***Finance is China's weakest link***

There is a solid consensus view that the financial system is China's weakest link. If destabilizing economic trouble erupts in the next decade, it likely will start in the financial sector. Manufacturing in China has made great strides in the last decade as we all can see. Retailing and trade have also developed quite well and more is to come. But the only way to describe the state of finance in China is both primitive and weak. If any sector in China is likely to create troubles that will hold China's economic progress back, and might spill over into causing trouble for the global economy it is finance. China's banks are not banks; they are lending arms of the government. China's two domestic equity markets, Shanghai and Shenzhen, are simply not equity markets in the conventional sense. China's debt markets are even less developed. Their currency remains, for all practical purposes, still pegged to the dollar despite the recent small 2.1% revaluation of the Yuan and the announcement of a narrow band and reference to a basket of currencies. Capital still does not flow freely into and out of China. Until China's financial structure is modernized, China will remain a country of incomplete development. China wants to be regarded as a full fledged member of the global economic and financial community. They are not there yet, but are highly susceptible to outside help and suggestions.

***Demonstrate and coax***

As outside observers, we are often impatient with the pace of reform that we see. We would be better off to demonstrate best practices and appropriate next steps by our actions and coax gently with examples and encouragement rather than push without limit the pace of these reforms. No one in 1978, just after the end of the 1966-76 "Cultural Revolution," easily the most damaging social experiment in the history of the world, could have imagined the strides China would make by 2005. Even the financial system is being modernized and making progress. To push too hard encourages a push back. We need to do all that we can to get China ever more engaged in the global economy. As that occurs, she will have no choice but to adopt something like global standards.

***China's "Commercial" Banking System***

China's banking system remains primitive and weak fully 27 years into the process of "reforms and opening up."

***China's Big-4 commercial banks***

China's "big-4 commercial banks" are not banks in the American sense of the word. They are lending arms of the government. These four banks—the Bank of China, China Construction Bank, Industrial and Commercial Bank of China and Agricultural Bank of China—are state-owned, and have a dominating 65% market share in China. They are in some ways reminiscent of the so-called "keiretsu" banks in Japan and the "chaebol" banks in Korea. The big-4 primarily provide lending services to the other state-owned enterprises in China in manufacturing, mining, retail, trade, services, agriculture and more. They still lack many operational tools and technologies essential to good banking practices as we understand them. They lack the managerial and strategic talent and expertise that is commonplace in global market-oriented banks. They serve the lending function for the other SOEs in China quite adequately, but do not allocate capital as a scarce resource to the best returning alternative in any meaningful market-tested sense. This is an ultimately fatal flaw. The result is that capital is not treated as a scarce resource in a way that is familiar to us. The banks don't really support the best projects and starve the worst ones. Recordkeeping remains hamstrung by lack of technology. They lack a sufficient pool of talent with real banking experience. They do not have experience in rationing credit, or in matching assets and liabilities on their balance sheets. Loan committees do not generally function in a judgmental and capital allocating way. Private sector companies are not supported in the way we are accustomed. These characteristics represent both the threat and the opportunity. Capital is allocated in a very haphazard way. Imagine what China's economic growth record might have been—or might become—if this were corrected.



### ***Non-performing loans (NPLs) and government bailouts***

Not surprisingly, China's big-4 banks have massive bad loan problems. The estimates vary widely. In December 2003, Beijing provided a cash infusion (bailout) of \$22.5 billion to Bank of China and \$22.5 billion to China Construction Bank to remove bad loans from the books and repair their balance sheets. This bailout was hailed, incorrectly, as a positive step. Until banking practices are changed and loans are written according to market principles, these \$45 billion of bad loans will simply be replaced by \$45 billion of new loans that are not yet bad simply because they are still new. Until China learns modern banking practices, the process of writing loans, the loans becoming bad, a bailout is provided and new loans that ultimately turn bad will be repeated. A \$30 billion bailout was provided in early 2005 to the Industrial and Commercial Bank of China. The Agricultural Bank of China is so widely regarded as beyond redemption, even in China, that no bailout has even been attempted that might set this bank on a positive course.

### ***The Asset Management Companies (AMCs)***

A few years ago, China set up four AMCs, each to receive the bad loans of the big-4 banks in the effort to clean up the big-4 banks balance sheets. This is China's version of the standard "good bank-bad bank" strategy that has been used to salvage struggling lending institutions. The AMCs have not lived up to the expectations for two principal reasons. First, China remains skeptical that the outside buyers (largely westerners) are trying to unfairly gain control of valuable properties at too-low prices. Second, western bids remain low because the potential buyers have no confidence that once they buy a property that they will be able to ultimately get free-and-clear title to the asset they bought. In principle the AMCs are potentially a useful tool. But in practice, to date China has not yet established the underlying conditions for them to work.

### ***The future of the big-4***

In the long run, we see the big-4 banks as dinosaurs bound for either extinction or a role limited to some kind of development role for the government. The investments being made in the big-4 banks by western banks are unlikely to provide any real returns. Likely they are being made in order to establish relations rather than on any expectation of a real return.

### ***The smaller municipal banks***

The future of banking in China is more likely with the smaller municipal banks in China which are also government-owned, but which do not have the baggage of the big-4. We expect western banks to establish joint relationships in one form or another—ownership or operational—with all of these banks, bringing technology, talent and perhaps capital to them. Anything we can do to support the modernization of China's banks will be a plus.

### ***No good monetary policy transmission mechanism***

The lack of a well structured and operational banking system in China means that China lacks the transmission mechanism that is essential for monetary policy to be an effective modulator of the economy. If interest rates flexed up and down in a coherent and regular basis, the opportunity to manage growth and inflation would be much more straightforward. This is even more fundamental than the lack of a monetary policy that is independent of the executive branch of the government.

### ***China Banking and Regulatory "Commission"***

This body performs the basic regulatory functions in banking in China. Discussions with this body quickly reveal that they do not see banking in the way that we see it and that the legacy of the origins (and even present operations) of banking in China have their banks in a different position from ours. More interaction between the relevant regulatory bodies in China and in America would be constructive. China is willing and eager to work with us. We need a healthy exchange of staff—in both directions—in order to accelerate the learning process.

### ***WTO Opening as of December 11, 2006***

China's entry into the WTO on December 11, 2001 established a schedule of dates in which China was obligated to open up various industries to foreign competition. The date for banking was 5 years after entry—or December 11, 2006. It is clear at present that China's banking sector is in no condition to compete head-to-head with a global quality commercial bank from the west. They simply do not have the talent, technology or experience to do so. As a consequence, it is in neither side's best interest for foreign banks to enter China's banking sector in December 2006 with an aggressive plan to take market share in the short run. No one wants a financial crisis.

Rather, we expect the foreign competition coming in to adopt a relatively go-slow approach. And we expect China to establish conditions and rules which will effectively slow the process and act as speed limits upon entry.

#### ***Next steps for China's banking system***

In summary, banking in China remains primitive, undeveloped and unsophisticated. But China is making progress. China needs to accelerate its reform process in anticipation of the December 2006 WTO mandated opening up of the banking system. We see the following steps as most important: expertise from the west; real lending standards; loan reviews that are operational; a functioning and independent monetary policy; more vigorous action from the CBRC; and the adoption of internationally accepted banking standards. China's economy continues to grow. If China can just adopt new standards and practices, the burden of non-performing loans can be absorbed over time.

#### ***China's Equity Markets***

China's equity markets, like China's banking system, remain underdeveloped and not an effective mechanism to match sources of capital with uses of capital. They have been the worst performing markets in the world for the last 18 months. And just like the banks, a well oiled equity market would be a major plus to China's economy.

#### ***The Shanghai and Shenzhen stock exchanges***

China's domestic equity markets were started in 1990. There are about 1,400 companies listed for a total market capitalization of about US\$425 billion. China's markets are the third largest in Asia, behind Japan and Hong Kong. Over 90% of the listings are state-owned enterprises rather than privately owned.

#### ***The purpose of equity markets in China***

China's equity markets were launched when China was far less developed than today. They were established to be policy-driven rather than market driven. China wanted to raise the value of the state-owned assets that it already had. Beijing also wanted to keep control of these assets. Accordingly they established the practice of issuing a majority interest of non-tradable shares for each of the stock issues. That legacy remains to this day. Unlike the basic function of the equity markets in America, the Chinese markets were not established in order to match capital needs with capital sources.

#### ***Reforms needed in China's domestic equity markets***

It is no accident that China's equity markets have been the worst performing in the last few years while China's economy has been the best performing. Global and domestic players have become increasingly aware that the domestic markets lack the features that are essential to fair investing. And until these markets are reformed investors will continue to stay away. A short list of the reforms China must make would include: better protection against insider trading; improved corporate governance; more transparency and openness; outside directors that are truly independent; more and more timely reporting of results and material events; adoption of internationally accepted accounting standards; elimination of the overhang of non-tradable shares owned or controlled by the state; more policing of practices in the brokerage community and generally a more market-based mentality. This list might seem straightforward enough, but when juxtaposed against the origin and purpose of the Shanghai and Shenzhen exchanges, these items represent a 179 degree turn from past practices.

#### ***China Securities Regulatory Commission***

The CSRC is China's equivalent of the SEC. While working hard to upgrade their capabilities, the CSRDC still lacks adequate staff with the requisite background and experience to reform, modernize and regulate these markets in a way that will install confidence in global or even domestic investors. The QFII (Qualified Foreign Institutional Investors) program, to allow foreign investors into Shanghai and Shenzhen, has been a disappointment. As with banking, any increased interaction between China and America that involves training and an exchange of views will be highly constructive.

#### ***IPOs on NASDAQ since 2000***

There are 23 high-tech companies from China that have done IPOs on NASDAQ since 2000. These are young companies with young managements, largely educated in the west. Some will succeed and some will fail—with good and bad plans, technology, management and execution. These companies represent the heart of China's most promising young companies. These firms choose to list on NASDAQ instead

of on the domestic Chinese exchanges because they are well aware of the shortcomings of the domestic markets. This fact is gradually being absorbed and accepted in China, and will become an ever more powerful incentive for reform in Shanghai and Shenzhen. We can't imagine a quality young Chinese company listing domestically under anything that remotely resembles the current environment. To use a baseball analogy, why play in the minor leagues (Shanghai, Shenzhen) when you can play in the majors (NASDAQ, NYSE)?

***Recent and future IPOs***

Last week a small Chinese Internet search company, Baidu, completed an IPO on NASDAQ to great fanfare and publicity. At present, there are discussions between a highly respected and rapidly growing private Chinese company, Alibaba (the Chinese Ebay), and Yahoo about a major transaction. That these most attractive companies in China are forsaking their domestic markets and looking to list in America speaks volumes about the need for reform in China's securities markets.

***Debt Markets, Foreign Exchange and Other Matters***

***Leaving the debt markets to later***

China's debt markets remain even more undeveloped than the equity markets. With SOEs still dominating the production side of China's economy, banking as noted above remains the dominant form of finance. Yet around the world, the record is clear—a well functioning debt market serves the private sector of the economy and serves the financing needs of the government as well. China is making some progress here, but it is slow, and in our view, of secondary importance to developing the equity markets and making the banking system modern and functional. With western talent still scarce in the finance arena, to focus on the debt markets at a later date is both understandable and appropriate.

***The currency and foreign exchange markets***

Without getting into the core of this contentious debate on the pegged currency, revaluation and trade, it is I believe appropriate to consider them briefly.

***Revaluation on July 21, 2001***

The revaluation of the Yuan by 2.1% on July 21, 2001 from the long-standing peg of 8.28 to 8.11 was a small step forward. The announcement that China was adopting a "managed floating exchange rate regime" with reference to a basket of currencies and to supply and demand conditions was especially heartening. China further indicated they might revalue (up or down) the currency by up to 0.3% on a daily basis. But at this point the focus seems to be more on managed and less on floating. And the reference to a basket of currencies seems almost entirely misdirection. Our calculations indicate that the daily movements in the currency bear no resemblance to what would seemingly have been implied by the currency basket movements. We hasten to add that China is a sovereign nation and can handle their currency in any manner they choose. It is their currency. However, China adopted the language of the currency markets in announcing their revaluation and new exchange rate regime changes on July 21. To then act differently from what any reading of their statement would mean has been distinctly unhelpful. We expect that in the coming weeks more unhappiness on how this matter was announced and is being executed will become widespread, to China's damage, not to her benefit.

***China's long run goal***

We believe that China wants to be regarded as a full fledged member of the global economic and financial community. To achieve this standing by the time of the Beijing 2008 Olympics would be most desirable from Beijing's perspective. To be so regarded, a necessary but not sufficient condition is that China has a currency that is freely floating and freely convertible—not fixed to the dollar. Much has to be done in reforming China's capital markets and financial system before they are ready for the rough-and-tumble of these markets. And for China to act before they have the requisite reforms and the knowledge base would be dangerous. But this is a date peg that suggests China will work hard to meet and should be susceptible to ideas for reform and modernization coming from any source.

**Panel III: Discussion, Questions and Answers**

Cochair WESSEL. Thank you. I do have to note before we turn to our first questioner that I did not find as much discrepancy in your views as you indicated with the previous witnesses, but we'll leave that for questioning.

Mr. Reinsch, you go first.

Commissioner REINSCH. Thank you. You've taken the words right out of my mouth on that latter point. Mr. Gaffney, you alluded in your opening remarks to the joint appearance you had with Chairman D'Amato before the House Armed Services Committee. I was distressed to discover from some of my colleagues that in that same appearance, you called me a lobbyist for Communist China or employed by entities that are.

What's your evidence for that statement?

Mr. GAFFNEY. My evidence is pretty much what you have said on the public record in terms of your role as an advocate for China in the Trade Council and in your representations in this Commission and in your public appearances on television and elsewhere. I have no—I did not represent and I certainly did not mean to suggest that you are paid by Communist China for representation.

I simply suggested, as was clarified in an exchange I had with one of the Members of the Committee, that this is a role that I think is completely inappropriate for a Member of this Commission playing an independent and objective function of overseeing the U.S.-China relationship.

Commissioner REINSCH. Well, it would certainly read differently by the people that talked to me including my wife who wants to know where all the money went that the Chinese are apparently paying me.

For the record, there is none. I must say I'm disappointed. We've attacked each other's views strenuously over the years. And actually it's been kind of fun. In this case, you've attacked my integrity, and I'm disappointed about that. I'm not a lobbyist for the Chinese. I think the fact that I don't agree with you doesn't make me one.

I regret very much that you chose to present this in a forum, not only where I wasn't there, but where—or I have been there and maybe I'll be there again, but where you've essentially called into question my integrity.

Mr. GAFFNEY. May I respond to that?

Commissioner REINSCH. Sure.

Mr. GAFFNEY. This is not a matter of integrity, sir. This is a matter of, I believe, a conflict of interest. And people can have complete integrity, and I certainly suggest that the other gentleman I mentioned, Mr. Langdon, who is the Chairman of the President's Foreign Intelligence Advisory Board, who does work for a company that is a paid lobbying operation for the Communist Chinese, is a man I'm sure of perfect integrity.

It's simply a conflict of interest, and I would suggest that that's undesirable and regrettable.

Commissioner REINSCH. Well, I think we have a disagreement over what integrity means and also over what the proper role of Members of the Commission is, but I don't think I'm going to get very far by pursuing it except to say that I'm disappointed and distressed.

Now with respect to the other two witnesses, what I would really like to do and what I think would be most interesting to the Commission is if we could ask the witnesses from the previous panels, several of whom are here, to get up and comment on what you've said because you really should have been on those panels

since you've addressed the same issues but presented a diametrically different point of view.

I really don't have anything to ask either of you because I'd really rather ask the other panelists think of what you've said, but I suspect we don't really have an opportunity to do that, Mr. Chairman.

Cochair WESSEL. No, we don't. If you'd like to ask those witnesses to supply comments in writing afterwards, I'd suggest that might be appropriate.

Commissioner REINSCH. If you would like to submit a comment on any of the three witnesses' statements, I'd be appreciative and would like very much to have it since they, in essence, disagreed with many of the things that several of you said.

Thank you, Mr. Chairman.

Cochair WESSEL. Thank you. Commissioner Dreyer.

Commissioner TEUFEL DREYER. Dr. Straszheim, I was very interested in hearing what you said about the market basket of currencies. I read an article in yesterday's Washington Post Business Section and was very surprised that, in addition to the usual suspects—the dollar, the euro, and the yen—the Singapore dollar was part of the basket, and also that the Chinese had refused to elaborate on what weighting they would give to each of these currencies.

If you were being asked by the Chinese government how to set up this market basket, what would you advise?

Dr. STRASZHEIM. Well, I think I would defer and not advise them.

Commissioner TEUFEL DREYER. Tell them to go somewhere else for advice?

Dr. STRASZHEIM. They're a sovereign country and from my perspective, they can manage their currency in whatever way they want. They can create a basket. They cannot create a basket. It could be a rigid formula. They could change the weights of the basket everyday. It's up to them.

Let me make two points. The idea that the Singapore dollar is there, I think it makes in some cases much sense to have the currencies of those countries that do a meaningful amount of business with China in that basket. So in our own work, we have suggested a basket before they announced this that would include the Singapore dollar, the Canadian dollar, the Aussie dollar, and the Russian ruble, Brazilian real and so forth. Those countries that are important to China.

My broader point is, though, they use the language that's known in the international finance markets, talking about a basket and talking about the potential for the currency to float by up to .3 of a percent a day, according to supply and demand conditions with reference to this basket. That's close to a precise quote.

So as we've looked at this, what it turns out is that these currencies are moving on a day-to-day basis and yet it looks like they have really adopted a regime which is ever so close to just a new peg at 8.11 instead of 8.28. That I think is not helpful because it's misleading.

I could say all day that the coat that you're wearing is black, whereas everybody else thinks it's tan. My saying it doesn't make it black or tan. But it just causes confusion because everybody else sees it and accepts some different definition.

Commissioner TEUFEL DREYER. But this leads me to a larger question: how does the People's Bank of China manage the economy? Is this bank going to decide the value of the yuan? Please help me to understand this better.

Dr. STRASZHEIM. Well, I—

Commissioner TEUFEL DREYER. Yes, I know—it's a lot to ask in two minutes or less.

Dr. STRASZHEIM. Well, quite frankly, none of us know. And People's Bank of China is not about to tell us. What I find most unsatisfactory when I look at China is not that they don't have an independent monetary policy, although I think an independent monetary policy has been proven around the world to be quite useful, but in some sense they hardly have any monetary policy at all, in the sense that they don't have a banking system that allocates credit according to kind of risk-reward criteria: the good applicants get the credit and the bad applicants don't.

So to flex the interest rates up and down, to modulate the economy is kind of a tried and true way. People's Bank of China just doesn't have that tool available, and accordingly it is really quite hamstringing in the sense of their ability to control growth, inflation and all the other variables that they would like to be able to influence.

Mr. GAFFNEY. Could I make a point on this? I would certainly defer to my colleague's expertise in the economic aspects of this. Just looking at it from a strategic point of view, I don't have any clearer idea than he does as to how this black box is going to operate, but I do think that factors that will be involved in how it operates are corruption, and the effort to jujitsu, if you will, this pressure on China to change the value of its currency into a new instrument for rewarding its friends and punishing its foes.

I think has been indicated, the people who are likely to be in the basket are countries that are important to China. What does that mean? My guess it means that you'll see it used to the detriment of the United States when it serves its purposes.

Commissioner TEUFEL DREYER. Dr. Tadesse?

Dr. TADESSE. Yes. On this point, what I would like to add is that countries have a choice to adopt a flexible exchange rate system or a fixed exchange rate system; there are legitimate reasons governments use fixed exchange rate mechanisms for. But a point we have to keep in mind is that China is a command economy and so the government's use of the fixed exchange rate regime could be excessive; and this is basically an extension of what I alluded to earlier as the government wanting to have its hands in every financial affair, including the banking sector as well as the exchange rate regime.

Another way to look at it might be that while domestic banking repression transfers wealth from the citizenry to the government, the fixed exchange rate system, when it is pursued excessively, could be used for expropriation of wealth from other countries to China. So they complement each other and, in that sense, we should be concerned about it.

Commissioner TEUFEL DREYER. Thank you very much.

Cochair WESSEL. Thank you. Dr. Straszheim, you just said if I could paraphrase a bit, that it's not really a float; it's a peg or a

new peg. I think part of what we're dealing with here is problem of terminology where we want to overlay our terminology on the Chinese, the incompatibility of our markets.

We want them to address the common rules of trade and ideology as it relates to free trade and comparative advantage when we have a market economy on one side and a non-market economy on the other side.

As part of that terminology, I'd like to know why we consider these to be bad loans? And I'd like to hear from each of the panelists. Bad loans that have brought an economy to the point where it's growing at eight, nine, ten percent per year; loans that have helped build up a military infrastructure that is becoming a world-class military force. Are we the only ones who consider these to be bad loans when, in fact, they are use of governmental and other financial tools to advance its own interests?

Mr. Gaffney?

Mr. GAFFNEY. Well, I think bad loan is a technical term, but I'm not sure.

Cochair WESSEL. It may be to us, but they're looking at it differently.

Mr. GAFFNEY. No, I think you're on to something. In terms of the Chinese government's, as has been now acknowledged, remaining a command economy, despite all that we hear about in this building and across the Hill and downtown, that it's now no longer Communist. In fact, I've been discouraged from even calling it Communist, though they call it Communist, and that it's a free enterprise operation, when it is clearly not.

Now, it may be something approaching a fascistic economy, but it is certainly not a free market economy. And as with fascism, I think the state finds ways to use capitalism or quasi-capitalistic operations to underwrite activities most especially of the kind you've highlighted, that are bad for us, the strategic purpose that I was talking about earlier. This military build up, this acquisition of influence in not only Latin America and Asia and so on, but here.

Are those bad loans? Are those loans that will not have a very handsome return on investment for China's longer-term strategy? And come at our expense? My argument is in that sense no, they're not bad loans at all. I think in the technical sense, meaning you're likely to get repaid with interest, they would probably fall outside of the realm of good loans.

Cochair WESSEL. I understand. Dr. Straszheim.

Dr. STRASZHEIM. These are bad loans in the sense that if you look at the books of these state-owned enterprises, they've not booked a profit that would allow them to pay the seeming interest to make them whole, so in that sense, I think they are bad. But it is an important point I think that we come from a different perspective than they do.

Our system is different. Their economy is part command and controlled economy, part market economy. It's mixed. I'm optimistic from the point of view that the command and control portion of the economy is declining and the market portion of the economy is rising. If you asked Starbucks who has a couple hundred Starbucks over there, selling decaf lattes for 3.35 a cup, they would tell you

in downtown Beijing, they would tell you that it's a real market economy to them.

On the other hand, the CNOOC loans, these weren't loans. These were zero interest loans. These were loans that ultimately would have to not be paid back at all. So in that sense, there's a lot of confusion here.

Cochair WESSEL. Just like the loans that I give to my children it sounds like.

Dr. STRASZHEIM. I'm sure.

Cochair WESSEL. Dr. Tadesse.

Dr. TADESSE. I think the confusion arises because we are using our standards in trying to understand what goes on there. In a way, as I suggested earlier, in the strict sense of the word, these are not loans; these are grants. With a grant, as it is a gift, there is no expectation of payback. But because these are banks, and banks are in the business of lending, we also have to use our standards, the standards of banking everywhere—if they are granted in the form of loans, and when they are not paid in full, they then would qualify as bad loans.

So it's a confusion of terminology. In a way, a confusion of culture; we are dealing with a different culture. But this also leads us to another question: what's the advantage of this government ownership of banks and therefore government direction of credits from the Chinese perspective?

There's a debate on this issue. One view holds that government ownership is completely bad, but my view is a little different in the sense that, from the Chinese perspective, what they're trying to accomplish is trying to catch up with the West, and so the marshaling of the resources is not intended for quality, quality of investment, it's rather for building up industry and whatever they're lacking in.

Well, of course, there is the bad side in this because, as you know, the screening and monitoring mechanism in banking is not at work here. When banks advance credits, they screen borrowers, they evaluate the risk/return tradeoff, and monitor the borrowers thereafter. That is not done here, and as a result, down the road, what you bring in is investment inefficiency; but that's not their main concern right now, which is quantity, not quality. Those are my thoughts on the questions you raised.

Mr. GAFFNEY. Commissioner, could I just add quick points on this?

Cochair WESSEL. Yes.

Mr. GAFFNEY. In response to what was said a moment ago, it does seem to me that if we're looking at a mixed economy with some being private sector and some being command and control or fascistic or whatever you want to call it, to turn to the topic of this hearing, is the effect of American investors purchasing the stocks they're allowed to buy, ten or 15 percent I think on average, of these state-owned enterprises the way China envisions perpetuating its otherwise unviable command and control sector?

I think that may well be the case and along with it the activities that we would not consider to be good or certainly good loan kinds of activities.



And the second is I think it really comes to the point that I was trying to speak to earlier: when we say these are banks, when they come to market dressed up like they're banks and nobody knows what's in their portfolio, the would be investor has no transparency, again, on what's this black box about, it creates, I'm afraid, a false confidence, a false expectation that it is going to be a bank, that it will return investment, it will otherwise be a wise thing to hold in portfolio.

I'm not sure that's true and that's why I think this hearing is important and the transparency that I hope you will encourage is so important.

Cochair WESSEL. I appreciate that. Chairman D'Amato.

Chairman D'AMATO. Thank you very much, Commissioner Wessel. First of all, I want to thank this panel. This panel is kind of a seamless web from end to another in various ways. I want to commend Mr. Gaffney for your long service on behalf of the nation. I remember working with you in the Senate many years ago, you with Scoop Jackson and I with Robert Byrd, doing a lot of things in the Armed Services Committee.

Yours is a somewhat different perspective from the previous panel, much of which they said I agreed with as well, and that may be contradictory. So I just want to point out to Commissioner Reinsch, that if we're going to have written comments from the previous panel on the statements made by this panel, that we can at least then provide those written comments to this panel for their written response, and that I think would be fair. We'll try and do that. We won't continue that on ad infinitum, but at least two rounds would be, I think, good.

I would like to say that in terms of the banks, it's hard for me to really envision these are really banks as institutions that we understand as banks. What you all are saying is that they are lending arms of the government. I think no one would really dispute that.

In a command and control economy, essentially command and control, maybe shifting in some ways, but still command and control and highly corrupt, I think there's a general consensus on that one, the question we have then is how do we help reform this system or do we just ratify the system? It seems to me that right now front and center of this whole IPO situation raises that question. How do we handle the IPO situation? Are we going to ratify the system as it exists or are we going to help reform it?

It seems to me—and I'd like the views of the panel on this—that we've got to find a way to put the same kind of standards of exposure of transparency and all of the things that we require of our own offerings in the New York Stock Exchange, impose them on these banks, and that means, it seems to me, we've got to find a way to get into the details of the loan portfolios. What are the loans that have been given? Loans given to Sudan, Iran? What kind of an institution do we have? Why? Because we just went through a bubble where millions of Americans were defrauded through a high tech bubble.

I don't want to see us sit around and watch millions of Americans get defrauded on a China bubble, and we're in the position now I think that we can move in the direction of strong, stringent transparency in this.

There was a mention—I think you mentioned two banks and NPLs. I think you mentioned the Bank of China and China Construction Bank.

Dr. STRASZHEIM. Yes, sir.

Chairman D'AMATO. I've got a rating system here that we've gotten from a reputable Wall Street firm that shows all of these Chinese banks are way below par compared to banks, international banks. International banks rate at the average of C plus. There is no Chinese bank that rates even a C minus. They're all either D or F or E, and those two banks, those two banks, Bank of China is a D minus. China Construction Bank is an E plus.

Now, it seems to me if those banks are going to come to our market with IPOs, our investors ought to know why they're being rated that way? Would you recommend that your cousin invest in these banks given that kind of rating?

So it seems to me—I'd like your opinion on this—that one way we can help move the system, reform the system, is not ratify IPOs which are going to have the potential of risk for our investors, for our teachers, for our policemen, for our firemen, for those retirement systems and mutual funds. We can do better than that. It seems to me in this case, we are well advised to insist on a kind of a transparency that would be equal to them coming on to our New York Exchanges.

Let me get your comment on that. Mr. Gaffney.

Mr. GAFFNEY. Well, I agree with you up to a point. I think it is certainly true that free pass that I was talking about in my testimony is ill advised. We are, I think, doing neither the Chinese nor certainly American investors any service by pretending that these are banks, credible, well-financed, well-managed banks. I was listening to my colleague here talk about what amounts to these poor banks.

They don't have technology, they don't have—let's be clear. The Chinese are very adept at business practices that serve their purposes. This is not because they can't figure out how to bank that they're running banks this way.

What makes this particularly important is I really believe that they have figured, based on past experience, both with banks. One of these Chinese banks I think went to Hong Kong and got \$1.9 billion just recently. They've got two more that as you say are coming. One that they think, I think both of them, I'd expect, may get as much as \$5 billion out of their capital markets.

This would reward them. But the point at which I think I disagree with you, and respectfully, is I'm not sure that it's enough given the character of the Chinese Communist government that owns these banks, and the use that they put these banks to, to simply say they ought to meet the same standards as American banks. I'm not sure that we have the right to look in the loan portfolios of American banks. I just don't know enough about that.

But I certainly think you're right. We do need to be able to see who's held in portfolio and what is being done with the money? Because the alternative is to simply be writing checks that will indeed turn into new bad loans and a lot more bad activity. You can bet.

Dr. STRASZHEIM. I think we ought to have, Mr. Chairman, I think we ought to have a great deal of confidence in our own capital markets and the collective investment judgment of the American investors who are potentially going to buy these IPOs.

If these banks try to do IPOs here, they're going to have to go through the same process, the same kind of disclosures that anybody else does to come with an IPO, whether it be from China or Germany or anywhere, and I think Wall Street will do quite a good job at looking at these IPOs and will be able to decide how to price them, and in the last analysis the pricing of these IPOs and what happens to the value of these different securities is up to the investors.

It's not up to the, it seems to me, any government agency and my own view is that these banks are nowhere close to being ready to stand up to Western scrutiny. In 2003, China Construction Bank and Bank of China were talked about in China to do IPOs in 2003. Didn't happen. Well, maybe we'll get them done in 2004. It didn't happen in 2004. Well, maybe we'll get them done in 2005, and now it's probably—it's not going to happen in 2005 and maybe it will be 2006 and mainly only in Hong Kong.

So I think the markets really work quite well, and we are weeding these potential issues out.

Dr. TADESSE. The question is how can we help China to reform its banking sector in general, and in particular with respect to the IPOs. Now from my perspective, I think the key ingredient for reform will be the opening up of the banking sector to foreign competition. That would serve as a prime catalyst in both improving practices and dealing with the other concerns we have.

It's competition and privatization. I do not think that—I would agree with my colleagues here—rushing into allowing IPOs of state-owned banks is to the interest of the U.S. I think we have to first ensure privatization and competition.

But with respect to introducing transparency and the like for IPOs, not only IPOs of banks but IPOs of non-financial institutions from China, it seems to me that the current regulatory regime where you basically look at the checklist of disclosure may not be adequate. My point is that we should realize that China is a command economy, and in a command economy what we have is that all economic agents, including auditors and accountants and agents of information are under guidance from above. Under these conditions, where you have a complete breakdown of governance or transparency, the way the disclosure, the manner in which the disclosure is produced, is much more important than, simply going through a checklist. There are some scandals, such as China Life, for example, which alerts us to this possibility.

Hence, I think a strengthening or rather changing the manner in which the SEC goes about disclosure, ensuring disclosure compliances, would be one area we have to look into.

Chairman D'AMATO. Thank you very much. I think that's quite important, the SEC. I must say, though, I don't have the kind of confidence that is expressed here in terms of Wall Street. Let's face it, what happened earlier with Sinopec I believe was being marshaled through by a Wall Street firm, and they get big fees. So anything they can make a market on and take a fee in and then they

hit the road afterwards. I think we've got a lot of expertise in bringing a pig's ear to make it look like a silk purse, and then there's a lot of people holding the bag later and find out it's not a silk purse.

In any case, I just want to also mention for the record that the rating I mentioned on Wall Street was a Moody's rating. These are Moody's ratings, and we'll put that in the record.

I just have one quick other question. You mentioned the basket of currencies. Do I understand that you have actually created a couple of model baskets of currencies and then show how they would move as opposed to what the Chinese are saying with their mysterious basket?

Dr. STRASZHEIM. Yes, what we've done, Mr. Chairman, is tried to estimate in our own way what we think the currency would have done since the revaluation of 2.1 percent on July 21, according to what our analysis suggests would be in a basket if, in fact, that's the way they were managing their currency.

So we've looked at the things that would be important, which are trade flows and foreign direct investment and so forth, and created a variety of different sets of weights looking at the euro, the yen, the Singapore dollar, and various different ones. And then accordingly calculated what the daily move in the currency, in quotes, "should," have been were they using that basket and compared that to the actual new announced rate which they said they were going to do, and in fact are announcing on a daily basis.

And our finding is that there is precious little correspondence.

Chairman D'AMATO. Well, can you submit for the record your findings on that or can you tell us what the differential is from what you know so far?

Dr. STRASZHEIM. I'll be happy to. I'll submit that. But it's material. It's material enough. I'll be happy to submit it for the record, but it is material enough to lead us to conclude that this basket concept is being in our perspective honored in the breach.

Chairman D'AMATO. Thank you. Very, very interesting.

Cochair WESSEL. Thank you. Vice Chairman and Cochairman Robinson.

Vice Chairman ROBINSON. Thank you, Mr. Cochairman. I just wanted to echo the Chairman's skepticism that the marketplace is necessarily going to serve us in this particular endeavor. Will the market really vet those state-owned banks in a manner that ensures that the investor has adequate information to make an informed judgment? The Chairman provided the example of Sinopec which came to the New York Stock Exchange for I believe 3.4 billion in June of 2000.

We've heard testimony that two of Sinopec's subsidiaries have been sanctioned by this country for the proliferation of weapons of mass destruction. In our preparation for these hearings, we made an effort to look at the prospectus of the Sinopec IPO and its other filings to see if in the risk section or another appropriate section the investor was made aware that two of this company's subsidiaries were reportedly involved in proliferation-related activities.

I think it's the case that the proliferation of weapons of mass destruction in this environment, as one of the two most pressing security issues of our time, along with global terrorism, should be

viewed as a material risk that should properly be disclosed to investors. We did not find any reference to these subsidiary activities in those filings.

We're not dealing with Belgium or Argentina here. We have a particular set of concerns. When it came to the CNOOC case what would have happened if the Congress had not played a more robust investigative role in scrutinizing that transaction? Would we have learned about MollyCorp and its rare earth minerals that have such military relevance to this country? Would we have learned about the potentially dual-use technology such as cavitation equipment? And would we have learned the breathtaking level of no interest or below-market loans totalling some 13 out of 16 billion in external financing?

It took a lot of extra debate, well beyond the Wall Street variety, to come up with the facts of the case, and we know what the epilogue was.

So I share the Chairman's concern that company's don't advertise the proliferation activities of their subsidiaries. And we have the added burden that sometimes we generate intelligence information that's unknowable by the public or even by the investment banks or others that are performing this due diligence. I don't have a ready answer to this concern.

I'm suggesting to you that the capital markets pose a particular type of challenge. My money and the money of the people observing this hearing were not implicated in the CNOOC-Unocal transaction. But they may well have their retirement dollars and other investment capital implicated here because they'll not know that their mutual fund and pension fund or 401(k) plan have purchased the stock of the Bank of China or the China Construction Bank. For example, they probably did not have a full understanding at Harvard that they owned a good deal of PetroChina stock, but only after they discovered the large-scale involvement of its parent company in the killing fields of Sudan.

I'd be interested in your view on mechanisms that go beyond standard operating procedure when it comes to these bank portfolios. We heard testimony earlier today that indicated that it's just too hard to look at what could be thousands of company names that represent the customer base of the Bank of China and the Construction Bank.

Those are legitimate questions and I understand that, but I'm just trying to probe a little further on whether you fundamentally believe that the magic of the marketplace, as President Reagan would have called it, or the standard Wall Street drill of due diligence is indeed adequate to ferret out, delineate and understand the true activities that are being funded by these institutions Mr. Gaffney and others have indicated, that to the American people would be potentially appalled were they to know that their hard-earned dollars were implicated? Do you have any views on that?

Mr. GAFFNEY. Is that a directed question or do you want all of us to comment on it?

Vice Chairman ROBINSON. Well, I just thought—

Mr. GAFFNEY. If I may leap into the breach here. I think this question that the Chairman has raised about a China bubble is directly relevant to this discussion. The market cannot work—let me

repeat that—the market cannot work without information. And to the extent that we do see nontransparent companies coming to market, it's impossible for investors, certainly individual investors, and I think probably most institutional investors as well, to make informed decisions, to understand material risk.

As you know, Mr. Vice Chairman, the SEC has begun calling some of this global security risk which has real financial repercussions. How can they assess that if the conditions that give rise to that risk are not disclosed? And they're not being disclosed, as your study of this has indicated.

I just have to say that I worry in addition, and again I don't want to sound as though I'm impugning anybody's integrity, but there are conflicts of interest at work in this area as well. You have qualified foreign international investors, QFIIs, that do get into the markets that Dr. Straszheim has said nobody would want to fool with, and through their investments, you do have institutional investors finding they're holding, if they have the whitt to look for it, in portfolios some of the A shares and things that would be turning up there.

You have companies, as has been mentioned, I think, by the Chairman, that have a very profound vested interest in successfully bringing to market in America these sorts of state-owned enterprises, and it's not to say they don't have integrity when they do it, but does it affect how intensively they do due diligence? I would think that's not an unreasonable guess.

Finally, I mention in my testimony something that I just, and urge this Commission to take a hard look at, because again as part of the larger strategy that worries me at least, the possibility that unwitting American investors could become, in effect, suborned, could become invested, even though they didn't know it, in China and in these otherwise unsustainable state-owned enterprises could give rise to a China lobby that would make what we've seen in terms of co-opted businesses in the past pale by comparison.

There would be no more talk of sanctions. There would be no more talk of the kinds of pressure perhaps on China that might jeopardize people's pensions, people's nest eggs, because unbeknownst to them they wound up being invested in places that happened to be supporting proliferation or terror or other activities inimical to our society.

Again, this is something I do not believe for a moment that veterans, firemen, policemen, state and local public employees, teachers, would want to have any part of. And yet they will not be able to do otherwise unless they know more, and without knowing more, the market cannot be a guarantee against it.

Dr. STRASZHEIM. Can I say something quickly on this? I think it would not be unreasonable to think about some additional disclosure requirements when, in fact, we're talking about IPOs of state-owned enterprises as opposed to IPOs of just conventional private sector companies.

Now, in fact, as I think it as I speak, you could require some additional requirements and then in the case that was just a private sector firm, those requirements would be moot, but they would be relevant only in the case of a state-owned enterprise. Nothing wrong with that it seems to me.

Two other things. The financial markets with respect to Molycorp and the rare earth minerals, I think the financial markets were well aware of that before CFIUS and all of this furor kind of began. Sinopec IPO in 2000, as you well know, in the risk statements of when various prospectuses, there's a standard litany of things about management and market conditions and industry, and so forth, and it's not at all obvious to me that there's—maybe there should be—some additional requirement, but this happened in 2000, not after 9/11, and I'm not sure we should be too critical about what we did know or what we didn't know at that time.

The investment by qualified foreign institutional investors in the Shanghai and Shenzhen markets in A shares, I believe in most of those cases, the rationale is not that these investments are going to be especially good investments, but rather that these are investments really in relationships in the future. And I think that's the case of the investments by the biggest banks in America buying into the big four banks.

I think the big four banks are dinosaurs and I believe those banks who are investing in them likely see them in some similar way, but they would like to get in the door and make those relationships for some unknowable potential future gain.

Cochair WESSEL. Thank you. I apologize. We're going to have to cut this line off and turn to Commissioner Mulloy for the last line of questioning.

Commissioner MULLOY. Thank you.

Dr. TADESSE. May I respond to his question?

Cochair WESSEL. Yes, a quick response.

Dr. TADESSE. I agree with the points you made, that markets are not equipped to assess the types of risks you alluded to. And that's not particular to China. Even within domestic setting, if you value two banks, one exposing the country to certain types of risks you mentioned, and the other safe on that regard, the evaluation differs based on the monetary returns, and not on the basis of security concerns—that is—even for domestic investments.

So then where do we go from here? Well, the question you raised is in the context of IPOs. But one point we have to be clear is that the advantages of IPOs for the constituents in the U.S. is mostly to investment banks and not really for the investing public because the investing public has many other menus or options to expose itself to China's investment opportunity.

They could use pension funds. They could use mutual funds and a number of other investment options. It may be, I think, prudent, or maybe operationally simpler to control or regulate the investment strategies of pension funds and mutual funds rather than to burden the financial markets here with additional requirements of going through new types of disclosures. So that avenue also should be looked into; probably discourage IPOs if they are uncertain, if the use for which they plan to deploy the funds is uncertain in terms of the security risks they pose, and regulate instead of the investment strategies of other investment avenues such as pension plans and mutual funds through which U.S. investor might be exposed to Chinese investments.

Cochair WESSEL. Commissioner Mulloy.

Commissioner MULLOY. Thank you, Commissioner Wessel. This is directed toward Dr. Straszheim, but if the others want to comment. Let me just spin out a little bit what I think may be, and then help me think through. China went through a bad couple hundred years. They were a great civilization, went through a bad time, people were ripping off parts of them and drug wars, making their people take drugs, the British and the opium wars and all this.

So they had Mao Zedong came to power in '49, they wanted to change this humiliation that they feel they went through—now they talk about this term “comprehensive national power,” which I think means political, economical and military integrated. They weren't able to build it under Mao Zedong and the Communists. Deng Xiaoping pushed for a different approach to how to do this, and he began to talk about, well, let's move forward technology, science and have the foreigners come in and help us do it.

They reached out to get foreign investment. They reached out to become part of the global economy, still being a pretty centrally directed political system. WTO entry I see as part of that because essentially what they do then, if the U.S. could take away MFN and instead of a 2.5 percent tariff, the Chinese have a 40 percent tariff, then the foreign investors aren't as likely to want to go into China to invest because a lot of it is shipped out.

Sixty percent of Chinese exports are from foreign invested companies. So WTO is another part of getting this system right, and they got it. They do have a strategy of pillar industries. There are certain industries they think are very important to build your comprehensive national power. Automobiles is one of them. I think aerospace is another. Semiconductors is another.

In the earlier panel, Mr. Bottelier and Professor Meyer both mentioned this phenomenon of they did a lot of consumer lending for automobile purchases in China, and then there was a lot of money then invested in to building automobile plants in China, investment building. Suddenly that went out and they're not selling as many automobiles in China, but now they've got the industry there so they're going to export more automobiles and auto parts and other things.

Now, you see Adelphi in trouble and GM in trouble. So what I'm thinking is, and then one more thing, the exchange rates, and you Dr. Straszheim say, well, they're a sovereign country, they can do what they want with their exchange rates. That may have been, but once they're in the WTO and the IMF, they have certain international obligations that don't let them do what they want with their exchange rate system because now they're part of a system where they're not supposed to be manipulating their exchange rate to gain trade advantage.

They seem to have an integrated view of how they're moving themselves forward, and we don't. We're kind of ad hocking everything. Well, we'll go after them on exchange rates or we better deal with the safeguards on textiles, but we have no comprehensive vision of what we got here. This is not Europe. This is a different kind of entity, and our policies and our vision of how to operate in a global economy is quite different than what we've got here. I'm just wondering, is that right?



Secondly, is that something that the United States really should begin to address at a lot of urgency, how do we nationally deal with this issue we've gotten ourselves into? So Dr. Straszheim.

Dr. STRASZHEIM. I'm not sure where to start, Mr. Commissioner. It is clear that after the Cultural Revolution from '66 to '76, which was arguably the most damaging and devastating social experiment in the history of the world, ended and they started the reform and opening up process in 1978, with Guangdong Province basically being a tested to see if they could kind of toy around the edges with a market economy and so forth, and then if it worked, then do a little more. It's kind of gone national now. That's kind of the way I would describe what's happened.

You called them pillar industries. They have a host of industries which they regard as strategically vital. The oil industry is a good example of that. CNOOC, PetroChina and Sinopec are the three main players. Beijing is in charge. The markets aren't in charge, the markets are not going to be in charge. Western involvement is going to be around the fringes rather than at the core of energy and oil sector in China.

Their lists of strategically vital industries I think is much wider than ours would be in some sense. I was quite frankly surprised during the whole CNOOC episode. Right in the middle of that China announced new regulations limiting foreign investment in the steel industry.

Commissioner MULLOY. Yes.

Dr. STRASZHEIM. Right in the middle.

Commissioner MULLOY. I remember that, yes.

Dr. STRASZHEIM. And I was kind of amazed at the silence, quite frankly, that people didn't jump on this more as the non-level playing field kind of issue, but whatever.

Commissioner MULLOY. We spoke about it.

Dr. STRASZHEIM. I think they are going to continue to have this perspective, and we don't, but I've looked at a lot of the Five Year Plans that China has developed all the way back to 1949 or '50, whenever the first one came out, and I must say I don't think that is an especially effective way to try to run an economy. I'm much more comfortable with the invisible hand than with the iron fist, but China clearly has part of the economy that is command and control economy, strategically vital, they're not going to change that.

Part of it is market economy, not that important, not damaging, let the market forces work, and I believe that the more involved we become with China over time and their involvement, their entry into WTO will encourage the shrinkage of the command and control portion and the increase of the market portion, and from my perspective, that's a good thing.

Mr. GAFFNEY. Well, maybe, maybe not. I'm concerned that one thing that I think perhaps inadvertently was left out of your synopsis was the emphasis that Deng Xiaoping and the 16 Characters formulation placed on everything being subordinated to the military. He was indeed interested in getting Western and outside help to build China's technology base, its scientific capacities, its industrial capacity, but it was in service of the military which brings me back to the strategy that I think is at work here.

You said it very well. I've used the same formulation in fact. They've had a bad couple of centuries. But in a society, in a civilization that prides itself on having been the center of the universe for millennia, it's coming back to its rightful place, and Deng's policies and those that have been I think advanced subsequent to his departure from the scene are very much of a piece with that and worrying for that reason.

It is of a strategic character, not simply of a commercial how do we retool our industrial base. Could I just say in that regard, there were several things that I didn't want the Commission to miss that I think were important acknowledgements perhaps by Dr. Straszheim.

One, the market did understand, he says, that we were 88 percent dependent upon Communist China for rare earth minerals. But it was unconcerned about that. And as you've said, I think, had it not been for a hue and cry being raised by Congress, this deal probably would have gone to the high bidder including the last source, other than Communist China, as a practical matter of these rare earth minerals which are critical for our industry.

He mentioned that QFIIs are doing this not because it makes business sense in a financial return in the near term on investment, what investors might reasonably think is going on, but rather it's getting into the game. It's building future relationships. Bingo. That's what I'm talking about. It is the co-option of our businesses into believing that if only they will play ball, whether it makes sense financially in the short term or not, they will get some bonanza down the road.

Michael Ledeen, a former Member of this Commission, is fond of saying, as I'm sure you've all heard, we've been looking for the illusive China market at least since Marco Polo's day, and it's still over the horizon, and yet QFIIs and people who unwittingly are investing through them or getting into their portfolio the products that don't make financial sense in the short run, but will be good for the long-term business relationship of at least the QFIIs are not necessarily the same thing as sensible business plans, let alone ones that would really be acceptable to those investors.

In conclusion, I would just say I think that it is time—and I really am grateful for the existence of this Commission—it is time for people to say wait a minute, these theories that illusive China market will actually pan out, that they're doing all these things like engaging us to help build up their auto base so that we will be able to sell to their market—uh-uh—so they will be able to sell to our market and so on, get a hard scrub and a second opinion. So, again, I thank you for doing that.

Dr. TADESSE. In response to your question, I take a little slightly different view in that I see prospects for China to come into the world economic good partnerships, and my indications are the extent of reform that has taken place since 1980 up till now, and the expansion of the private sector, although it was not at the pace we would have liked it to be.

There is a prospect, also because of the joining of China to the WTO and, of course, its commitment to open up its markets to international competition as a result. This is also another indicator that strengthens my belief that China will come to the fore.

Now, however, it seems to me that the financial sector, the reform in the financial sector, is the critical step or it is the key. Why do I say this? The IMF and the World Bank had been in the business of forcing governments in third world countries to reform their economy, including financial sectors. From their experience, we learn it is pushing these countries to open up their banking systems, their financial sector, that is the last hurdle.

Basically, governments come to believe that the banking sector is an extension of their treasury, and they don't easily give it up. Thus, I think our last push to getting would be to pressure it on the financial reform. By that I mean privatization, change of ownership, and competition, particularly foreign bank competition. The government's power, essentially, is from the control it has on financial resources through the banking system. You take that away, then we I think will be on the right track.

Commissioner MULLOY. Thank you very much.

Cochair WESSEL. Thank you to the panel. We appreciate your time and all your service to us this afternoon. We're going to do a shift of panelists. Mr. Chao is here to begin, and we'll move accordingly.

[Whereupon, a short break was taken.]

Cochair WESSEL. Thank you. Mr. Chao, we appreciate your being here. I know you have had long flights to get here, and had planned on being on this morning's panel.

Mr. Chao is partner in charge of O'Melveny & Myers Asia practice. During his 25 years of practice with the firm, Mr. Chao has been engaged in a broad variety of transactional matters. He is responsible for establishing the firm's China offices and was stationed in their Shanghai office for seven years.

He's currently engaged in their general corporate practice with an emphasis on cross-border and Asia matters. He is a recognized authority on China and has extensive experience advising clients on China matters. He has advised clients from many sectors in connection with their investments and operations in China.

In the U.S., Mr. Chao has advised clients in connection with a variety of transactional matters including venture investments, corporate finance and M&A activities and we're pleased to have you here this afternoon. We are going to be fairly strict in our time requirements. Any prepared testimony will be submitted for the record and will be included and seven minutes, if appropriate, for your oral testimony, then questions.

Thank you.

**STATEMENT OF HOWARD CHAO  
ASIA PRACTICE HEAD, O'MELVENY & MYERS LLP**

Mr. CHAO. Thank you, Mr. Cochairman. It's a pleasure to be here. Thanks for honoring me with an invitation to speak. The beaches of Greece were getting old so I decided to come out and join you.

I have submitted some written comments and so I'm not going to try to go through all of those and I suspect much of what I covered in my written comments were covered this morning as well by other speakers, and I don't propose to duplicate their remarks either.

I will try to pick out a few key highlights from what I submitted to you to perhaps illustrate some of the changes that have occurred in China's participation in the international capital markets in the last year or so. I know that the Commission held a hearing on the subject in April of last year. And I believe that there are some significant changes that have occurred since then that may be noteworthy for the Commission.

First, to self-introduce a bit, as you said I'm the head of our Asia practice. O'Melveny & Myers is an international law firm with a very large presence in China. We have offices in Shanghai, Beijing, and Hong Kong, and I spent seven years in Shanghai building up our Shanghai presence before moving back to Silicon Valley about four years ago.

So we've been involved in the thick of much of the foreign direct investment as well as a lot of the IPO activity more recently that's been coming out of China. In particular, last year, we were involved with Shanda, which was the largest, a very large online gaming company out of China that did a Nasdaq IPO, the most successful U.S. IPO of last year.

This year we were involved with the Focus Media IPO on behalf of the underwriters Goldman Sachs and CSFB, which was the largest Chinese IPO on Nasdaq to date.

The numbers for China's capital markets participation are staggering. I won't go through those numbers because I'm sure you're familiar with those. I will also skip the discussion of why Chinese companies are coming abroad since I think you are probably familiar with those as well, but I would like to point out that because of the fact that the numbers are so big, that this is now becoming a two-way street in terms of benefits for the United States and China, and what I mean by that is if you look at some of the statistics, the investment bankers are telling you that Chinese IPOs were the second-largest source of fee revenue for the investment banking community in the last year, and that the Chinese IPOs were in fact IPOs more important last year than the European IPOs.

In addition, therefore, it's fair to assume that the trading volumes of Chinese companies in international capital markets—including U.S. capital markets—will be very significant in the future both in terms of overall volumes and also in terms of generating fee income for the financial community in the markets where they trade.

So I think it's important for us to look at this also from the point of view of the importance of the U.S. capital markets globally and their role in taking on the most important financial assignments globally including some of the most important companies that come to market and whether the United States is going to get that business in the future or whether that business is going to go somewhere else.

The pace of Chinese IPOs coming out in our estimation is accelerating. I believe that it's probably the largest pipeline of Chinese IPOs since Chinese IPOs have started to come out internationally. This is based partly on anecdotal market evidence and partly upon our own pipeline, but we believe that the pace will only accelerate.

So I think it is very possible that, given the number of Chinese companies projected to come to market that within a few years, Chinese companies will constitute a very significant and increasing portion of market capitalization of all international capital markets, and that the trading volumes of these Chinese companies will be very significant, and so this is important for the U.S. financial markets.

Now, I would like to bring to the Commission's attention two very important trends that have occurred since the April hearing that the Commission had last year, trends which I think have a bearing on many of the subjects that have been discussed today.

One is that there has been a marked trend away from U.S. listings by all non-tech Chinese companies in the last year. So much that, in fact, much of the discussion that was heard this afternoon might be mooted in the sense that a lot of these companies will simply not come to the United States markets.

They will not list in the United States, and I think the reason for that is partly out of concern for the burdens of Sarbanes-Oxley, partly out of concerns of liability of shareholder suits, and we have seen a large number of shareholder suits against Chinese companies in the last year.

And so the net result is that this year, in 2005, there have been no non-tech Chinese companies coming to the United States markets to list, unlike last year where there were several—but in contrast, there have been several very large Chinese IPOs in the last year or so. There was the \$1 billion Air China IPO in London and Hong Kong. There was the Shanghai Electric Company IPO of \$700 million in Hong Kong. Shenhua Energy of \$2.95 billion in Hong Kong. China Cosco of \$1.2 billion in Hong Kong. Bank of Communications, \$1.9 billion. All these were in Hong Kong. None of these listed in the United States in this last year.

So that's one very important trend. The second trend since the Commission met last April is the fact that there have been a very significant number of venture backed, international venture capital backed companies that have come to the U.S. markets. These are tech companies.

I have attached to my written submission as Exhibit 1 a listing of the venture backed tech companies that have actually come to the U.S. markets to list in the last few years. What's interesting to note about the history of these companies coming to U.S. markets was that there were a few such companies that came during the tech bubble. Similar, in fact, to many of the U.S. tech bubble companies.

That died off in the year 2001–02. 2003, there was one. 2004, there were actually a significant number, I believe 11 such companies, venture backed companies, tech companies that came to the United States, and this year there have been already five if you count the one that priced yesterday. So that is a very significant trend.

All of these are tech companies that get very good valuations in the United States. They would much prefer to be listed in the U.S. than in Hong Kong or some other international market. They're very different in quality and nature and management than ones that you see coming in the SOE, the state-owned sector.

Their management tends to be international. Their boards of directors tend to be peopled by international managers, by venture funds and by people that you might see on the boards of directors of Silicon Valley companies. And increasingly, many, many of these companies are being funded by venture capitalists from the United States or other international venture capital funds.

There is a very large pipeline of these kind of companies being funded in China, and the net result is, of course, that there will be many more IPOs of these companies, most likely in the United States because they are tech companies, and the United States has the best reputation for being a marketplace for tech companies. We understand tech companies better. The multiples for these companies are better.

The analyst community understands them better, et cetera, et cetera. So I think these are the two trends that I would point out to the Commission. Obviously a lot can happen in one year. A lot is still happening in China. I'm not at all advocating that the loss of these large state-owned enterprise listings in the United States means that we should change or diminish our corporate governance standards or Sarbanes-Oxley or any of that.

I think that the corporate governance, what we have in the United States is the state of the art globally for corporate governance. It is certainly worth noting, though, that we are losing these deals. Maybe over time we will get more of these as Chinese corporate governance improves, and as they're able to raise their level of corporate governance in China for these state-owned enterprises.

But in the meantime, the good news is that we are getting these tech venture-backed companies coming to the United States, and these I think are probably some of the best governed, managed Chinese companies and it's very possible in my mind that they may be the companies of the future for China. They may be the Microsofts, the Googles of the future for China.

So I think these are all worth I think the Commission's consideration.

[The statement follows:]

**Prepared Statement of Howard Chao  
Asia Practice Head, O'Melveny & Myers LLP**

**Introduction**

Honorable Cochairmen and Members of the Commission, I am honored to speak on today's panel and to share my observations on participation by Chinese companies in international capital markets activities. I head up the Asia Practice of O'Melveny & Myers LLP, a leading U.S. international law firm with a strong presence in China. We have substantial operations in Beijing, Shanghai and Hong Kong, and have been involved in an increasing number of initial public offerings, or IPOs, by Chinese companies in both the U.S. and Hong Kong stock markets. We represent both Chinese issuers and international underwriters in such transactions. Because of our firm's strong California roots, we have a robust venture capital practice and, partly as a result, we have been particularly involved with the IPOs by a newer group of Chinese technology companies who are backed by venture funds. In particular, last year our firm represented Shanda Interactive Entertainment Ltd., an interactive entertainment company and one of the largest operators of online games in China, in its U.S. IPO, which was the best performing U.S. IPO of last year. More recently we represented the underwriters, led by Goldman Sachs and CSFB, in connection with the IPO of Focus Media Holding Ltd., the first Chinese advertising company to list in the U.S. and the largest NASDAQ listing of a Chinese company to date.

The issues that you have asked me to touch upon today are particularly timely since Chinese companies are now emerging as truly significant global capital markets players. The head of CSFB's Asian equity syndicate in Hong Kong was recently quoted as saying, "China is the second most important IPO market after the U.S."<sup>1</sup> Bloomberg Financial recently reported also that in 2005, China IPOs are expected to generate more fees for investment banks than European IPOs.<sup>2</sup> Indeed in absolute terms, China IPOs are attracting very large volumes of capital and at an accelerating pace. In 2003, new Chinese international stock issuances attracted approximately \$8 billion. Last year the figure was in the vicinity of \$13–\$14 billion. This year Chinese IPOs have already reached more than \$8 billion and upwards of \$17 billion is expected by the end of the year according to some estimates.<sup>3</sup> The Boston Consulting Group reported that China accounted for 14% of the global IPO market for 2003 and 10% in 2004.<sup>4</sup>

The tapping of international capital markets by Chinese companies has significant ramifications for Chinese companies and the Chinese economy, as well as the U.S. capital markets and the U.S. economy. International capital has become an important force for sustaining the growth of and imposing market discipline on the Chinese economy. At the same time, as Chinese companies grow in size and become an increasingly significant component of the world capital markets, Chinese companies become an increasingly important customer-base for U.S. capital markets to service. As Chinese companies reach out beyond China's borders and grow into sophisticated, international concerns, the United States can, through capital market mechanisms, help shape China's developmental trajectory.

### Background

"Chinese companies" are hard to define because of the many ways that they can be structured. For purposes of today's discussion, my usage of the term "Chinese company" includes not only companies incorporated in the PRC, but also companies that are domiciled outside of the PRC but whose primary business operations are in China. In fact most internationally listed mainland Chinese companies are domiciled in the Cayman Islands, Bermuda, the British Virgin Islands or other similar jurisdictions, although they conduct their primary operations in the PRC.

Before discussing why Chinese companies are looking to list abroad, I'll mention briefly why they do not simply list domestically in China. After all, despite its central planning past, since 1990 China has had a remarkable record of domestic stock market development in Shanghai and Shenzhen, and there are now a total of about 1,400 companies listed on those two exchanges. There are several reasons why many of the best Chinese companies are not content to list domestically:

- China's domestic listing process can be very time consuming, sometimes taking as long as four years;
- Unlike the U.S. "disclosure-based" system, listings in China involve government approvals, which require, in part, meeting certain profitability and other financial thresholds that many companies are unable to meet;
- Shares held by the original investors in a domestically listed company are usually not tradable on the exchange and can only be sold in private transactions, so that a listing does not provide a viable "exit" for investors;
- Regulations in China make it difficult for management of state owned enterprises, or SOEs, to participate in equity, whereas this practice is commonplace for companies listed in international markets;<sup>5</sup>
- Chinese companies that have restructured themselves as offshore holding companies (which often happens before a listing) enjoy greater independence from the Chinese government;
- Private companies in China have experienced great difficulty obtaining government approvals to list domestically;
- Listing on a non-PRC exchange permits profits denominated in Chinese currency to be converted into other currencies offshore; and
- China's domestic exchanges have performed poorly over the past several years.

Perhaps most importantly, the international capital markets are much larger and more liquid than Chinese domestic exchanges, and an offshore listing on a major

<sup>1</sup> *China Tops Europe on IPOs; Goldman, Morgan to Win \$550 Mln Fees*, Bloomberg.com (June 7, 2005), available at <http://quote.bloomberg.com/apps/news?pid=nifea&&sid=aR16O0PCGJLI>.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> The Boston Consulting Group, *Investment Banking and Capital Markets* (November 30, 2004).

<sup>5</sup> The Chinese government just recently announced that these rules may be liberalized.

exchange is considered a badge of honor for a Chinese company, an indication that the company is one of the elite that has won acceptance by demanding international investors. Also, recently international markets have provided higher valuations than the domestic market.

### **The Growth of Chinese International IPOs**

Chinese companies that have gone public on international markets generally can be divided into three categories: (1) SOEs, (2) Chinese domestic private companies, and (3) international private equity or venture capital backed companies.

The Chinese government has used privatizations and overseas listings as a tool to reform and restructure some of its largest SOEs, converting them from subsidized creatures of the central plan into market driven enterprises. This has had a profound reforming effect on China's economic system. The large volume of Chinese SOE IPOs over the past decade would have been unimaginable only a few years earlier.

In addition, the government now clearly encourages the formation and development of home-grown private enterprises. Private enterprise represents as much as 40% to 60% of China's GDP according to some estimates. Private companies are growing at a rapid pace but they have difficulty listing domestically, so they often list offshore. Most of these listings have gone to Hong Kong.

Finally, foreign venture capital and larger private equity investors have become quite active in China, investing in companies at all stages of development, from startups to more mature companies. Zero2ipo, an advisory, support and value-added service provider for venture capital and related industries in China, reported that venture capital investment into China was over \$1.2 billion in 2004.<sup>6</sup> According to a PricewaterhouseCoopers report, the aggregate deal value of private equity in China in 2004 was \$2 billion with 70 China-related private equity deals announced (an increase from \$1.7 billion with 53 deals announced in 2003).<sup>7</sup> The Asia Venture Capital Journal reported that the aggregate deal value of private equity in China from January to August 2005 is already over \$2 billion.<sup>8</sup> In a more recent development, many of these companies are undertaking international IPOs.

Some of the most important large-scale IPOs of the past decade have been Chinese companies. China Unicom Limited's over \$5.5 billion IPO in June of 2000 was listed in both New York and Hong Kong. In November of 2002, China Telecom Corporation Limited completed its dual-listed \$1.5 billion IPO and has proceeded to outperform the S&P almost every year up to the present. In 2003, China Life Insurance Company Limited was the largest IPO of the year, raising \$3.4 billion in its dual-listings in New York and Hong Kong. Shanda Interactive Entertainment Limited, went public on NASDAQ in May 2004 and as mentioned earlier was the best-performing U.S. IPO in 2004. The second best was another Chinese issuer, 51job, Inc., and yet another, China Netcom, was the fifth largest IPO of 2004. China Shenhua Energy raised around \$3 billion in the largest IPO to date this year. China Construction Bank is expected to be the largest global IPO in 2005 with upwards of \$5 billion in proceeds.

Not only has China's presence in global capital markets been significant in dollar terms, the number of Chinese international IPOs has increased appreciably since 2000 and will likely continue to increase. In the 28 years from 1972 through 1999 around 150 Chinese companies listed in the major international stock markets around the world (Hong Kong, U.S., London, Australia, Canada and Japan). In the four years from 2000 through 2003, there were over 120 Chinese IPOs in these markets, and around 120 more in the past year and a half alone. Not only has the number of deals increased, but the average size of China IPOs is up considerably. Less than a decade ago, China's international IPOs were relatively small in dollar value terms and there were far fewer listings in the international market outside of Hong Kong. Since the late 1990s, however, an increasing number of Chinese issuers have launched IPOs on a range of international markets and raised proceeds in excess of \$1 billion in some cases, ranking among the largest in the world.

The pace of Chinese companies going public is only likely to increase going forward. It appears that the flow of SOE IPOs will likely continue in waves as new sectors are privatized. The next wave of sectors appears to be financial services, energy, industrial (especially automotive), and possibly media. The banking sector is particularly active currently. Market sources indicate that there are a significant

<sup>6</sup> *China Venture Capital Annual Report 2004*, available at <http://www.zero2ipo.com.cn/en>.

<sup>7</sup> PricewaterhouseCoopers, *Continuing Strong Growth in China M&A Activity will see Larger and More Complex Transactions* (February 3, 2005), available at [http://www.pwchk.com/home/printeng/pr\\_030205.html](http://www.pwchk.com/home/printeng/pr_030205.html).

<sup>8</sup> *Asian Venture Capital Journal*, Volume 18, Number 29 (August 1, 2005).



number of Chinese domestic private companies and international private equity and venture capital backed Chinese companies preparing for international public offerings. In particular, our firm's pipeline of IPO deals includes a significant number of venture backed companies.

The pipeline of Chinese companies planning to access international capital markets may be the largest that it has ever been. Given the numbers of Chinese companies projected to come to market, it appears likely that within a few years, Chinese companies will constitute a significant and increasing portion of the market capitalization of international capital markets. Trading volumes in Chinese company securities will be significant. Revenues generated by Chinese companies for international financial services firms will become increasingly important and stock exchanges that capture this business may significantly benefit as well.

### **The Historical Role of Hong Kong and U.S. Exchanges for Chinese Companies**

Hong Kong has played a very important role for Chinese companies going public. The Hong Kong Stock Exchange (HKEx) classifies listed Chinese companies as either H-share or red-chip companies. The HKEx uses the term "H-share company" to refer to Chinese incorporated companies (usually SOEs) listed in Hong Kong, and uses the term "red-chip company" to refer to offshore incorporated companies which are significantly controlled by Mainland China shareholders (at least 20% to 30%, depending on certain factors). At this point the HKEx is increasingly dominated by these China-related companies.

The market capitalization of Chinese companies on the HKEx (both H-share and red-chip) is, according to a research paper published on the Hong Kong Securities and Futures Commission website, around \$200 billion and growing.<sup>9</sup> The HKEx offers some unique advantages to Chinese companies:

- Hong Kong has a large class of investors knowledgeable about and interested in investing in China;
- in general, China companies are likely to get more analyst coverage in Hong Kong than elsewhere;
- Hong Kong has grown over the years into a major financial center;
- investment banks, stock analysts and other professional financial sector services have traditionally based their Asia operations in Hong Kong; and
- underwriting and other transaction fees tend to be lower in Hong Kong than in the U.S.

Although a greater number of Chinese companies has historically listed in Hong Kong than in the United States, the United States has until recently attracted the larger Chinese IPOs, raising tens of billions of dollars for Chinese companies since the early 1990s. Several key factors have historically contributed to the relative attractiveness of the U.S. exchanges, including:

- greater market depth and liquidity;
- access to follow-on capital;
- greater prestige;
- high quality advisory services; and
- greater availability of stock options.

### **Market Trends: Movement away from U.S. Listings for Non-Technology IPOs**

On April 16, 2004, this Commission heard testimonies on a range of issues relating to China's presence in the global capital markets. Since that time there have been two significant market trends that have become more pronounced, which I would like to bring to your attention. First, a trend has emerged where many non-technology Chinese companies are avoiding listing in the United States and are instead listing elsewhere. Although the U.S. market (especially NASDAQ) continues to draw Chinese technology companies because of the favorable valuations and analyst research coverage it offers for that sector in particular, this year there have been no SOE or other Chinese non-technology registered offerings in the United States. Several recent larger IPOs have ended up in Hong Kong and elsewhere: Air China's more than \$1 billion IPO listed in London and HK. Shanghai Electric Group Company Limited (about \$700 million), Shenhua Energy (about \$2.95 billion) China Cosco Holdings Company Limited (about \$1.2 billion) and Bank of Communications (about \$1.9 billion) each listed only in Hong Kong and not the United States.

<sup>9</sup>Joseph Lee and Joanna Poon, *The Listing of Mainland Companies on HKEx and the Implications for Hong*, Research Paper No. 17 (September 2004), available at <http://www.sfc.hk/sfc/html/EN>.

What is behind this redirection of these mega-sized China deals away from U.S. exchanges? One concern that Chinese issuers have voiced when contemplating a U.S. listing is regarding the Sarbanes-Oxley Act of 2002, or SOX. In particular, SOX Section 302, which requires that CEOs and CFOs certify their company's annual and quarterly reports, and SOX Section 404, which relates to internal controls, are often mentioned as reasons to avoid the U.S. market. Direct costs associated with Sections 302, 404 and other Sections of SOX (including, for example, increased external auditing fees and increased costs relating to implementation of corporate governance mechanisms) as well as costs associated with the attendant increase in contingent liability risk have, according to many, shifted the cost-benefit balance in favor of listing outside the United States.<sup>10</sup> In addition to costs and risks to the company, under SOX officers and directors face increased personal liability risk and greater potential criminal penalties for securities laws violations and other fraudulent acts. SOX tends to be an even greater concern for foreign issuers such as Chinese issuers because (1) SOX compliance costs are high and Chinese issuers tend to be cost conscious; (2) Chinese company executives tend to be less familiar with U.S. corporate governance standards; and (3) Chinese company CFOs are often more familiar with PRC generally accepted accounting principles, or GAAP, and International Accounting Standards, or IAS, and have less experience with U.S. GAAP. Moreover, we believe that parent companies of Chinese SOEs (which by definition are Chinese SOEs also) contemplating international listings may be reluctant to expose themselves to U.S. corporate governance and disclosure related liabilities resulting from their control person relationship with a U.S. listed company.

Independent of SOX, however, there is also a concern that the risk of class action law suits is much greater in the United States than in virtually any other country. For example, in Hong Kong there are no specific procedures for bringing shareholders class actions. Underscoring this concern, a significant number of Chinese companies listed in the United States have been the subject of class action lawsuits in the past few years. For example, the following companies have been sued during the past several years: Netease, Asiainfo, UTStarcom, Chinadotcom (now CDC Corporation), China Life, Kongzhong, 51job, and Sina.

Where else have the Chinese companies gone to list, in addition to Hong Kong? Singapore has also attracted a significant number of Chinese company IPOs. Chinese listings there have spiked recently with less than 20 before 2000 and as many as 60 since 2000. In addition, a small number of Chinese companies have listed in London, Canada, Australia, and in Japan. Although it has only attracted a handful of companies to date, the London Stock Exchange is actively competing for Chinese company listings. It opened an office in Hong Kong in October 2004. Japan has had an initial success in attracting Xinhua Finance Ltd to complete a listing in Tokyo in October 2004.

#### **Market Trend: New Wave of VC-Backed Technology Company Listings in U.S.**

The second major market trend has been a wave of international venture capital backed Chinese technology companies coming to list in the U.S. stock markets, particularly on NASDAQ. The most active segments have been the Internet, wireless or value-added telecom.

During the "tech bubble" period in the late 1990's there were a few Chinese companies of this type that were listed in the United States, including Sina, Netease, Sohu, Chinadotcom, Asiainfo and UTStarcom. However, with the bursting of the bubble, there were virtually no Chinese technology IPOs in the U.S. for the years 2001 and 2002. In 2003, with the reawakening of the technology sector, although only one Chinese technology IPO was concluded, a number of companies commenced the IPO process and in 2004 eleven Chinese technology IPOs were completed. This year the deals started more slowly, perhaps as a result of a general market softening, and to date there have been four deals completed. However, the pace has been picking up significantly in the past few weeks, and anecdotal information as well as our firm's internal pipeline suggests that this will be another very good year for this sector. *Exhibit I* lists recent Chinese venture backed technology IPOs by year.

There is one noteworthy difference between this new generation of Chinese technology companies and many of the earlier technology companies that went public

<sup>10</sup> A review of SOX undertaken by Financial Executives International, a non-profit professional organization, suggests that the cost of compliance with Section 404 alone could be about \$3 million for companies with revenues around \$2.5 billion. See Financial Executives International, *Sarbanes-Oxley Compliance Cost Estimates*, available at [http://www.fei.org/news/404\\_july.cfm](http://www.fei.org/news/404_july.cfm).

during the 1990's tech bubble—this new generation are generally profitable, and, in many cases, have remarkable earnings growth rates. These new companies tend to be operationally stronger and have a greater potential for international success. In addition, the size of public offerings by this new generation, on average, tends to be increasingly larger.

These companies also have a very different profile than the traditional non-technology Chinese companies that listed in the U.S. They are international venture backed, which means that a significant portion of their funding originates from sophisticated, international institutional investors. Major venture firms often have a significant say in the choice of management of these companies and (especially while the companies are still private) appoint representatives to their boards of directors. Thus, the management and board of directors tend to be much more international in outlook, and they often have strong technical and management backgrounds. Many of them are U.S. citizens or permanent residents. These companies are operationally very different from SOEs.

Therefore, it is not surprising that these companies opt to list in the United States. Their management is used to the U.S. capital markets environment, and their venture capital investors tend to expect their companies to do their IPOs in the United States. U.S. markets understand technology companies best and tend to value them at higher price multiples than other markets, such as the HKEx. U.S. markets give better liquidity to investors who are exiting. For technology companies, listing in the U.S. offers credibility and cachet. In addition, unlike SOEs and even most Chinese domestic private companies, venture backed companies usually use a holding company outside of China to hold their operations in China and therefore are not required to get government approvals prior to listing in the United States.

Our experience is that companies of this type tend to be more familiar with U.S. disclosure rules, standards of corporate governance, and other market expectations. On average they tend to have higher management standards than many other Chinese companies. They tend to be more market-driven.

Our law firm, because of our very substantial California and China practices, has a significant pipeline of these types of deals. We are witnessing growth of this sector first hand. In prior years, most of the venture funds backing Chinese technology companies tended to be China specialty venture funds or Asia regional venture funds. Many of the early IPO successes in this sector were funded by this type of venture fund. In the past year, in a further development, many mainstream Silicon Valley based venture funds have started to invest in China based technology startup companies. Our firm has been involved in a large number of these transactions, and we expect that many of these companies will seek a U.S. IPOs in the not too distant future.

### **Conclusion**

As you can see, a great deal can happen in China in one year. Not only are Chinese international IPOs gaining further momentum, but the nature of their participation in the U.S. capital markets has changed significantly. We are seeing a clear bifurcation between the listing destinations of Chinese non-technology and Chinese technology companies. In the past year almost all of the former are choosing to avoid the U.S., whereas almost all of the latter have chosen to list here.

While the loss of many Chinese non-technology listings for the U.S. should be cause for some concern, I do not mean to recommend a lowering of the high corporate governance and disclosure standards of the United States. We are aware of the ongoing debates about whether the benefits of certain provisions of SOX outweigh the associated compliance costs for those provisions. Notwithstanding, we believe that the strong corporate governance standards demanded in the U.S. have a positive effect on all U.S. listed companies and the markets in which they trade. I do have some personal reservations about how prevalent class actions are in the U.S. in general (not just with respect to Chinese companies), and indeed our firm has been at the forefront of class action litigation reform recently.

The good news is that U.S. stock markets are getting virtually all of the new wave of Chinese technology companies. These are dynamic, fast-growing, internationally-minded companies that look very similar to many of our U.S. technology companies. It could well be that these will be the real growth story for China, not the SOE IPOs. And the pipeline of these companies is very significant, which is good news for the U.S. capital markets.

I hope that my perspectives on these recent developments have been of use to the Commission, and I thank you for inviting me to testify.

EXHIBIT I. Recent Tech Sector IPOs by Venture Capital Backed Chinese Companies in the U.S.

Company Name	Date of Issuance	Ex-change	US\$ Value of IPO <sup>1</sup>	Business Description
CDC Corporation (Originally Chinadotcom Corporation)	July 13, 1999	NASDAQ	85,600,000	Originally a pan-Asian Internet company and now focused on enterprise software and mobile services
UTStarcom, Inc.	March 3, 2000	NASDAQ	180,000,000	Designs, manufactures and sells telecommunications equipment and provides services associated with their installation, operation, and maintenance
Asiainfo Holdings, Inc.	March 3, 2000	NASDAQ	120,000,000	Provider of software solutions and information technology
Sina Corp	April 13, 2000	NASDAQ	68,000,000	Online media company and value-added information services provider
Netease.com, Inc.	July 3, 2000	NASDAQ	69,750,000	Internet technology company
Sohu.com Inc.	July 13, 2000	NASDAQ	59,800,000	Provider of comprehensive online products and services to consumers and businesses
CTRIP.COM International Ltd.	December 9, 2003	NASDAQ	75,600,000	A consolidator of hotel accommodations and airline tickets in China
Linktone Ltd.	March 4, 2004	NASDAQ	85,960,000	Entertainment-oriented wireless value-added services to mobile phone users over the 2G, and increasingly over the 2.5G, mobile telecommunications networks
Tom Online Inc.	March 8(10), 2004	NASDAQ/ HKEx	174,960,000	Multimedia products and service in China
Shanda Interactive Entertainment Ltd.	May 13, 2004	NASDAQ	152,399,357	Interactive entertainment company and one of the largest operators of online games in China
Kongzhong Corporation	July 9, 2004	NASDAQ	100,000,000	Provider of advanced second generation, or 2.5G, wireless interactive entertainment, media and community services

51job, Inc	September 29, 2004	NASDAQ	73,500,000	Provider of integrated human resource services in China, with a strong focus on recruitment related services
Semiconductor Manufacturing International Corp.	March 12, 2004	NYSE/ HKEx	1,712,878,650	Semiconductor foundry
China Finance Online Co. Ltd.	October 15, 2004	NASDAQ	80,600,000	Provider of online financial and listed company data and information in China
eLong, Inc	October 28, 2004	NASDAQ	62,134,385	Online travel service provider in China
Ninetowns Digital World Trade Holdings Ltd.	December 3, 2004	NASDAQ	105,600,000	Software company that enables enterprises and trade-related PRC government agencies to streamline the import/export process in China
the9 Limited	December 15, 2004	NASDAQ	103,275,000	Online game operator and developer in China
Hurray! Holdings Co. Ltd.	February 4, 2005	NASDAQ	70,520,000	Provides wireless value-added services such as ringtones, picture downloads, community and entertainment services to mobile phone users in China
China Techfaith Wireless Communication Technology Ltd.	May 6, 2005	NASDAQ	141,813,051	Independent mobile handset design houses
Focus Media Holding Ltd.	June 14, 2005	NASDAQ	171,700,000	An out-of-home advertising network using audiovisual television displays instead of traditional billboards to broadcast advertising
Baidu.com, Inc.	August 5, 2005	NASDAQ	109,090,854	Internet Search

<sup>1</sup> Excludes the amount, if any, purchased pursuant to the underwriters' over allotment option.

### Discussion, Questions and Answers

Cochair WESSEL. Thank you. Let me ask a couple of questions about the business of taking these companies to market because you talked about losing out on many of them.

Are our investment firms or our law firms globalizing in the sense that you talked about? I guess the three offices your firm has in China, Goldman I believe is over there. Morgan Stanley, the others are over there. Are the fees being earned for taking these companies to market in other markets, meaning does your firm take a Chinese company to the Hong Kong Exchange, meaning that you're getting the fee there? Or Morgan if it were to take one of these firms to the London Exchange, that that they're staying away from the U.S. market, while your comment saying that we're not getting the money, we're just getting the money in different places, our firms are?

Mr. CHAO. I think that's a perceptive question, yes. I believe that the statistics that I quoted refer to the fees generated by IPOs of Chinese companies regardless of where they were listing outside of China.

Cochair WESSEL. Okay.

Mr. CHAO. That was international Chinese IPOs.

Cochair WESSEL. Does your firm or other U.S.-based firms help take Chinese firms public on other markets?

Mr. CHAO. In our case, yes. We help Chinese firms on the Hong Kong Exchange as well.

Cochair WESSEL. What are the different independent standards? We heard testimony—I don't know if you were in the room at the time—that Hong Kong has a standard that you have to be a profitable company to go to market there, to be an IPO; is that correct?

Mr. CHAO. Yes, on the main board, that's correct.

Cochair WESSEL. So that's one of the reasons why they may come here? A tech company which—

Mr. CHAO. That's correct.

Cochair WESSEL. Not vaporware but ether profits if you will or far out in the future whatever. Vaporware is a different question. As it relates to the independence of directors, the New York Stock Exchange after Sarbanes-Oxley and other reasons, internal reforms as well, has a fairly stringent standard. Does Hong Kong have a similar standard?

Mr. CHAO. Hong Kong has very good standards for corporate governance. They have followed many of the leads of the U.S. markets and regulators. They have imposed not quite as rigorous of a standard of independent directors, but they have a requirement of a certain number of independent directors, audit committees, and other rules that help transparency and corporate governance.

I think in general people believe that the Hong Kong rules are good. Not as rigorous as the U.S., but good.

Cochair WESSEL. Okay. As we look at a company that is moving into, wants to move to a U.S. exchange potentially, how much of an impediment is Sarbanes-Oxley to their activities? Is it the cost? Is it the internal structure? Is it the overall reporting and continuity of that reporting? What are the principal impediments?

Mr. CHAO. I suspect that most Chinese state-owned enterprises, when they analyze this issue, they may not analyze it at that level

of detail. I think what they're most concerned about is probably the level of potential liability that they may be incurring, and frankly that kind of liability existed even before Sarbanes-Oxley potentially.

Cochair WESSEL. Liability in terms of shareholder?

Mr. CHAO. Shareholder suits, class actions.

Cochair WESSEL. Securities litigation reform.

Mr. CHAO. Yes, exactly. But I think Sarbanes-Oxley has made that even more acute in their eyes because they've heard about the additional burdens and certification requirements, internal controls and cost burdens of Sarbanes-Oxley. But frankly, my sense is that they're most concerned about the liability risk.

Cochair WESSEL. Which is independent of Sarbanes-Oxley?

Mr. CHAO. Ironically it goes, to a certain extent, to the point that was discussed in the earlier panel of do our markets work? Because if they're not coming to our markets because they're concerned about liability and there are the kind of companies that aren't able to comply with our transparency and disclosure requirements, then in a sense maybe we are doing, our rules are doing what they're designed to do.

Cochair WESSEL. Correct. I understand. Let me ask you a final question relating to the recent Executive Order on the weapons of mass destruction proliferators. Are you aware of this, that was recently promulgated?

Mr. CHAO. I'm sorry?

Cochair WESSEL. There was an Executive Order released on June 29 of this year by the President relating to financing essentially of WMD proliferators. Are you aware of this?

Mr. CHAO. No, I'm not aware.

Cochair WESSEL. Well, let me back up then with a question. Is the question of whether an entity that's controlled by a Chinese company, since we've seen a number of sales of high tech missile equipment to Iran, et cetera, as a practicing attorney in this area who I assume puts together the blue sky proposals for the IPOs, et cetera, is that a material fact?

To the extent that they are engaged in transactions that potentially could open them up to sanctions under U.S. law, is that something that should be listed in the blue sky as a material fact?

Mr. CHAO. Certainly. Anything that impacts the ability of the company to remain within the law, to stay within the bounds of law is material. Anything that might imply the company might be in breach of law, it would be potentially of interest.

Cochair WESSEL. Whether it's the entity itself or one of its controlled subsidiaries, I assume that answer would be the same; correct?

Mr. CHAO. I think so, yes.

Cochair WESSEL. Okay. Thank you. Chairman D'Amato.

Chairman D'AMATO. Thank you, Commissioner Wessel, and thank you very much for your patience and for coming and for your testimony, Mr. Chao. I think you have a great of expertise that is of interest to this Commission in this area.

I'm interested in the differences between the Hong Kong Exchange and the New York Stock Exchange in terms of the standards of performance and so on, including Sarbanes-Oxley. Do you

have or do you know of a detailed comparison of the requirements for entry into the two markets and a comparison of the two? We'd be interested in that.

Mr. CHAO. I can give you a listing, a comparison of the differences between the two listing requirements, yes. I can provide that. I can give you a list. In fact, I can do better and give you a listing of the requirements for both the New York Stock Exchange, the Nasdaq and Hong Kong Exchange.

Chairman D'AMATO. We would like to have that. I think that's very important because there is a lot of discussion here about the question of standards. I'm glad to hear that you don't feel that we should reduce our corporate governance standards, that basically they're state-of-the-art here. Hopefully the rest of the world will come up to that state. We would like that.

Mr. CHAO. Right.

Chairman D'AMATO. My question on Hong Kong is now if the IPO is going to Hong Kong and listing on Hong Kong, then the investors that are investing in that stock, of course, many of those are coming from the United States, and they would be the investors that would have invested in it if it went to the New York Stock Exchange and goes to Hong Kong. I guess my question is when those investors go to Hong Kong—

Mr. CHAO. Right.

Chairman D'AMATO. —to invest, what is the difference in the standard of information and disclosure for them at that point in that way as opposed to investing in the New York Stock Exchange, I guess?

Mr. CHAO. I understand your point and I think it's a valid point. Very often the very same investors that would otherwise be investing in New York would be investing in Hong Kong.

Chairman D'AMATO. Yes.

Mr. CHAO. But on the other hand, there are groups of investors that would not. For example, the retail sector. U.S. retail investors have great difficulty getting to the Hong Kong state market and investing in Hong Kong because you would have to find a way to open a retail account in Hong Kong which most people don't have great ease in doing.

Chairman D'AMATO. Yes.

Mr. CHAO. It tends to be the institutional investors that would invest internationally in that type of situation, a mutual fund.

Chairman D'AMATO. Yes.

Mr. CHAO. Or a larger institutional investor that has the facilities, the people—

Chairman D'AMATO. Yes.

Mr. CHAO. —to analyze that market. The disclosure they're getting from Hong Kong is good, but not as detailed—

Chairman D'AMATO. Yes.

Mr. CHAO. —and not as thorough as you would from the United States.

Chairman D'AMATO. Yes. We're concerned about the mutual fund, pension fund participations, the teachers, the firefighters, the police and so on in this country that are relying on their mutual fund managers and their pension fund managers to make good investments.



So that's what we're worried about, that we may be getting, what I call the China bubble, a large number of IPOs coming at once where the standards of disclosure may not be as good for those particular investors in Hong Kong versus the New York Stock Exchange. I guess that's the concern I have.

Because you're saying that the incidents and the pace is picking up.

Mr. CHAO. Yes.

Chairman D'AMATO. And it will be picking up in Hong Kong.

Mr. CHAO. Yes. I think Hong Kong and the United States are the two, have historically been the two most important markets by far for Chinese IPOs.

Chairman D'AMATO. Yes.

Mr. CHAO. And I think the trend is now that instead of the large ones coming to the United States, which they historically have done—every large one historically came to the New York Stock Exchange practically—

Chairman D'AMATO. Right.

Mr. CHAO. Now, the large ones are not coming.

Chairman D'AMATO. And you're talking SOEs as well.

Mr. CHAO. Exactly.

Chairman D'AMATO. Yes. So the SOE comes to Hong Kong, it's a very big one, and then the question we have is about disclosure. So that comparison would be very interesting to us to take a look at.

Thank you very much.

Mr. CHAO. Sure.

Cochair WESSEL. Commissioner Wortzel.

Commissioner WORTZEL. Thank you very much for being here and the long trip, although I question your judgment on leaving the beaches of Greece.

I'd like to draw you out on whether or not you can explain how the Chinese government has made or makes its decisions on what companies are allowed to list? I've got a couple of other questions, but that's a big one for me. What drives the Chinese government to say you can list, you can't? What kind of strategic decisions and what sectors are those decisions—of the economy or of technology are those decisions designed to influence?

Second, what is it that's driving non-technology IPOs away from the U.S.? And technology IPOs here, I guess? Again, does the Chinese government have anything to do with that? Do these enterprises have the independence to make those decisions?

The third thing that struck me is while it might hurt offerors if a Chinese company doesn't list in the U.S., why does it hurt the U.S. economy? And why does that hurt the American investor? Why should we care if they list elsewhere if we're, unless we're interested in the transparency that we might get from the listing?

Mr. CHAO. I made a mistake in not writing down all the questions. Please, what was the first one?

Commissioner WORTZEL. The first one, how does the Chinese government make its decisions on what companies are allowed to list?

Mr. CHAO. On the first question, before I answer that fully, I would like to make one point, and that is that the Chinese economy

and Chinese companies actually are not lacking in capital. The Chinese economy is flush with capital. So I don't think that the main driving force behind Chinese companies coming to the United States or indeed to international capital markets is to raise money.

They don't really need to come here to get the money. They could raise it domestically. We all know that China has huge amounts of domestic capital. The capital is washing back and forth within the Chinese financial system.

So I think that's one thing we should get off the table, that they're coming here primarily to get money, which is clearly a goal, but I'm not sure that that is necessarily the primary, primary goal.

I think one of the reasons the Chinese companies and the Chinese governments to list outside of China is because China is not a monolith, there are many different people, there are many different interest groups, there are many different leaders that have different agendas and different policies just like in the United States, we do.

But one of the things that was clear at a certain level of leadership, at a very high level of leadership, is a belief that if you made a state-owned enterprise go public internationally, you would cause it to shape up. You would make them shape up. If you didn't make them do it, they would never shape up. So I think one of the things that they were trying to do is because they say a lot of their companies bleeding to death. They had to keep feeding them money; they had to keep making them loans, as you said, and how do they stop that bleeding?

Well, one way to stop that bleeding is to say, look, we're cutting you loose. You're going to be a public company on the New York Stock Exchange or the Hong Kong Stock Exchange, we're not going to give you any subsidies anymore. We're going to give you that one last boost before you go, we're going to put in some more capital. It's like before you graduate from college, you're going to get that last loan from me, and then after that, you're on your own. And you know you're going to have your own balance sheet, you're going to have your own shareholders. Now we're going to be a shareholder, yeah, but, we're not going to subsidize you anymore in theory—okay—in theory.

So that's what happens to a lot of these state-owned enterprises. Now, were they successful and are they really companies yet? Are they really independent yet? That's still a question to be debated.

Commissioner WORTZEL. But you're suggesting that the American investor becomes the risk taker as a management and reform tool for the Chinese government and its enterprises?

Mr. CHAO. That's what has happened in some cases, yes. Absolutely.

Commissioner WORTZEL. Dick, could I?

Chairman D'AMATO. Go ahead.

Commissioner WORTZEL. Then what is driving the technology IPOs away from the U.S. or non-technology IPOs away and technology IPOs here? And does the Chinese government have any influence in those sorts of decisions?

Mr. CHAO. I think it certainly has an influence on the move away from the U.S. The experience that China Life had and other SOEs have had, the fact that there have been a series of other class ac-

tion lawsuits against Chinese listings in the U.S., all have created this impression that it's a risky thing to go to the United States to get listed.

So, why do we need to do that if we can just the money in Hong Kong?

Commissioner WORTZEL. But it's not about money?

Mr. CHAO. Well, that's right, but they can still get, they can still achieve those goals that we just talked about—independence, auditing. You know all these audits are by big four accounting firms. In corporate governance, not as rigorously imposed as in the U.S., but still from a reputable well-regarded international exchange, the Hong Kong Exchange.

We can get that without the risk of liability. There are very, very few shareholder lawsuits in Hong Kong. Part of that is because the plaintiff's bar doesn't have the ability to—its legal fees are paid by the loser in Hong Kong so you take a lot of risk. All right. So it's not like if you lose you just take your marbles home and that's it. You have to pay the other side.

Commissioner WORTZEL. Then the third one is why should we care? It might hurt your firm or another law firm if a company doesn't list on the New York Stock Exchange, but why should the American investor care if some Chinese company goes somewhere else?

Mr. CHAO. Well, it's a complicated question. In my view, the U.S. capital markets have always been, in the last 100, 150 years the leader. The leader of global capital markets has been the United States. We have the deepest, most sophisticated, highest volume capital markets in the world. We take public the biggest companies in the world. We trade in the biggest companies. We catch the biggest trends.

What is the biggest trend that's happening economically in the world today? It's the growth of China. Where are the biggest companies in the world going to be coming from in the next ten to 20 to 50 years? Many of them will be Chinese. Where will they raise their capital? Will they raise it in Hong Kong, London, Shanghai or New York?

To the extent the New York Stock Exchange and the Nasdaq do not get their fair share of that business, that will diminish the competitiveness of our capital markets. So I think there is something to be said about being concerned about that as one of our most important industries in the United States, the financial industry.

Commissioner WORTZEL. Thank you very much. I appreciate your time on that.

Cochair WESSEL. Commissioner Mulloy.

Commissioner MULLOY. Thank you, Commissioner Wessel. Mr. Chao, I really appreciate your being here and talking so clearly about what is going on. In fact, I even quoted you to the first panel because I read their testimony and then asked them if that was right because I could understand what you were saying. I wasn't quite sure what they were saying. So thank you.

We held a hearing in Palo Alto in April looking at the growth of China's high technology industries and how quickly that is happening. We looked at the role that apparently American venture

capitalists are playing a role in this. So we're playing a role from two ways.

One, our people are helping identify these companies and then putting some venture capital into them, and then another group like you are bringing them into the market to raise additional money.

If you were just Americans saying, well, I'm worried about our high technology industry versus China's because they seem to be doing awfully well now, we're running a big trade deficit with them in advanced technology products, about 40 billion a year and growing fast, do you ever think about that? I know you're a "Boiler-maker," you're a Purdue guy and graduated in engineering, I think.

Mr. CHAO. Yes.

Commissioner MULLOY. Do you ever think about what we should be doing here to better compete in this high tech area?

Mr. CHAO. Absolutely. This is one of the hot button subjects of the Silicon Valley. I live in the Silicon Valley and have been for the last four years. I've actually been quite active in the other flow of business you just referred to which is the venture capital investment in the Chinese tech sector. So I see both it coming and going because those are actually two related cycles, as you can imagine, both the investment end and the IPOs out. That's the cycle.

There are many, many people in the Silicon Valley that are quite concerned about this because they feel that really what we need to do in this country, in order to keep our competitive edge in the U.S. and in particular in the Silicon Valley in the tech sector is we need to continue to create a number of technical and engineering students that we have historically, and we are not.

We are not keeping pace. And that's one of the number one concerns that many of my clients, colleagues in the Silicon Valley have, is that if you look at the total number of Ph.D.s coming out of China and India, and you compare them with how many we're producing in this country, we're losing the battle of engineers, and engineers are the fodder for technology creation as we all know.

So, the Silicon Valley to my mind is still the center of the universe when it comes to technology creation. We have fantastic companies in the Silicon Valley. We have tremendous technology. We have great innovation in the Silicon Valley, and the Chinese tech sector can't hold a candle to that right now, and I think everybody knows that. That's acknowledged in China; it's acknowledged in the Silicon Valley.

What we're looking for is projecting down 20 years from now. We ought to get our house in order here in order to prepare for the future because we're talking about the long haul of competition. This can be a completely friendly but still competitive relationship we're going to have here, and so if we don't take the right steps in the area of education, then we're going to fall behind.

Commissioner MULLOY. That was our impression. There are two things we saw going on. One, we have some things to address with China and then there were some things we have to address here at home in order to be competitive with this entity that's really coming on so fast.

Do you and your group have a list of ten things what you ought to do to get your house in order?

Mr. CHAO. You mean on this particular subject?

Commissioner MULLOY. Yes.

Mr. CHAO. You know I think that education is really the number one issue. There are few other things that people gripe about these days. They'll talk about stock options and the concern that they've had about that, but ultimately that's gone away. I think education is still the number one hot button issue.

Commissioner MULLOY. Thank you, Mr. Chao.

Cochair WESSEL. Commissioner Vice Chair, Cochair Robinson.

Vice Chairman ROBINSON. Thank you, Mr. Cochairman. Thank you again, Mr. Chao, for joining us. I know it was a long haul and we're very grateful. I'd like to follow up on Commissioner Wortzel's points with respect to Hong Kong and the fact that it appears to us that it's almost like a warehousing of deals.

In other words, this is quite a market movement over the past 12 months in favor of Hong Kong listings versus New York Stock Exchange, for example. And I think that this Commission basically is comfortable, if not favorably inclined, toward the developments on the Nasdaq because the character of those Chinese high tech enterprises is particularly entrepreneurial and commercial in nature. I don't want to speak for all my fellow Commissioners, but I think as a whole, we're more comfortable with American investors being involved with genuinely commercial enterprises that are in a bottom line profitability and innovation mode.

Where we get concerned, as the Chairman has stated and others, regards some of the more traditional state-owned SOEs that are involved in everything from the manufacture of refrigerators to the skins for ICBMs. They also have Iranian, Sudanese and other operations and a host of other activities that include, in some cases, the proliferation of weapons of mass destruction.

That's when it gets complicated from our point of view concerning Chinese state-owned enterprise access to the U.S. capital markets. No one is suggesting capital controls or restrictions, but we are concerned about the disclosure elements, the governance dimensions and the impact on our security interests.

So when you see a plethora of deals coming to Hong Kong, one question I would have is if so many Chinese state-owned enterprises are coming to the Hong Kong market, is there a risk that the Hong Kong regulatory regime and fairly rigorous disclosure requirements, already not quite up to our standards, could be further diluted as China utterly dominates the Hong Kong listing market.

Second, can these listed Hong Kong entities more easily come into the U.S. market at a later date because they've already been seasoned? They've already been listed for a couple of years in Hong Kong? They're seen as ready for prime time.

The third concerns the Bank of China. Whether or not you buy the notion that's been put forward today, the Bank of China seems to be intent on coming to the New York Stock Exchange, that they don't want to go the weigh-station route or the second-tier route of Hong Kong. Whereas the China Construction Bank more likely would choose some combination of Hong Kong, Singapore, and maybe one of the European exchanges.

So I'm just trying to get your sense of whether you think that the Bank of China is the one that's most likely to come to the New York Stock Exchange and what is their thinking?

Thank you.

Mr. CHAO. On the question of the Hong Kong Stock Exchange and whether their standards might be diluted because of the flood of new listings there, you know, one thing I'm told is that the Hong Kong Stock Exchange has a pipeline, a queue of deals, and that basically they will take on more deals as they are able to do.

They have a certain number of people, a certain number of staff, and if they are not able to handle the deals, the queue will just get longer. That's not a full answer to your question, but I'm not sure that they just allow themselves to be totally inundated with deals.

Second, my sense is that in the long run, the number of SOE listings, whether it's in Hong Kong or the United States, is not going to take off. You know China does not have an unlimited number of SOEs. In fact, if you look at what's happened to the Chinese economy, they have basically gotten rid of state-owned enterprises at the small- and medium-sized levels now.

They've gone through a privatization process where they basically auctioned off, sold off, leased off or otherwise disposed of state-owned enterprises at the small level. It used to be you walked down the street and every "mom and pop" shop, the grocery store, restaurant was state owned. That's not true anymore. It's all private.

If you look at medium-sized enterprises, many, many, many of those have been auctioned off. Okay. So now you're left with pillar industry and larger companies. Many of those have been IPOed, some of those have been sold off, some of those are being privatized. There are going to be some that will not ever be IPOed because they're too strategic or too important for the government.

But, over time my personal belief is that you're going to see, as you already have seen in the last ten years, the private sector and the foreign-owned sector get bigger and bigger and bigger over time, the mixed sector if you will, because it's not clear where the lines come anymore.

But it's going to get bigger and bigger and bigger. We know that private enterprise is a powerful force based upon our own economic history, and China is no exception to the natural rules of economics. Private enterprise in China is becoming bigger all the time. And then also foreign investment, which is just another form of private enterprise, of course. That's getting bigger.

The IPOs coming out of China eventually I think will be more and more the mid-sized, either privately funded, mixed funded or venture funded companies. There will continue to be big IPOs of state-owned enterprises, but I don't think that's an unlimited supply.

As to the standards of the Hong Kong Stock Exchange in general, my perception is that their reputation continues to be very good.

Vice Chairman ROBINSON. And the Bank of China question?

Mr. CHAO. Just to answer your second question.

The fact that companies are listed in Hong Kong I think does prepare them to be listed in the United States because it could be

viewed as a stepping stone, as a pressure chamber to get, you know, get to the next level.

I don't see that necessarily as a bad thing, that companies' management are better acclimated to the rigors of corporate governance standards internationally, reporting, disclosure, transparency, auditing. All those things are potentially new to a lot of state-owned enterprises in China.

And then for them to eventually become listed in the United States, if they can make the grade, why not?

As far as Bank of China, I frankly don't have a good window on that. I don't want to speculate on whether they will or will not come to the United States. I really don't know. Sorry.

Vice Chairman ROBINSON. Thank you.

Cochair WESSEL. Commissioner D'Amato.

Chairman D'AMATO. Thank you, Commissioner Wessel. I think it was mentioned that we had a hearing in April in Palo Alto. We want to get you a copy of that record. We produced a report to the Congress on that. We had a number of high tech companies, venture capitalists. William Perry testified, very interesting testimony. There was the comment made and Perry ratified it that there was, they thought, a need for a more structured dialogue between Silicon Valley and Washington. So, we're recommending that, and we'd like to talk to you a little bit more about how is the best way to structure such a dialogue.

In terms of the IPOs coming into the United States in the high tech area, I'm assuming almost all of those go to Nasdaq?

Mr. CHAO. All in my list in Exhibit 1, with the exception of SMIC were Nasdaq.

Chairman D'AMATO. Yes. One of the messages from that hearing was the question of competitiveness on the part of the United States here, and our education system, and the need for, I think we called for a post-Sputnik type of American educational, federally funded education program in the sciences, engineering. In the past, the Federal Government has been the stimulus for such major programs that have gone on for decades, and we think this is the time again to do such a major federally funded education program in the United States.

My question to you on the high tech Nasdaq oriented firms, you talked about the question of competition. Can you identify what particular sector or sectors the United States apparently is falling behind in in high tech in terms of the companies that are coming in here in terms of our competitiveness? Is there one or more sectors that you think are particularly of concern that we need to pay attention to?

Mr. CHAO. Well, one of the areas where I've heard the concern expressed in particular is the semiconductor industry.

It is, as you well know, true that there are a large number of Chinese foundries and fabs that have been established. Many of the venture companies that we see funded that we either represent or that we represent venture capitalists investing into are semiconductor start-ups. And these are start-ups that don't have their own fab, they're so-called "fab-less" semiconductor companies, which are basically design houses. They design chips.

But it's pretty easy nowadays to go to China and hire engineers that can help you design chips in China for a lot cheaper than in the United States. And so a lot of these start-ups are happening in China through venture money, and ultimately this is going to happen one way or the other. I guess the question is are we going to be able to keep a significant portion of the high level, high margin, high value added piece of this industry in the United States?

Parts of this are going to go offshore regardless of what we do whether it's going to go to China, it's going to go to Taiwan, it's going to go to India. But we as a country have an interest in retaining as much of the high value part of this business as possible in the United States, and I'm being told by clients that in order to do this, we need to have more engineers in this country.

Chairman D'AMATO. Yes. That's interesting. How would you rate our competitiveness in the biotech area?

Mr. CHAO. Biotech—we're way ahead.

Chairman D'AMATO. Way ahead.

Mr. CHAO. Way ahead. You know Asia still is in its infancy when it comes to biotech, whether you're talking about China or other places. But, you know, there's a lot of money being thrown at biotech as well in Asia. Not just China but other places.

Chairman D'AMATO. Yes, thank you. I'll yield the last few minutes of time to Commissioner Mulloy.

Commissioner MULLOY. Thank you. Thank you, Chairman D'Amato. Yes, exactly. Because of our medical system in this country, we pour a lot of money into biotech and it shows because we're the leaders in it.

But on engineering and semiconductors, for example, we had testimony that the Department of Defense Science Board was very worried about that industry moving out of this country, semiconductor manufacturing and design, because it's so important to our military capabilities.

They were making some recommendations. I think it would be useful maybe if we would send that recommendation to your group, the people are thinking about these issues and are in the forefront right now of what is going on in both countries, to help us think through. We want to make some recommendations in that area in our coming report, and if we could ask you to comment, that would be very helpful to us.

Mr. CHAO. Be delighted to.

Commissioner MULLOY. Thank you.

Chairman D'AMATO. Thank you very much.

Cochair WESSEL. Great. Thank you. Thank you for your long travels and thank you to the staff for their hard work in preparing us for today. The hearing is adjourned.

[Whereupon, at 4:50 p.m., the hearing was adjourned.]



**Copy of Email Letter Dated 14 August 2005 to Commissioner Reinsch,  
Member of the U.S.-China Economic and Security Review Commission**

Dear Commissioner Reinsch,

During the hearing last Thursday (8.11.05), you invited witnesses who had testified in earlier sessions to comment on testimonies presented during the Third Session. I do not have time for a detailed response to your invitation, but I would like to share with you a few general observations.

The characterization of China's intentions towards the U.S. by Frank Gaffney as implacably hostile, bent on replacing the U.S. as the world's sole superpower through military conquest, if necessary, was as long on opinion as it was short on facts or evidence. I do not share this perspective. On the contrary; I believe that China has been consistent in seeking constructive relations with the U.S. ever since the start of market reforms in the late 1970s and the exchange of ambassadors on 1.1.79. There is much evidence in numerous areas to support this view. I cannot think of any truly convincing evidence that would support Mr. Gaffney's position. If Mr. Gaffney's perspective on China is accepted as a basis for recommendations by the USCC and for policymaking by Congress, I am afraid that this will put U.S.-China relations in a negative tailspin, generating lots of unnecessary problems with unpredictable consequences. I was surprised that Commission Members did not seriously question or challenge Mr. Gaffney's testimony.

The basic question at issue last Thursday was whether the U.S. should introduce special screening procedures or outright restrictions on access to U.S. capital markets by Chinese corporations. While there are undoubtedly serious corporate governance problems in China, things are, in my opinion, broadly moving in the right direction. China is trying to professionalize and de-politize the management of SOEs and state banks, while leveling playing fields and improving transparency in business in general. China is also privatizing many state firms. The rate of progress in this regard may not satisfy members of the USCC—or even the Chinese themselves—but the direction of change is obvious. The financial sector, perhaps more than any other sector, is the battlefield where success or failure in China's modernization and economic liberalization efforts will be determined. The U.S. should support China in its economic reform and modernization efforts, as all other developed nations are doing.

My bottom line on the issue at hand is that there is no need for special restrictions on China's access to U.S. capital markets. When there are genuine security concerns in specific instances, e.g. linked to unlawful proliferation activities by Chinese SOEs, special review procedures and restrictions may indeed be called for. Otherwise, financial markets, the SEC and other existing regulatory agencies and mechanisms are, in my view, just as capable of screening out bad Chinese corporate apples as they are in other situations. Besides, IF Congress were to limit China's access to U.S. capital markets in some generic sense, there is nothing to prevent U.S. companies or individuals from investing in Chinese firms through other stock exchanges (Hong Kong, London, Frankfurt, Singapore etc.) or to channel funds directly into China through various alternative mechanisms, including the local Chinese stock exchanges, which have been partially opened to "Qualified Foreign Institutional Investors." Congressional action of the generic variety would be futile and counterproductive. Finally, China does not desperately need American money at present. The pool of domestic financial and fiscal resources is more than ample to recapitalize all state banks and all SOEs. The primary motivation of Chinese state banks and SOEs to list in the U.S. or other respected capital markets, is the prestige associated with such a listing and the opportunities it offers to strengthen management and improve corporate governance standards through the participation by foreigners on their boards.

Sincerely,

Pieter Bottelier

## MOODY'S RATINGS FOR CHINESE BANKS

Bank	Rating:		
	Credit	BSFR	Outlook
1 Agricultural Bank of China	A2	E	Stable
2 Bank of China	A2	D-	Stable
3 Bank of Communications	Baa2	D	Stable
4 China Construction Bank	A2	E+	Stable
5 China Development Bank	A2		Stable
6 China Everbright Bank	Ba1	D-	Stable
7 China Merchants Bank	Ba1	D	Stable
8 CITIC Industrial Bank	Baa3	D-	Negative
9 Export-Import Bank of China	A2		Stable
10 Guangdong Development Bank	B1	E+	Stable
11 Industrial and Commercial Bank	A2	E+	Stable
12 Shanghai Pudong Development Bank	Ba1	D	Stable
13 Shenzhen Development Bank	Ba3	E+	Positive

Credit ratings: From least to greatest risk of default in investment grade, Aaa, Aa, A, Baa.

(Subscripts 1-2-3, least to higher risk) and Ba, B for "noninvestment grade."

Bank Financial Strength Ratings (BSFR): A, B, C, D, and E.

Global universe average is C+, meaning adequate intrinsic financial strength.

A and B mean superior and strong strength without outside support (e.g., from the government).

C and E mean modest and very modest intrinsic strength.

**STATUTORY MANDATE OF THE U.S.-CHINA ECONOMIC AND SECURITY  
REVIEW COMMISSION**

Pursuant to Public Law 108-7, Division P, enacted February 20, 2003

**RESPONSIBILITIES OF THE COMMISSION.**—The United States-China Commission shall focus, in lieu of any other areas of work or study, on the following:

**PROLIFERATION PRACTICES.**—The Commission shall analyze and assess the Chinese role in the proliferation of weapons of mass destruction and other weapons (including dual use technologies) to terrorist-sponsoring states, and suggest possible steps which the United States might take, including economic sanctions, to encourage the Chinese to stop such practices.

**ECONOMIC REFORMS AND UNITED STATES ECONOMIC TRANSFERS.**—The Commission shall analyze and assess the qualitative and quantitative nature of the shift of United States production activities to China, including the relocation of high-technology, manufacturing, and R&D facilities; the impact of these transfers on United States national security, including political influence by the Chinese Government over American firms, dependence of the United States national security industrial base on Chinese imports, the adequacy of United States export control laws, and the effect of these transfers on United States economic security, employment, and the standard of living of the American people; analyze China's national budget and assess China's fiscal strength to address internal instability problems and assess the likelihood of externalization of such problems.

**ENERGY.**—The Commission shall evaluate and assess how China's large and growing economy will impact upon world energy supplies and the role the United States can play, including joint R&D efforts and technological assistance, in influencing China's energy policy.

**UNITED STATES CAPITAL MARKETS.**—The Commission shall evaluate the extent of 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.

**CORPORATE REPORTING.**—The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China and incentives that China may be offering to United States corporations to relocate production and R&D to China.

**REGIONAL ECONOMIC AND SECURITY IMPACTS.**—The Commission shall assess the extent of China’s “hollowing-out” of Asian manufacturing economies, and the impact on United States economic and security interests in the region; review the triangular economic and security relationship among the United States, Taipei and Beijing, including Beijing’s military modernization and force deployments aimed at Taipei, and the adequacy of United States executive branch coordination and consultation with Congress on United States arms sales and defense relationship with Taipei.

**UNITED STATES-CHINA BILATERAL PROGRAMS.**—The Commission shall assess science and technology programs to evaluate if the United States is developing an adequate coordinating mechanism with appropriate review by the intelligence community with Congress; assess the degree of non-compliance by China and [with] United States-China agreements on prison labor imports and intellectual property rights; evaluate United States enforcement policies; and recommend what new measures the United States Government might take to strengthen our laws and enforcement activities and to encourage compliance by the Chinese.

**WORLD TRADE ORGANIZATION COMPLIANCE.**—The Commission shall review China’s record of compliance to date with its accession agreement to the WTO, and explore what incentives and policy initiatives should be pursued to promote further compliance by China.

**MEDIA CONTROL.**—The Commission shall evaluate Chinese government efforts to influence and control perceptions of the United States and its policies through the internet, the Chinese print and electronic media, and Chinese internal propaganda.

**FACT SHEET****U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION****ESTABLISHMENT:**

The Commission was created in October 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Pub. L. No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001)), as amended, and the “Consolidated Appropriations Resolution of 2003,” Pub. L. No. 108-7, dated February 20, 2003.

**PURPOSE:**

To monitor, investigate, and submit to congress an annual report on the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China, and to provide recommendations, where appropriate, to Congress for legislative and administrative action.

Public Law 108-7 directs the Commission to focus its work and study on the following nine areas: proliferation practices, economic reforms and U.S. economic transfers, energy, U.S. capital markets, corporate reporting, regional economic and security impacts, U.S.-China bilateral programs, WTO compliance, and media control by the Chinese government.

**COMPOSITION:**

The Commission is composed of 12 members, three of whom are selected by each of the Majority and Minority Leaders of the Senate, and the Speaker and the Minority Leader of the House. The Commissioners serve two-year terms.

**COMMISSIONERS:**

Hon. C. Richard D’Amato, Chairman; Roger W. Robinson, Vice Chairman; Carolyn Bartholomew, George Becker, Stephen Bryen, Thomas Donnelly, June Teufel Dreyer, Hon. Patrick A. Mulloy, Hon. William A. Reinsch, Hon. Fred D. Thompson, Michael R. Wessel, and Larry M. Wortzel (brief bios are attached).

**STAFF:**

The Commissioners are supported by a professional substantive and administrative staff with extensive backgrounds in trade, economics, weapons proliferation, foreign policy, and U.S.-PRC relations. Some are fluent or proficient in Chinese (Mandarin), and most have significant prior working and traveling experience in China and Taiwan. The staff is headed by T. Scott Bunton, Commission Executive Director (brief bio is attached).

**WEB SITE:**

The Commission’s web site provides the Commission’s complete charter, hearing schedule, hearing transcripts, and selected research papers, and economic and trade data [www.uscc.gov](http://www.uscc.gov).

**The Hon. C. Richard D'Amato (Chairman)**

Maryland attorney; former delegate Maryland House of Delegates; former Counsel to Senator Robert C. Byrd (WV). Reappointed by Senate Democratic Leader Tom Daschle for a term expiring December 31, 2005. Served as Commission Chair and Vice-Chairman beginning in April 2001 and was unanimously approved as Chairman for report cycle 2004 to 2005.

**Roger W. Robinson, Jr. (Vice Chairman)**

President and CEO, Conflict Securities Advisory Group, Inc.; former Senior Director of International Economic Affairs at the National Security Council. Reappointed by Senate Majority Leader Bill Frist for a term expiring December 31, 2005. Served as the Commission Chair beginning October 2002 through July 2004 and was unanimously approved as Vice-Chairman for report cycle 2004–2005 on July 19, 2004.

**Carolyn Bartholomew**

Former Chief of Staff, Counsel, Legislative Director, and Foreign Policy Advisor to U.S. House of Representatives Democratic Leader Nancy Pelosi; former Professional Staff Member on the House Permanent Select Committee on Intelligence. Reappointed by House Democratic Leader Nancy Pelosi for a term expiring December 31, 2005.

**George Becker**

Vice President, Executive Council, AFL–CIO; former International President, United Steelworkers of America. Reappointed by House Democratic Leader Nancy Pelosi for a term expiring December 31, 2005.

**Stephen D. Bryen**

President of Finmeccanica, Inc.; former Deputy Under Secretary of Defense and founder and First Director of the Defense Technology Security Administration. Reappointed by House Speaker J. Dennis Hastert for a term expiring December 31, 2005.

**Thomas Donnelly**

Resident fellow in defense and security policy studies at the American Enterprise Institute; former policy group director of the House Armed Services Committee; former editor of Army Times and executive editor of the National Interest. Appointed by Senate Majority Leader Bill Frist for a two-year term expiring December 31, 2006.

**June Teufel Dreyer**

Professor of Political Science at the University of Miami; Senior Fellow of the Foreign Policy Research Institute. Reappointed by House Speaker J. Dennis Hastert for a term expiring on December 31, 2005.

**The Hon. Patrick A. Mulloy**

Adjunct Professor of International Trade Law at Catholic University and George Mason University law schools; former Assistant Secretary of Commerce for Market Access and Compliance; former General Counsel, U.S. Senate Banking Committee. Reappointed for a third two-year term upon the recommendation of the Senate Democratic Leader beginning January 1, 2005 and expiring December 31, 2006.

**The Hon. William A. Reinsch**

President, National Foreign Trade Council; former Undersecretary of Commerce for Export Administration; former legislative assistant to Senator John Heinz (PA) and Senator John D. Rockefeller, IV (WV). Reappointed by Senate Democratic Leader Tom Daschle for a term expiring December 31, 2005.

**The Hon. Fred D. Thompson**

Attorney and former United States Senator from Tennessee and member of the Senate Select Committee on Intelligence. Former Special Counsel to both the Senate Select Committee on Intelligence and Senate Committee on Foreign Relations. Appointed by Senate Majority Leader Bill Frist for a two-year term expiring December 31, 2006.

**Michael R. Wessel**

Senior Vice President, Downey McGrath Group; former Counsel to Congressman Richard A. Gephardt (MO). Reappointed by House Democratic Leader Nancy Pelosi for a term expiring December 31, 2006.

**Larry M. Wortzel**

Visiting Fellow at The Heritage Foundation; former Director of the Strategic Studies Institute of the U.S. Army War College; former Army Attache at the U.S. Embassy in China. Reappointed by House Speaker J. Dennis Hastert for a term expiring December 31, 2006.

**T. Scott Bunton—Executive Director**

Served from 1998 to 2002 as Deputy Under Secretary of Commerce for Export Administration and in 2002–2003 worked in the Transition Planning Office in the Executive Office of the President that was responsible for “standing up” the Department of Homeland Security when it was established by law. Previously served as national security advisor, policy director, and chief of staff to two U.S. Senators, staff director of a Senate leadership Committee, and staff designee to the Senate Committee on Intelligence.





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