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Re-Thinking U.S. Policy on Engagement with Chinese Financial Institutions

By Connie M. Friesen*

Against the backdrop of heightened tensions between China and the United States that is accompanying the Ukraine war, this article considers practical measures that the United States might take to manage the inbound investment activities of certain Chinese financial institutions in the United States more effectively. It also explores steps that might be taken by U.S. policy makers and regulators to manage outbound investments by U.S. entities and individuals in Chinese financial institutions and securities. Several policy suggestions are made. First, regulators need to broaden the concept of national treatment to include a full review of state ownership and political party influence. Second, U.S. policy makers and regulators should require appropriate disclosure to investors of the risks presented by direct investments in Chinese financial institutions such as asset managers. Third, the widespread use of variable interest entities and measures to ensure state and CCP influence within Chinese companies merit a more active U.S. government role to protect U.S. investors and markets. Fourth, resolution of issues related to potential large-scale delisting of Chinese companies from U.S. exchanges should be pursued through continued active discourse between U.S. and Chinese regulatory agencies.

EXECUTIVE SUMMARY

The invasion of Ukraine has focused world attention on the high stakes of "weaponized" cross-border economic measures such as sanctions, embargoes and export controls. The threatened use of secondary sanctions has complicated China's response to the war. Chinese President Xi Jinping has been attempting to uphold principles of state sovereignty and neutrality while supporting China's strategic relationship with Russia and seeking to avoid irreparable damage to China's relations with the European Union and the United States.[1]

In the first days after the Russian invasion, China adhered to the Russian script of citing Russian security interests and blaming NATO for provoking a

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[1] *See, generally*, Evan A. Feigenbaum, "China Faces Irreconcilable Choices on Ukraine," Carnegie Endowment for International Peace, February 24, 2022, available at https://carnegieendowment.org/2022/02/24/china-faces-irreconcilable-choices-on-ukraine-pub-86515.

crisis. Then, for a time, China's strategy emphasized neutrality and a need for diplomatic resolution of the crisis. Subsequently, China seemed determined to support Russia regardless of the consequences. However, despite its shifting diplomatic messaging, China seems to be avoiding actions that would constitute overt noncompliance with Western sanctions or that would directly provoke the imposition of comprehensive secondary sanctions.[2]

One reason for China's caution is that its payments messaging system, the China International Payments System ("CIPS"), is not yet a realistic substitute for the Society for Worldwide Interbank Communications ("SWIFT") system. The renminbi is not yet ready to challenge the dollar. In other words, China is not yet prepared for the economic shock that might be unleashed by secondary sanctions. This presents an opportunity for the United States to employ discrete, pragmatic steps to manage its overall economic relationship with China more effectively. Such steps will not change China's view that it is "on the right side of history" in supporting Russia, but they may facilitate continued helpful U.S.-China dialogue on cross-border investments and support the role of the U.S. dollar and SWIFT in enabling them. In taking steps based on a strategy of pragmatic containment, the United States also needs to recognize that, just as a policy-driven fear of secondary sanctions stemming from the Ukraine war may temper Chinese attempts to challenge the U.S. dollar and SWIFT, policy-motivated objectives inform China's approach to managing its inbound and outbound investments with the United States.

Against the backdrop of heightened tensions between China and the United States that is accompanying the Ukraine war, this article explores practical measures that the United States might take to manage the inbound investment activities of certain Chinese financial institutions in the United States more effectively. It also explores practical steps that might be taken by U.S. policymakers and regulators to manage outbound investments by U.S. entities and individuals in Chinese financial institutions and securities. Assuming that the United States will not need to apply comprehensive secondary sanctions against China, such pragmatic measures should serve the United States well in the aftermath of the Ukraine war. However, if circumstances change in a manner that makes application of comprehensive secondary sanctions inevitable, such measures would need to be adjusted to meet the challenge of hostile competition between the United States and China. Such adjustments would be painful.

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[2] *See, generally*, Center for Strategic and International Studies (CSIS), Transcript, Press Briefing: Ukraine Update #2, March 24, 2022, available at https://www.csis.org/analysis/press-briefing-ukraine-update-2.

Inbound Activities. Chinese banks have invested in the United States for many years. Each of the major Chinese commercial banks conducts its U.S. operations under a U.S. regulatory regime premised on "national treatment and equality of competitive opportunity" ("national treatment"). As implemented by U.S. banking regulators, national treatment assumes that the objectives of foreign banking organizations ("FBOs") will primarily be to conduct commercial banking activities in the United States. The current U.S. bank regulatory concept of national treatment does not explicitly evaluate the consequences of state ownership or the mandate of certain state-owned banks, such as those in China, to support government and dominant political party strategic and economic objectives. A failure to acknowledge and evaluate publicly the policy mandates of these banks means that U.S. regulators may miss important opportunities to engage them (and indirectly their Chinese regulators) in pragmatic discussions about such important policy matters as U.S. dollar clearing, internationalization of the renminbi, extra-territorial jurisdiction and access to documents, use of the SWIFT international payments messaging system and anti-money laundering ("AML") and sanctions issues.

A revised national treatment paradigm that explicitly addresses how state ownership and dominant political party influence might affect the strategic and business objectives, management and operations of an FBO may result in challenges for U.S. regulators and policy makers. However, it also suggests a way to achieve more effective regulation and opens a pathway for more constructive dialogue on resolution of practical issues. While their current economic footprint is small, the U.S. operations of Chinese commercial banks present one of the few opportunities for direct, ongoing interactions between Chinese enterprises and U.S. regulators that take place on U.S. territory. This opportunity for dialogue is increasingly difficult to replicate as China and the United States pursue divergent strategies.

Chinese nonbank financial institutions ("NBFIs") such as Ant Financial Services Group, Ltd ("Ant Financial") have also made significant investments in U.S. business operations. Because they are not "banks," they face a U.S. regulatory regime based on a broader concept of national treatment as interpreted by state regulatory agencies and the federal Committee on Foreign Investment in the United States ("CFIUS"). Lessons from this approach might be applied more generally to Chinese commercial banks.

Outbound Activities. Chinese regulatory changes that commenced in 2018 have dramatically increased opportunities for U.S. investment in specific Chinese financial sectors, such as asset management. U.S. asset managers have been quick to take advantage of the current favorable environment. In addition, individual U.S. investors have increasingly invested in Chinese securities. In

contrast to this enthusiasm for investment in China, a countervailing regulatory theme that contemplates potential delisting of Chinese securities from U.S. securities exchanges threatens to undermine the global importance of U.S. securities markets. These developments present a number of issues for U.S. policy makers and regulators.

First, it is possible that the Chinese leadership may favor "opening up" in order to allow Chinese financial and capital markets to benefit from the expertise of U.S. asset management firms to jump start the asset management business in China. It is possible that once significant transfer of knowledge about the asset management business has taken place, the Chinese authorities might find it appropriate to determine that the U.S.-owned firms are engaged in activities that require intervention by the Chinese state. Such intervention might have adverse consequences not only for the China-based U.S.-owned asset manager, but also for numerous U.S. investors in these firms. It could also result in substantial disruptions to U.S. securities markets.

Additionally, even if the Chinese authorities take a more circumspect approach, U.S. fund managers could find it difficult to conduct a China-based business over the longer term. For example, the CCP committees that are active within Chinese commercial banks might obtain access to highly sensitive commercial information because of the role played by these banks in introducing customers.

Further, there is a possibility that, unless appropriate safeguards can be put in place, the CCP might seek to influence the day-to-day operations of China-based fund managers in a manner that would adversely affect U.S. interests.

There are also issues with the variable interest entity ("VIE") structure that seems to be the norm for individual portfolio investments by foreigners in Chinese companies. VIEs may leave U.S. investors without recourse in the event of market problems or political changes because such investors lack a specific, enforceable ownership interest in the underlying Chinese operating company. Another risk is that, because of the complicated structure of many Chinese companies and the many avenues of CCP and state influence, foreign capital invested in Chinese companies may inadvertently fund Chinese government and CCP objectives that are adverse to U.S. interests.

Finally, in the wake of U.S. insistence that Chinese companies (and their auditors) wishing to list their securities on U.S. exchanges must meet certain U.S. accounting standards, some Chinese companies have taken steps to list on non-U.S. exchanges and potentially to "delist" their securities from U.S. exchanges. Such steps might undermine the global importance of U.S. securities markets.

Policy Suggestions. Within a framework of pragmatic containment, there are a number of practical steps that could be taken to address these issues.

First, regulators need to broaden the concept of national treatment to include a full review of state ownership and dominant political party influence.

Second, U.S. policy makers and regulators should require appropriate disclosure to investors of the risks presented by direct investments in Chinese financial institutions such as asset managers.

Third, while portfolio investments by individual investors in foreign companies have traditionally not been subject to U.S. government oversight, the widespread use of VIEs as well as measures to ensure state and CCP influence within Chinese companies may merit a more active U.S. government role to protect U.S. investors and markets.

Fourth, resolution of issues related to potential large-scale delisting of Chinese companies from U.S. exchanges should be pursued through continued active discourse between regulatory agencies such as the Securities and Exchange Commission ("SEC") and China Securities Regulatory Commission ("CSRC").

Further Implications. The Ukraine war has changed the world. The threat of nuclear war has made it necessary for the United States to weaponize sanctions against Russia as deterrent measures. In managing its economic relationship with China, the United States should pursue a carefully implemented policy of pragmatic containment. Assuming that the need to deploy comprehensive secondary sanctions against China can be avoided, such a policy should provide a prudent pathway towards better U.S.-China economic relations in the future.

INTRODUCTION

Have the United States and China already embarked on Cold War II? Should the United States continue to pursue a policy of economic engagement with China? Focus on decoupling? Seek to "blunt" China's strategic advances? Is the eventual ascent of China to sole superpower status already a foregone conclusion? Is it possible to achieve a viable balance between confrontation and cooperation? Can the U.S.-China relationship be confined to intense interest-driven economic competition in the wake of President Xi Jinping's pronouncement that the China-Russia relationship "has no limits"? Will the Ukraine war alter the world order in a manner that will render such inquiries meaningless? Such questions and alternative responses fill the pages of U.S. scholarly journals.

At a pragmatic level, developing an appropriate response to China's growing economic and strategic power and managing engagement and competition with

China on terms compatible with U.S. interests are bipartisan goals that have led to a reassessment of various U.S. policies. Trade, technology transfer, cybersecurity and intellectual property issues have dominated this discussion in the recent past. Another area where the United States might appropriately revisit policies toward China is financial services.

For many years following Deng Xiaoping's opening of the Chinese economy to foreign investment, U.S. business leaders and policymakers focused on the opportunities to be found in Chinese financial markets and, to a lesser extent, the potential benefits of certain Chinese banking and financial services investments in the United States.

More recently, amidst claims that "maintaining strict control over commercial activity [including banking and financial services] is an increasingly urgent priority for the Chinese Communist Party ("CCP")," serious questions have been raised about the potential challenges of such cross-border financial services investments. There are also concerns about whether Chinese financial institutions support objectives that are contrary to U.S. interests and harmful to the U.S. economy and investors.[3]

With its focus on Chinese self-reliance, the "dual circulation" strategy articulated by Xi Jinping provides theoretical support for an expanded role for the CCP in executing China's domestic and international economic and financial policies and has led some observers to comment that China is pursuing a policy of "asymmetrical decoupling."[4] The dual circulation strategy was first publicly articulated at a meeting of the CCP Politburo Standing Committee in May 2020 and was later included in China's 14th Five Year Plan in March 2021. As explained by Xi Jinping, because the world is undergoing "profound changes unseen in a century," China needs to chart a new economic course of dual internal (domestic) and external (international) circulation, in which internal and external markets reinforce and sustain each other, with a focus on establishing the domestic market, guided by the CCP, as the primary driver of China's development.[5]

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[3] U.S.-China Economic and Security Review Commission ("USCC"), Report to Congress, November 2021 (Washington, D.C.: U.S. Government Publishing Office, 2021) (the "2021 USCC Report"), available at https://www.uscc.gov/sites/default/files/2021-11/2021_Annual_Report_to_Congress.pdf.

[4] "China Courts Global Capital on its own terms," The Economist, December 11, 2021, available at https://www.economist.com/leaders/2021/12/11/china-courts-global-capital-on-its-own-terms.

[5] Center for Strategic and International Studies ("CSIS"), China Power Project, "Will the Dual Circulation Strategy Enable China to Compete in a Post-Pandemic World?," available at

Under the control-focused leadership of Xi Jinping, the CCP has a significant role in managing the domestic and international activities of Chinese banks, NBFIs and securities firms. These Chinese entities are active in the United States. Simultaneously, U.S. financial firms have actively expanded into Chinese financial and capital markets. The U.S. regulatory regime is not equipped to deal with the consequences of these developments. A more nuanced U.S. policy approach is needed to address the political, strategic and economic risks and benefits that accompany such cross-border financial services investments. A revised approach also needs to include a realistic assessment of the role of the CCP as the ultimate overseer and frequent decision maker in Chinese banks and other financial institutions.

The primacy of the Chinese state and the CCP in directing the activities of Chinese financial institutions is a policy concern in the case of Chinese expansion into the United States as well as U.S. investments in China. Chinese state-owned banks with business operations in the United States are expected to serve the interests of the CCP and Chinese state by supporting Chinese policy initiatives, identifying vulnerabilities in U.S. regulations (such as anti-money laundering ("AML") regulations), and gaining practical knowledge that can be used to Chinese advantage in support of certain objectives such as internationalization of the renminbi.

Growing U.S. investments in financial institutions such as asset management firms in China also present policy issues. A greater awareness of how the role of the Chinese state and CCP in Chinese financial institutions may present risks for foreign investors is critical. For many years, the Chinese state and CCP limited carefully the access of U.S. financial firms to Chinese markets. The current opening for U.S. asset managers might quickly be reversed in the event of a change in official Chinese state or CCP policy objectives. Such a reversal might harm U.S. direct investors and could trigger serious instability in U.S. capital markets. Similarly, the growing interest of U.S. investors in purchasing Chinese securities as portfolio investments may merit a more active U.S. government role.

The Ukraine war poses further challenges for each of China and the United States in managing cross-border investments. Despite its strident domestic support for Russia and even though it has stated its disapproval of Western sanctions in no uncertain terms, China has not taken actions that would openly contravene them. China's reluctance to assist Russia in a manner that would provoke the imposition of secondary sanctions is an indication that China views its commercial ties with the United States and other Western countries as

https://chinapower.csis.org/china-covid-dual-circulation-economic-strategy.

important. This provides a reason for U.S. policy makers to stand firm on compliance and maintain clarity on the consequences of noncompliance.

COMMERCIAL BANKS

Generally

To date, the important role played by the CCP in the U.S. operations of Chinese state-owned commercial banks (referred to herein as "Chinese commercial banks") has not been addressed in depth. Rather, these banks have generally been welcomed as potential members of the active business community of FBOs present in the United States. Premised on national treatment and equality of competitive opportunity, U.S. regulatory policy on the entry, expansion and oversight of FBOs, including Chinese commercial banks, has long focused on comprehensive, consolidated supervision ("CCS"), financial measures of strength such as capital and liquidity, and evaluation of banking activities that FBOs propose to conduct in the United States. A key question is whether this policy should be adjusted in light of the hybrid nature and strategic policy objectives of certain FBOs that are state-owned or have substantial government sponsorship, most notably Chinese commercial banks with U.S. operations. Such Chinese commercial banks are not specifically "policy banks" in the manner of China Development Bank, but they are nonetheless expected to reflect the shareholder concerns of their state owners and support the strategic policy goals of the CCP and the State Council.

These banks include Bank of China ("BOC"), the Industrial and Commercial Bank of China ("ICBC"), China Construction Bank ("CCB"), Agricultural Bank of China ("ABC") and Bank of Communications ("BoCOM"). While they rank among the world's largest banks based on asset size, Chinese commercial banks have a relatively modest U.S. footprint. However, their experience in the United States helps to inform the thinking and policies of the Chinese leadership, including on specific important issues such as use of the renminbi in foreign trade and investment, and promotion of CIPS as an alternative to SWIFT.

Among other activities, Chinese commercial banks that establish U.S. branches are eligible to apply to become direct participants in the U.S. dollar clearing system that supports the conversion of foreign currency-denominated payments into U.S. dollars. As direct participants, they are customers of either (or both) the Fedwire Funds Service ("Fedwire") or the Clearinghouse Interbank Payment System. Historically, FBOs have viewed the role of direct

participant as one of prestige that also signifies commitment to the U.S. market.[6]

Like other FBOs, Chinese commercial banks face a key unwanted consequence of participation in U.S. dollar clearing activities: exposure to U.S. enforcement actions and sanctions related to AML issues. Especially in recent years, U.S. regulatory authorities have assessed significant penalties on FBOs for lapses. While even FBOs that do not operate branches or subsidiaries in the United States may be prosecuted if there is a significant U.S. connection, branches that are direct participants in the U.S. dollar clearing system face particular challenges.[7] Such challenges are one of the reasons why Chinese commercial banks may be especially interested in promoting CIPS and use of the renminbi as a reserve currency, as such measures would support an alternative to the U.S. dollar clearing system.

Policies that support the continued successful participation by Chinese commercial banks in the U.S. dollar clearing system through their U.S. branches may temper the determination of the Chinese leadership to facilitate use of the renminbi as a reserve currency that would rival the U.S. dollar. Successful U.S. operations may also moderate Chinese eagerness to develop international payment messaging systems other than SWIFT. SWIFT is currently used by more than 11,000 banks and other financial institutions to send funds transfer information around the globe. U.S. dollar transfers often involve a combination of SWIFT and Fedwire or CHIPS instruction messages and SWIFT is a vital component of the U.S. dollar clearing process.

The importance of continued successful U.S. dollar clearing activities by Chinese banks has been underscored by the Ukraine war. It is often noted that the power of sanctions on Russia (and potential secondary sanctions against China) is premised on the dominance of the U.S. dollar.[8] One result of the war

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[6] Duncan Kerr, "Clearing: European Banks Weigh Up U.S. Dollar Clearing Options," Euromoney, January 5, 2015, available at https://www.euromoney.com/article/b12kjyygbzp9v4/clearing-european-banks-weigh-up-us-dollar-clearing-options.

[7] Allen & Overy, Legal and Regulatory Risk Note, "U.S. Continues Aggressive Sanctions and Anti-Money Laundering Enforcement Against Non-U.S. Banks," July 18, 2019, available at https://www.allenovery.com/en-gb/global/news-and-insights/publications/us-continues-aggressive-sanctions-and-anti-money-laundering-enforcement-against-non-us-banks; *see also* Lexology, Export Law Blog, USA, Robert Clifton Burns, Bryan Cave, "Touch a U.S. Dollar Anywhere, Go Directly to U.S. Jail," August 2, 2017, available at https://www.lexology.com/library/detail.aspx?g=9c7fc8c1-8e12-4a56-9a72-00fb3d1c0b66.

[8] Robin Wigglesworth, Polina Ivanova and Colby Smith, "Financial Warfare: Will There Be a Backlash Against the Dollar?" Financial Times, April 7, 2022, available at https://www.ft.com/content/220db8f2-2980-410f-aab8-f471369ac3cf.

is likely to be a renewed focus on Chinese development of the renminbi as a reserve currency and promotion of the CIPS platform. Zhang Yanling, a former senior officer of BOC, has claimed that tough sanctions against Russia would "cause the United States to lose its credibility and undermine the dollar's hegemony in the long run."[9] Eswar Prasad, a former IMF official, has stated that CIPS has the potential to develop in a manner that could one day provide a viable alternative to the Western-dominated financial system and SWIFT.[10]

In addition to furthering specific policy objectives related to SWIFT and the U.S. dollar, the United States has much to gain from the continued successful operation of Chinese commercial banks in the United States. U.S. regulators may achieve a better understanding of the regulations and policies of their Chinese counterparts through communication with their representatives at times of Chinese commercial bank entry, expansion and examination.

Similarly, Chinese regulators study and respond to U.S. regulations and policies and rely on feedback from Chinese branch managers and other senior Chinese commercial bank officers who are resident in the United States (many of whom are members of the CCP) for information about the objectives and consequences of such regulations. Chinese commercial bank personnel located in the United States have a window on U.S. business practices and expectations and experience day-to-day interaction with U.S. business colleagues. Not insignificantly, the continuing presence of Chinese commercial banks facilitates ongoing communication about financial policy issues between China and the United States at a time when high-level general policy discussions are sporadic and divisive.

Changing Perspectives from 1997–2021

A brief introductory note about the ownership structure and regulation of Chinese commercial banks may be helpful. China Investment Corporation ("CIC") was established on September 29, 2007, as China's sovereign wealth fund and was incorporated in accordance with China's Company Law. CIC has three subsidiaries, CIC International Co., Ltd., CIC Capital Corporation and Central Huijin Investment Ltd. ("Huijin").[11] Huijin was established in December 2003 and mandated to exercise its rights and obligations as an

[9] *Id.*

[10] *Id.*; *see also* Eswar Prasad, "Eswar Prasad Says More . . . ," Project Syndicate, April 12, 2022, available at https://www.project-syndicate.org/say-more/an-interview-with-eswar-prasad-2022-04.

[11] CIC Overview, available at https://www.china-inv.cn/chinainven/About_CIC/Who_We_Are.shtml.

investor in major state-owned financial enterprises on behalf of the Chinese state. In September 2007, the Ministry of Finance issued special treasury bonds and acquired all of the shares of Huijin from the Chinese central bank, the People's Bank of China ("PBOC"). The acquired shares were injected into CIC as part of its initial capital contribution. However, Huijin's principal shareholder rights are exercised by the State Council. The members of Huijin's Board of Directors and Board of Supervisors are appointed by and are accountable to the State Council.[12] In practical terms, this means that there is a direct oversight link from the Chinese commercial banks to the State Council.

As background, it is also useful to reflect on the evolving Chinese policies and perspectives guiding the entry and expansion of Chinese commercial bank operations in the United States. During the period from 1997–2001, in particular, Jiang Zemin was eager to promote China's greater participation in the world economy and to secure Chinese accession to the World Trade Organization ("WTO"). At about the same time, Prime Minister Zhu Rongji announced China's "Going Out" strategy.[13] Under the "Going Out" strategy, the Chinese government encouraged Chinese firms to expand overseas. The large Chinese commercial banks were encouraged to follow this guidance "partially in support of the overseas expansion of China's manufacturing firms, but also as part of a strategy for China to play a much larger role in the global financial markets and to establish a financial presence all over the world."[14]

It was at this time that ICBC, CCB and ABC (followed by partially state-owned China Merchants Bank ("CMB") in 2002) first established representative offices in the United States. (BOC and BoCOM had established branch operations in the United States much earlier, in 1981 and 1991, respectively.) Jiang's successor, Hu Jintao, favored continuation of greater engagement of Chinese commercial banks in the U.S. marketplace. Between 2007–2008, Federal Reserve Board ("FRB") approval was obtained for initial New York branches for CCB, ICBC and CMB. Optimism about the potential for U.S. expansion continued through 2012, at which time ABC obtained approval for its New York Branch, ICBC was permitted to acquire a controlling

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[12] Huijin, Company Profile, available at https://www.huijin-inv.cn/huijineng/About_Us/index.shtml.

[13] David Shambaugh, China Goes Global: The Partial Power (New York: Oxford University Press, 2013), available at https://global.oup.com/academic/product/china-goes-global-9780199860142?cc=us⟨=en&, at 223 (digital version).

[14] James Stent, China's Banking Transformation (New York: Oxford University Press, 2017), available at https://oxford.universitypressscholarship.com/view/10.1093/acprof:oso/9780190497033.001.0001/acprof-9780190497033, at 327 (digital version).

interest in a U.S. bank (The Bank of East Asia (USA), National Association) ("Bank of East Asia") and BOC was permitted to open an additional branch, in Chicago. ICBC's acquisition of Bank of East Asia was cited by some observers as a signal that the FRB had become comfortable with Chinese banks. There was a general expectation at the time that other Chinese banks would seek to expand their presence in the United States, especially in metropolitan areas where there were large Chinese communities.[15]

In the early days of his leadership, President Xi Jinping spoke of the "Chinese dream of great rejuvenation of the Chinese nation" in terms reminiscent of U.S. rhetoric about the American Dream.[16] Xi Jinping's public statements and actions thereafter were more confrontational, perhaps due in part to perceptions of the Chinese leadership that the United States was reneging on its previously warm welcome to the Chinese commercial banks. The period from 2015 through 2018, in particular, was marked by significant U.S. regulatory enforcement actions against ABC, CCB, BOC and ICBC.

While these actions were firmly grounded in a failure by the Chinese commercial banks to adhere to specific U.S. rules and regulations applicable to all FBOs with U.S. operations and were not policy initiatives, they would, by themselves, have provided a reason for the Chinese leadership to review any further U.S. expansion plans for Chinese commercial banks.

Moreover, it seems that, from the perspective of the Chinese leadership, the regulatory enforcement actions of 2015–2018 were likely incorrectly interpreted as adverse U.S. policy initiatives aimed at restraining Chinese commercial bank expansion in the United States. This is not surprising in view of the significant compliance burden imposed on the head office and U.S. branch of banks that had only a few years earlier been warmly welcomed into the FBO community in the United States. The enforcement orders typically required burdensome attention to compliance issues by both head office and branch. Not only did the U.S. branch need to hire outside advisers and additional compliance and internal audit personnel to support measures required by the orders or imposed by monitors selected by the regulators to enforce them, it also needed to explain its proposed responsive actions to a sometimes incredulous head office.

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[15] CNBC News, "Fed Clears Way for Chinese Firms to Buy U.S. Banks," available at https://www.cnbc.com/id/47360297.

[16] Xi Jinping, Speech, March 17, 2013, at the closing meeting of the first session of the 12th National People's Congress, speech summary, available at https://www.chinadaily.com.cn/china/2013npc/2013-03/17/content_16314303.htm.

In fact, total assets attributed to U.S. operations of Chinese banks reached a plateau during the period from 2015 to 2018 and, as of September 30, 2021, were slightly lower than total assets held as of June 30, 2014 ($121,752 vs. $127,696 [assets in millions]).[17]

In addition to a more cautious Chinese leadership perspective on U.S. expansion due to enforcement actions and Trump Administration policies, the Belt and Road Initiative ("BRI") was a factor supporting the levelling off of U.S. investment, as it encouraged a focus on establishing new banking offices to support lending in countries where BRI infrastructure projects were located. By the end of 2020, ABC had 13 overseas branches, three overseas representative offices and five overseas subsidiaries, an accomplishment cited in ABC's 2020 Annual Report as support for the BRI and internationalization of the renminbi.[18] BoCOM noted in its 2020 Annual Report that it had set up 23 overseas branches and representative offices in 18 countries, thereby "forming an overseas operating network covering major financial centers across five continents."[19] Each of ICBC, CCB and BOC had developed even more substantial international branch and subsidiary networks—totaling 33 branches and 20 subsidiaries in 45 countries for ICBC, 25 branches and eight subsidiaries in 30 countries for CCB, and an impressive network of overseas offices covering 61 countries and regions (including 25 BRI countries), for BOC.[20]

The Ukraine war will likely further undermine China's interest in expanding its U.S. banking presence. Enthusiasm for "going out" and participating in the globalization of financial markets has been challenged by actions of the United States and its Western allies to remove Russian banks from SWIFT. In a bifurcated world where China has cast its diplomatic lot with Russia, the Chinese leadership has less incentive to seek a substantial commercial position for its banks within the U.S. marketplace.

Just as the Chinese leadership's eagerness for a strong U.S. presence by Chinese commercial banks has waned over the years, U.S. views on the entry and expansion of Chinese commercial banks have also changed quite dramatically between 1997 and 2022. Comments made by the FRB in its public

[17] Federal Reserve Board, Structure Data for U.S. Banking Offices of Foreign Entities, available on FRB website at https://www.federalreserve.gov/releases/iba/.

[18] ABC Annual Report 2020, (overseas offices) at 171–172; (support for BRI and renminbi) at 51.

[19] BoCOM Annual Report 2020 H Share, at 5.

[20] ICBC Annual Report 2020, at 313–316; CCB Annual Report 2020, at 162–164 (branches) and at 62–63 (subsidiaries); BOC Annual Report 2020, at 55.

approval and enforcement orders during this period are instructive, with FRB actions regarding ICBC noted here as an example. In issuing its 1997 approval order permitting ICBC to establish a representative office, the FRB noted approvingly that, "In connection with ongoing efforts to modernize China's financial system, [ICBC] now engages in more traditional commercial banking activities."[21] Despite ICBC's historical focus on compliance with state economic and financial goals, the FRB commented that, "in the last several years the Chinese authorities have taken steps to develop a more market-oriented bank supervisory program placing greater emphasis on prudential standards."[22]

In August 2008, when it approved the establishment of ICBC's New York branch, the FRB noted that the China Bank Regulatory Commission ("CBRC"), ICBC's principal supervisory authority in China, was "actively working" to establish arrangements for the consolidated supervision of ICBC and also cited steps taken in China to combat money laundering.[23] While it was not acknowledged in official FRB statements, some sources indicate that the government ownership of ICBC presented an obstacle to approval and that it was only after the Chinese government was able to placate fears about bank operations that ICBC was awarded entry.[24] One article further observed that "while CIC [the state agency that is the ultimate owner of Chinese commercial banks such as ICBC] purports to be an autonomous entity that is engaged in apolitical investment opportunities, it remains difficult for many to discount the potential for government influence."[25] Significantly, such concerns about state ownership were never publicly discussed by U.S. regulators.

By 2012, when the FRB approved ICBC's application to acquire a controlling interest in The Bank of East Asia, the FRB Order noted in support of its decision that both ICBC and its controlling shareholders, state investment entities Huijin and CIC, had "committed that, to the extent not prohibited by applicable law, they will make available to the [FRB] such information on their operations and the operations of their affiliates that the [FRB] deems necessary

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[21] FRB Order, January 27, 1997, https://www.federalreserve.gov/boarddocs/press/bhc/1997/19970127.

[22] *Id.*

[23] FRB Order Approving Establishment of Branch, August 5, 2008, available at https://federalreserve.gov/newsevents/pressreleases/files/orders20080805a1.pdf.

[24] John D. Fitzpatrick, "Chinese Banks' Re-emergence in the United States," 13 N.C. Banking Institute 413 (2009), at 427, citing Li Liming, "Chinese Banks Get U.S. Fed's Nod to Set Up Branches," Econ. Obs. Online, June 24, 2008 (Liu Peng, trans.), available at http://www.eeo.com.cn/ens/finance_investment/2008/06/24/104214.html.

[25] *Id.* at 428.

to determine and enforce compliance with the [Bank Holding Company Act of 1956 ("BHCA")], the International Banking Act [("IBA")] and other applicable federal laws. . . ."[26] The FRB Order also noted that the FRB had consulted with the CBRC about access to information and that U.S. bank regulators had participated in the November 2009 supervisory college for ICBC hosted by the CBRC.[27] Citing a 2004 Memorandum of Understanding, the FRB indicated that the CBRC had agreed to cooperate with the FRB and other U.S. regulators to share appropriate supervisory information.[28] If there were concerns about state ownership issues other than information sharing, they were not publicly discussed.

By 2018, ICBC (like its sister banks CCB, ABC and BOC) was subject to an enforcement action citing serious deficiencies in its New York branch compliance with federal and state laws, rules and regulations relating to AML and risk management. Enforcement actions against Chinese commercial banks citing multiple failures to adhere to U.S. laws and regulations were a hallmark of the 2015 to 2018 period and were symptomatic of the more confrontational economic and financial relationship that had developed between China and the United States. However, it is notable that the enforcement actions remained strictly focused on matters deemed directly relevant to U.S. bank regulation and supervision, such as compliance with U.S. AML and sanctions laws. Throughout the entire period from 1997 to the present, public statements and commentary of the FRB and other U.S. federal and state bank regulators have not focused on the role of state ownership and CCP influence in guiding the U.S. activities of Chinese commercial banks—factors which are critical in understanding the strategic and business objectives of these banks and developing appropriate U.S. policy responses.

National Treatment

Each of the Chinese commercial banks has entered the United States and/or conducted its U.S. operations under a U.S. regulatory regime premised on "national treatment and equality of competitive opportunity" ("national treatment"). National treatment was first articulated in the context of the IBA. As explained in a widely-cited FRB discussion paper, "[N]ational treatment, which precludes the use of rules that discriminate between foreign and domestic

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[26] FRB Order, May 9, 2012, at 9, available at https://www.federalreserve.gov/newsevents/pressreleases/files/order20120509a.pdf.

[27] *Id.*

[28] Memorandum of Understanding between the CBRC and the FRB, OCC and FDIC, June 17, 2004, available at https://www.fdic.gov/news/press-releases/2010/pr10122a.pdf.

firms, seeks to ensure equality of competitive opportunity for foreign firms entering or operating in a host country. . . . Under a policy of national treatment, foreign banks are treated, as nearly as possible, like domestic banks: they have the same opportunities for establishment that domestic banks have, they can exercise the same powers in the host country, and they are subject to the same obligations."[29]

National treatment was the subject of renewed attention in the Foreign Bank Supervision Enhancement Act of 1991, as well as in the Riegle-Neal Interstate Banking and Branching Act of 1994. The Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") tweaked national treatment when it introduced the intermediate holding company requirement based on an FBO achieving certain thresholds related to U.S. non-branch assets, but the FRB noted in its preamble to a key implementing rule that, "The principles of national treatment and equality of competitive opportunity were central considerations in the design of the enhanced prudential standards for [FBOs]."[30]

National treatment presumes that the objective of FBOs will be primarily to conduct "banking activities," as is assumed to be the case for their U.S. bank counterparts. As noted by a former Federal Reserve Governor in a 2012 speech, "[National treatment recognizes that] differences in business organization, domestic regulatory systems, and other factors mean that there must sometimes be determinations whether foreign and domestic firms are 'like' one another in relevant aspects."[31] To date, this analysis has been directed primarily at differences in corporate structure and governance. In the case of Chinese commercial banks, a recognition of their mandate to support government and CCP strategic and economic policy objectives should explicitly inform any discussion of national treatment and equality of competitive opportunity.

As noted in a comprehensive handbook on Chinese financial institutions, "The big banks [Chinese commercial banks] strive to balance the goal of earning profits and expanding operations guided by the overall economic policy objectives of the State Council, the [People's Bank of China (the "PBOC")],

[29] Sydney J. Key, "Is National Treatment Still Viable? U.S. Policy in Theory and Practice," FRB, International Finance Discussion Papers, Number 385, September 1990, at 1, available at https://www.federalreserve.gov/pubs/ifdp/1990/385/ifdp385.pdf.

[30] 79 Federal Register 17239, at 17268 (March 27, 2014), available at https://www.govinfo.gov/content/pkg/FR-2014-03-27/pdf/2014-05699.pdf.

[31] Daniel Tarullo, "Regulation of Foreign Banking Organizations," Speech at the Yale School of Management Leaders Forum, November 28, 2012, footnote 2, at 2, https://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm.

and other government agencies."[32] Huijin holds controlling equity investments in the major state-owned commercial banks and "exercise[s] its shareholder rights accordingly."[33] As explained above, CIC holds the shares of Huijin. Under the leadership of Xi Jinping, the Financial Stability and Development Committee (the "FSDC") (established in 2017) of the State Council works to align the policies of agencies such as the PBOC and the China Banking and Insurance Regulatory Commission (the "CBIRC") (formerly, the CBRC) with the objectives of the CCP.[34]

In 1979, when he was president of the Federal Reserve Bank of New York ("FRBNY"), Paul Volcker reiterated the prevailing view that national treatment means that "foreign banks would be permitted to operate in the United States on substantially the same basis as United States banks."[35] However, he also noted that "[T]here are some special areas that deserve exploration and debate." For example, "Should we be equally hospitable to institutions that may not be subject to usual market disciplines such as foreign government-owned banks, particularly if there is a pattern of state direction?"[36] Four decades later, Volcker's question remains relevant. The current paradigm for national treatment focuses primarily on matters of corporate structure and percentage ownership. It needs to be revised to accommodate analysis of the special policy objectives that may accompany state ownership.

Questions such as the following may be pertinent:

- Are U.S. branch officers and employees expected to prioritize effective implementation of home country government or dominant political party policy objectives over purely commercial objectives in conducting branch operations?
- Are U.S. branch officers and employees expected to report to head

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[32] Guofeng Sun, "Banking Institutions and Banking Regulations," at 14, in Marlene Amstad, Guofeng Sun, and Wei Xiong, eds., The Handbook of China's Financial System (Princeton University Press, 2020), https://www.press.princeton.edu/books/hardcover/9780691205731/the-handbook-of-chinas-financial-system.

[33] *Id.* at 18.

[34] Robin Hui Huang, "Financial Regulatory Structure in China: Challenges and Transitioning to Twin Peaks," Research Paper No. 2021-43, The Chinese University of Hong Kong, Faculty of Law, at 23, available at https://www.cambridge.org/core/books/cambridge-handbook-of-twin-peaks-financial-regulation/D45EBC5BB624EE50531C70F4FF666953.

[35] Paul Volcker, "Treatment of Foreign Banks in the United States: Dilemmas and Opportunities," FRBNY Quarterly Review, Summer 1979, https://www.newyorkfed.org/medialibrary/media/research/quarterly_review/1979v4/v4n2article1.pdf.

[36] *Id.* at 3–4.

office on a frequent basis on matters such as U.S. policies or regulatory requirements that are or appear to be contrary to home country requirements?

- If there is a divergence between U.S. and home country requirements, can U.S. branch officers and employees be relied upon to follow U.S. requirements?
- How will the state-owned bank deal with matters of extra-territoriality? Will it acknowledge and adhere to U.S. requirements that mandate U.S. access to head office records?
- Will the management of the U.S. branch be expected to report to head office on possible ways to circumvent U.S. policies or requirements that are viewed by head office as contrary to home country government or dominant political party policies?
- Will the U.S. branch seek to hire officers and employees who will likely comply with requests from branch management or head office that are contrary to U.S. requirements?
- Will head office cooperate with U.S. regulatory requests for information in connection with bank examinations and enforcement actions?
- Will the U.S. branch maintain separate books and records for purposes of reporting to head office and reporting to U.S. regulators?
- Will U.S. employees be expected to identify U.S. regulators who might be supportive of head office policies or practices that diverge from expected U.S. business practices?

Answers to such questions are important because they may help U.S. regulators to identify situations where a state-owned bank is likely to engage in practices that undermine the assumption of commercial integrity that supports U.S. banking markets. While a revised concept of national treatment would need to be applied to all FBOs, wherever headquartered, it would be especially relevant for Chinese commercial banks because of the dominant role and frequent intervention of the state and the CCP in their oversight and management. Other state-owned banks, such as certain banks from India and the German Landesbanks, could be readily distinguished because there is no dominant political party directly involved in their day-to-day operations and the interactions of their U.S. operations with home country regulators are demonstrably more distanced and infrequent.

As practically applied at the stages of entry, expansion, examination and enforcement, a revised national treatment evaluation would explicitly include an analysis of how state ownership, if applicable to a particular FBO, affects its

strategic and business objectives, management and operations. It would also include a review of relevant guidance on foreign operations issued by home country regulators and the influence of dominant political parties.

Entry, Expansion, Oversight and Enforcement

Most international banks, including the Chinese commercial banks, have commenced U.S. banking operations through a branch of the head office. Regardless of whether they elect to pursue a federal or state license granted by the Office of the Comptroller of the Currency ("OCC") or a state regulator (most often the New York Department of Financial Services (the "NYDFS")), each Chinese commercial bank must also obtain approval from the FRB.

A number of the questions set forth in the FRB's branch application form (FRB Form K-2) relate to home country supervision and whether the applicant FBO is subjected to CCS by the appropriate authorities in the FBO's home country.[37] For example, an FBO is required to provide a description of:

- The scope and frequency of on-site examinations by the home country supervisor;
- Off-site monitoring by the home country supervisor;
- The role of external auditors;
- Transactions with affiliates; and
- Other prudential requirements.

An FBO applying for approval of a branch license is also required to provide information about the proposed office: "Describe the major types of business to be conducted and the major types of services to be offered and note whether any existing business would be transferred to the proposed office."[38] None of these entry questions is explicitly directed at any additional or policy-linked motivations for establishing the office, supplemental activities to be conducted or significant reporting lines that might result from an FBO's state ownership. While responsive information about an applicant bank's structure and operations is required, questions do not directly contemplate or inquire about the influence of state ownership or a dominant political actor within a party-state system.

FBOs that wish to expand their U.S. banking operations are generally required to file notices or applications with the FRB and to comply with the so-called nonbanking prohibitions of the BHCA. FBOs became subject to these

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[37] FRB Form K-2, available at https://www.federalreserve.gov/apps/reportforms/.

[38] *Id.*

prohibitions pursuant to the IBA, which treats the head office of an FBO as though it were a U.S. bank holding company for certain purposes.

While the FRB has consistently maintained that foreign governments are not "companies" subject to the BHCA, this conclusion has been adjusted to address particular situations, beginning with the FRB's review of the application of Banca Commerciale Italiana ("BCI") to take over Irving Bank Corporation in 1988. In 2008, the FRB determined that CIC and Huijin were companies under the BHCA. Relying on Section 4(c)(9) of the BHCA, the FRB exempted CIC and Huijin from the nonbanking prohibitions of the BHCA and permitted them to make investments in any company, including a U.S. or foreign company with U.S. operations, without regard to the nonbanking restrictions of the BHCA.[39]

However, the FRB also determined that any foreign bank subsidiary of CIC or Huijin (such as Chinese commercial banks) would remain fully subject to the FRB's regulations K and Y with respect to activities and investments and would be treated the same as any other FBO. As in the case of the entry questions noted above, the FRB focused on domestic U.S. activities and did not make any public comments on policy issues related to government ownership and CCP influence on the Chinese commercial bank subsidiaries of CIC and Huijin.[40] The FRB Letter reflects the difficulty that entities such as Huijin and CIC present for national treatment analysis. In determining that Huijin and CIC were companies, the FRB focused on their formal structure rather than on the manner in which Huijin's shareholder rights are exercised (by the State Council).[41]

Oversight of the U.S. operations of PRC commercial banks is exercised primarily through the bank examination process. While the specific content of bank examination questions is confidential in accordance with the bank examination privilege, it is generally acknowledged that examination questions relate primarily to a U.S. branch's conduct of its U.S. banking business. The bank examination process does not seek to address issues related to state ownership, political party influence on specific business decisions or identification and evaluation of any policy-related activities or initiatives that might be undertaken by a U.S. branch. Business lines are reviewed with reference to products and services offered. Credit risk, credit risk management and asset

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[39] FRB Letter, dated August 5, 2008, addressed to H. Rodgin Cohen, https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeinControl/2008/20080805.pdf.

[40] *Id.*

[41] CIC, Organizational Structure and Governance, available at http://www.china-inven.cn/chinainven/Governance/Organizational_Structure.shtml.

quality are discussed in the context of U.S. activities. Similarly, analysis of funding and liquidity risk, market risk and market risk management, operational risk and operational risk management are discussed in this context. Compliance with AML and Office of Foreign Assets Control ("OFAC") regulations and general corporate compliance are reviewed by determining compliance with specific U.S. rules and regulations.

To date, policy issues relating to strategic economic and political objectives that result from the state ownership of PRC commercial banks have mostly been addressed indirectly, primarily through enforcement actions. Enforcement actions are focused on a bank's failure to comply with applicable U.S. rules and regulations. Enforcement-related written agreements and cease-and-desist orders affecting Chinese commercial banks have cited deficiencies in such matters as compliance programs relating to AML and OFAC regulations, customer due diligence, suspicious activity monitoring and reporting, and transaction review, but have not commented on the effect of Chinese laws or the influence of CCP guidelines which may be underlying factors in the failure of Chinese commercial banks to meet U.S. requirements. While there are varying levels of enforcement actions (including some that receive confidential treatment), there have been a number of public enforcement actions directed at the five major Chinese commercial banks. For example, ABC was fined $215 million in 2016. A monitor was appointed by the NYDFS to oversee the implementation of changes mandated by the consent order.[42]

Subpoenas and Sanctions

Just as the concept of national treatment needs to be adjusted to include an evaluation of the consequences of state ownership and CCP influence, U.S. policy on subpoenas and sanctions needs re-evaluation. Subpoenas and sanctions have sometimes been used in a manner that escalates day-to-day operational issues capable of practical resolution into larger policy issues. This can lead to intransigence on the part of U.S. and Chinese regulators and may make it unnecessarily difficult for Chinese commercial banks to conduct routine business operations in the United States. Continued imprecise and inconsistent use of subpoenas and sanctions in connection with U.S. enforcement actions may encourage Chinese commercial banks to question whether maintaining U.S. branches to gain direct access to the U.S. dollar clearing system is worth the effort. Increasingly, the Chinese answer seems to be that promoting the internationalization of the renminbi and the development of

[42] *See* Consent Order under New York Banking Law Sections 39 and 44, entered into between the NYDFS and ABC, November 4, 2016, https://www.dfs.ny.gov/system/files/documents/2020/04/ea161104_agricultural.pdf.

CIPS might be a viable alternative strategy. This could lead to further financial "de-coupling" if the Chinese leadership should decide to downsize or withdraw U.S. branches and might diminish the important role of Chinese commercial banks as intermediaries in an ongoing China-U.S. dialogue on financial policy issues.

Interestingly, Ernest Patrikis, formerly a regulator and a keen observer of the U.S. financial services industry, noted such concerns in the use of extreme penalties for FBO violations of AML and sanctions laws in connection with an FBO's U.S. dollar clearing business. As noted by Patrikis, "Compliance with U.S. laws and regulations, including those related to money laundering and sanctions, must and should be a necessary cost of conducting U.S. dollar clearing. . . . There is a question, however, of whether penalties that not only involve stiff monetary fines but require suspensions and limits on how future business is to be conducted will motivate [non-U.S. banks] in the wholesale U.S. dollar payments market to retreat from that business."[43] As stated by Patrikis, "[P]enalties . . . may prompt [FBOs] to explore alternatives. Developing a viable alternative to the U.S. dollar as the global medium of exchange may take some time. But the potential is on the horizon. Traditional currencies, such as the renminbi . . . may be groomed to take on that role, as the [renminbi] takes on a singular form that facilitates its use, export and repatriation within and outside China. . . ."[44]

In recent years, the Department of Justice has been very active in seeking to expand the use of subpoenas to obtain information held overseas that is related to accounts held in the United States by branches of Chinese commercial banks. In a court case commonly referred to as the "Three Chinese Banks Subpoena Case," the appellate court for the D.C. Circuit affirmed a civil contempt order against certain Chinese banks for failure to produce documents in response to Department of Justice subpoenas.[45] The recently enacted Anti-Money Laundering Act of 2020 goes further and authorizes the Secretary of the Treasury or the Attorney General to subpoena records from any FBO (even an FBO without a U.S. branch) that maintains a correspondent account in the United States in order to obtain information about any account of the foreign bank,

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[43] Ernest Patrikis, Will Enforcement of U.S. Sanctions Reshape How U.S. Dollar Transactions are Cleared? Financier Worldwide, September 2014, https://www.financierworldwide.com/will-enforcement-of-us-sanctions-reshape-how-us-dollar-transactions-are-cleared#.YfbEL-rMluU.

[44] *Id.*

[45] *In re Sealed Case*, 932 F.3d 915 (D.C. Cir. 2019).

including records maintained outside the United States.[46] These U.S. measures have been strongly criticized by Chinese regulatory authorities as an illegal exercise of extra-territorial jurisdiction.

A number of other recently enacted laws and executive orders, such as the Holding Foreign Companies Accountable Act of 2020 (the "HFCAA"), the Hong Kong Human Rights and Democracy Act, Executive Order 13936 (Hong Kong Related Sanctions) and Executive Order 14032, which generally prohibits U.S. persons from purchasing or selling securities of issuers identified as Communist Chinese Military-Industrial Companies ("CCMC"), have escalated the potential for penalties against Chinese enterprises, including Chinese commercial banks and NBFIs with U.S. operations.[47] If the precedent established by these strong initiatives is continued and makes it even more difficult for Chinese commercial banks to operate in the United States, it is possible that relevant Chinese authorities might further question the importance of maintaining their banking presence in the United States.

The complicated and sometimes unintended consequences of U.S. sanctions regulations have been well-documented. Especially in the context of compliance with AML rules, Chinese banks have been cited for violations of OFAC and similar sanctions rules. To date, most of the banks targeted by sanctions have been relatively small and are not among the Chinese commercial banks that maintain branches in the United States. U.S. policy makers are keenly aware of the disruptions and retaliatory actions that might occur if any of the Chinese commercial banks were put on the OFAC list of specially-designated nationals ("SDNs").[48] Macau-based Banco Delta Asia was designated as a "primary money laundering concern" under the USA PATRIOT Act in 2005 because it engaged in money laundering on behalf of North Korea.[49] On another

[46] Anti-Money Laundering Act of 2020, available at https://www.fincen.gov/anti-money-laundering-act-2020.

[47] HFCAA, available at https://www.sec.gov/hfcaa; Hong Kong Human Rights and Democracy Act, Public Law 116-76, available at https://www.govinfo.gov/app/details/PLAW-116publ76; Executive Order 13936, 85 Federal Register 43413 (July 17, 2020), available at https://www.federalregister.gov/documents/2020/07/17/2020-15646/the-presidents-executive-order-on-hong-kong-normalization; Executive Order 14032, 86 Federal Register 30145 (June 7, 2021), available at https://www.federalregister.gov/documents/2021/06/07/2021-12019/addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples.

[48] Jeffrey J. Schott, Peterson Institute for International Economics, Policy Brief 21-1, Raising a Caution Flag on U.S. Financial Sanctions Against China (January 2021), at 8, available at https://www.piie.com/publications/policy-briefs/raising-caution-flag-us-financial-sanctions-against-china.

[49] FinCEN Notice of Finding, 70 Federal Register 55214 (September 20, 2005), available at

occasion, the Bank of Dandong and two other smaller Chinese banks were sanctioned because they facilitated transactions with North Korea.[50]

Recently, counter measures by the Chinese government to deter compliance with U.S. sanctions deemed to have extraterritorial consequences have made it even more difficult for Chinese commercial banks to comply with U.S. rules. China's new Rules on Counteracting Unjustified Extraterritorial Application of Foreign Legislation and Other Measures were issued by the Ministry of Commerce ("MOFCOM") on January 9, 2021. A new Anti-Foreign Sanctions Law was adopted on June 10, 2021.[51]

The Ukraine War and the Possible Use of Secondary Sanctions

The use of sanctions by the United States, United Kingdom and European Union against Russia in the Ukraine war has further raised the stakes for China. To date, perhaps because of previous experience with U.S. sanctions, China seems wary of becoming the target of secondary sanctions. Chinese leaders have spoken out against the sanctions imposed on Russia since the early days of the Ukraine war. President Xi Jinping told President Biden on March 18, 2022 that "sweeping and indiscriminate sanctions would only make the people suffer."[52] In an Op-Ed piece in the Washington Post on March 15, 2022, Chinese Ambassador to the United States, Qin Gang, spoke specifically of secondary sanctions: "Wielding the baton of sanctions at Chinese companies while seeking China's support and cooperation won't work."[53]

Officials of China's Ministry of Foreign Affairs have stated that China is "contributing to the global economy by conducting normal trade with

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https://www.govinfo.gov/content/pkg/FR-2005-09-20/html/05-18660.htm); however, note that FinCEN issued a final rule repealing the special measure in 2020, 85 Federal Register 48105 (August 10, 2020), available at https://www.govinfo.gov/app/details/FR-2020-08-10/2020-17143.

[50] FinCEN, Imposition of Special Measure, 82 Federal Register 51758 (November 8, 2017), available at https://www.federalregister.gov/citation/82-FR-51758.

[51] Mary E. Lovely and Jeffrey J. Schott, Peterson Institute for International Economics, Policy Brief 21-13: Can China Blunt the Impact of new U.S. Economic Sanctions? (June 2021) at 1, available at https://www.piie.com/publications/policy-briefs/can-china-blunt-impact-new-us-economic-sanctions.

[52] Zhang Yunbi, "China Opposes Unilateral Sanctions for Good Reasons," China Daily Global, March 28, 2022, available at http://epaper.chinadaily.com.cn/a/202203/28/WS6240e39ba3109375516eae17.html.

[53] Qin Gang, "Opinion: Chinese Ambassador: Where We Stand on Ukraine," Washington Post, March 15. 2022, available at https://washingtonpost.com/opinions/2022/03/15/china-ambassador-us-where-we-stand-in-ukraine/.

Russia."[54] However, China does not appear to be actively circumventing Western sanctions on Russia. In a March 15, 2022 article, Tianlei Huang and Nicholas Lardy of the Peterson Institute for International Economics noted that, "[T]he evidence suggests that China is not acting to undermine economic and financial sanctions on Russia . . . China's firms and China's leadership are acutely aware that major efforts to support Russia that violate existing sanctions could bring down similar sanctions on them."[55] Similarly, Scott Kennedy of the Center for Strategic and International Studies stated, "It appears that the Chinese are so far abiding by the sanctions."[56]

Nonetheless, the possibility remains that, as the Ukraine war continues, China might openly seek to evade U.S. and other Western sanctions in order to support Russia. For example, China could invoke its Anti-Sanctions Law to help Russia evade the U.S. Commerce Department's export controls targeting defense, aerospace and maritime sectors or otherwise assist the Russian military effort in contravention of U.S. sanctions.[57]

U.S. officials seem keenly aware of the risks. In a speech to the Atlantic Council, U.S. Treasury Secretary Janet Yellen noted that, "[T]he unified coalition of sanctioning countries will not be indifferent to actions that undermine the sanctions we have put in place."[58] She spoke specifically of China and said that, "Going forward, it will be increasingly difficult for the United States and its allies to separate economic issues from broader considerations of national interest, including national security."[59] As reported in the

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[54] Yew Lun Tian, "China Says Not Deliberately Circumventing Sanctions on Russia," Reuters, April 1, 2022, available at www.reuters.com/world/china/china-says-not-deliberately-circumventing-sanctions-russia-2022-04-02/.

[55] Tianlei Huang and Nicholas Lardy, "China is Too Tied to the Global Economy to Risk Helping Russia," Peterson Institute for International Economics, March 15, 2022, available at https://www.piie.com/blogs/realtime-economic-issues-watch/china-too-tied-global-economy-risk-helping-russia.

[56] Scott Kennedy, "Ukraine and Taiwan: Parallels and Early Lessons Learned," Center for Strategic and International Studies, March 22, 2022, available at https://csis.org/analysis/Ukraine-and-taiwan-parallels-and-early-lessons-learned.

[57] Gary Clyde Hufbauer, "How Effective are Sanctions Against Russia?," Peterson Institute for International Economics, March 16, 2022, available at https://www.piie.com/blogs/realtime-economic-issues-watch/how-effective-are-sanctions-against-russia.

[58] "Transcript: U.S. Treasury Secretary Janet Yellen on the Next Steps for Russia Sanctions . . . ," Atlantic Council, April 13, 2022, available at https://www.atlanticcouncil.org/news/transcripts/transcript-us-treasury-secretary-janet-yellen-on-the-next-steps-for-russia-sanctions-and-friend-shoring-supply-chains.

[59] *Id.*

Wall Street Journal, then-White House Press Secretary Jen Psaki declined to say whether the United States planned to impose secondary sanctions against China or other countries that fail to comply with the Biden Administration's restrictions against Russia.[60] However, it seems that the United States would be very likely to impose such sanctions if China openly supplies weapons to Russia in direct contravention of U.S. sanctions.

Access to U.S. Dollar Clearing Market

As noted above, access to the U.S. dollar clearing market has been an important motivating factor for Chinese commercial banks (like other FBOs) to establish branches in the United States. Establishment of a branch is a prerequisite for filing the operating circular documentation required by the FRB to participate directly in such activities. Dollar clearing activities constitute a major business line for each of the U.S. branches of Chinese commercial banks. The threat of sanctions that might be applied to prevent these banks from accessing the U.S. dollar clearing system is often cited as a factor influencing Chinese determination to promote the internationalization of the renminbi and encouraging the development of CIPS as a payment system for renminbi settlements. If the renminbi were to become a viable alternative reserve currency, the threat of being denied access to U.S. dollar clearing might be less compelling.

While the renminbi still accounts for a very small percentage of international payments (less than two percent as of April 2019), the 2016 addition of the renminbi to the IMF's special drawing rights as well as the BRI initiative have presented significant opportunities for growth.[61] CIPS, launched in 2015, currently settles international claims in renminbi and has adopted the ISO 20022 (an emerging global benchmark) as its international payments messaging standard. These are important steps toward making the renminbi a viable alternative reserve currency. As of 2020, CIPS had about 1200 member institutions across 100 countries and payments made through CIPS were approximately RMB 45.2 trillion (USD$7.1 trillion).[62] Eventually, if confronted with an inhospitable regulatory environment in the United States,

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[60] Andrew Duehren, "Neutral Nations Face Isolation, Yellen Warns," Wall Street Journal, April 14, 2022, available at https://wsj.com/articles/yellen-warns-nations-staying-neutral-in-russias-war-with-ukraine-11649879113.

[61] Beyond Borders: China Opens Up to the World, SWIFT, RMB Tracker, Special Edition, June 2019, available at https://www.swift.com/swift-resource/227391/download?language=en.

[62] H. Lockett and T. Kinder, "How the Ukraine War Could Boost China's Global Finance Ambitions," Financial Times, March 7, 2020, available at https://www.ft.com/content/d5346dcd-d23c-4f82-abc9-e29dc53a0fb5?desktop.

Chinese policy makers might decide that it is in China's interest for Chinese commercial banks to disengage from the U.S. financial markets and promote the use of the renminbi as a reserve currency rather than to be a direct participant in the U.S. dollar clearing system.

The Ukraine war seems to be accelerating "de-dollarization" and the development of CIPS. As noted in one recent study, "Beijing is poised to dramatically accelerate efforts aimed at building out China-led, renminbi-denominated payments channels . . . that are largely impervious to U.S. sanctions and less reliant on SWIFT."[63] The study further noted that communication lines to circumvent SWIFT and support renminbi payments are also likely already in place between Russian banks and Chinese financial institutions. In addition, Russian firms with accounts at Chinese commercial banks can send and receive renminbi-denominated funds to other entities that have accounts with Chinese commercial banks.[64] Nevertheless, a comprehensive regime of secondary sanctions that attempts to disconnect Chinese entities that conduct business with sanctioned Russian entities from SWIFT would have significant adverse consequences for China. CIPS and other alternatives are not yet prepared to overcome the challenge of such measures.

The Impact of State Ownership and the Role of the CCP

U.S. bank regulatory policy has not addressed explicitly and fully the impact of state ownership on Chinese commercial banks with U.S. operations and has failed to recognize publicly the influence of the CCP and Chinese regulatory entities such as the FSDC on day-to-day U.S. operations of the Chinese commercial banks. Rather, U.S. bank regulatory policy has generally focused on the formalities of share ownership of these banks by government entities such as Huijin and CIC and has treated the potential impact of state ownership and CCP influence as subtle issues to be addressed separately and confidentially in the context of particular facts and circumstances. There is little public discussion about the effects that state ownership might have on communications and reporting lines between the head office of such banks and U.S. branches and subsidiaries, staffing of such branches and subsidiaries, responsibilities of employees, strategic business objectives, overall U.S. expansion plans, and attitudes towards meeting U.S. regulatory requirements.

In fact, a deeper understanding of the reporting lines between branch, head office, the CCP and Chinese regulatory agencies and the influence of the CCP

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[63] Robert Greene, "How Sanctions on Russia Will Alter Global Payments Flows," Carnegie Endowment for International Peace, March 4, 2022, available at https://carnegieendowment.org/2022/03/04/how-sanctions-on-russia-will-alter-global-payments-flows-pub-86575.

[64] *Id.*

on Chinese commercial banks operating in the United States might helpfully inform U.S. policy positions. While generally, FBOs are expected to report on a regular basis to head office and home country regulators, the authority and influence of the Chinese leadership, expressed through entities such as the State Council, the FSDC, the PBOC and the CBIRC on day-to-day operations of U.S. branches exceeds the norm, especially when considered in conjunction with CCP influence.

The importance of the CCP and Chinese state in guiding company and bank decisions within China is well known and appears to be growing. As noted by China scholar Elizabeth Economy in a recent Foreign Affairs article, "Within China, Xi has . . . significantly enhanced the control of the CCP over the decision-making power of Chinese companies."[65]

As explained in another study, "The leading role of the [CCP] is enshrined in the Constitution and is very much evident across all sectors of the economy, especially banking."[66] To date, however, the lessons of these insights have not been applied to U.S. regulatory policies affecting the entry, oversight and expansion of the Chinese commercial banks. One reason for this might be that the influence of CCP committees is "widely discussed in Chinese writings and journalism . . . but rarely referred to in foreign language writings, journalism or offshore listing offering[s]."[67] Whatever the reasons for the divergence, the impact of the CCP on U.S. operations needs to be better understood.

As noted in a recent Staff Research Report issued by the U.S.-China Economic and Security Review Commission ("USCC"), "While Chinese banks appear similar to their U.S. counterparts, there is a key difference: they remain beholden to and supported by the state. This makes them operate in fundamentally different ways than U.S. banks. Despite four decades of promised liberalization, the Communist Party-State retains the ability to

[65] Elizabeth Economy, "Xi Jinping's New World Order: Can China Remake the International System?" Foreign Affairs, January/February 2022, available at https://www.foreignaffairs.com/print/node/1128147.

[66] Douglas J. Elliott and Kai Yan, "The Chinese Financial System: An Introduction and Overview," July 2013, published by John J. Thornton China Center at Brookings, at 2, available at https://www.brookings.edu/research/the-chinese-financial-system-an-introduction-and-overview.

[67] Nicholas Calcina Howson, "China's Restructured Commercial Banks: Nomenklatura Accountability Serving Corporate Governance Reform?" (2008), in Zhu Min, Cai Jinqing and Martha Avery, eds., China's Emerging Financial Markets: Challenges and Global Impact (2011), at 142–143, available at https://www.wiley.com/en-us/China%27s+Emerging+Financial+Markets%3A+Challenges+and+Global+Impact-p-9781118179024.

intervene decisively in the banking system to achieve desired outcomes."[68] While some analysts find the conclusions of USCC reports generally to be too strong, many China observers have commented on the "heavy hand" of state and CCP influence.

A 2012 Congressional Research Service study spoke directly about the implications of government ownership interests in Chinese commercial banks, and concluded that China's central government and the CCP have significant influence over the administration of these banks. For example, the board of directors and senior bank officers are generally directly appointed by the CCP Organization Department.[69] Other studies have noted that executives in the Chinese commercial banks have political ranks similar to local and central government officials and that political integrity is one of the most important factors considered in making appointments to executive positions.[70] Each Chinese commercial bank has a CCP committee which is consulted on all important decisions.

Moreover, "Under the leadership of . . . Xi Jinping, financial policymaking has become increasingly integrated and directly subordinated to the CCP."[71] The Chinese party-state organizational system provides a direct link between Xi Jinping and his close leadership team and U.S. operations of the Chinese commercial banks. While the PBOC is charged with developing bank regulatory policy, it is subordinate to the State Council, a fact which has been underscored by recent inspections of its operations. As part of the reinvigoration of the CCP's Central Commission for Discipline Inspection ("CCDI") as a tool to track and control perceived corruption and malfeasance, the CCDI has been charged with conducting inspections of the PBOC, CBIRC, CSRC, the Shanghai and Shenzhen stock exchanges, and the Chinese commercial banks.

According to an article in the People's Daily, Zhao Leji, a member of the Standing Committee of the Political Bureau of the CCP's Central Committee and head of the CCDI, said that the inspections would focus on checking for gaps in political awareness among the party leaders of the various entities to be inspected and on problems that hinder the high-quality development of the

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[68] V. Bisio, "China's Banking Sector Risks and Implications for the United States," USCC, Staff Research Report, May 27, 2020, at 3, available at https://uscc.gov/research/chinas-banking-sector-risks-and-implications-united-states.

[69] Michael F. Martin, "China's Banking System: Issues for Congress," Congressional Research Service ("CRS"), February 20, 2012, at 20, available at https://sgp.fas.org/crs/row/R42380.pdf.

[70] Elliott and Yan, *supra* note 66 at 11.

[71] Bisio, *supra* note 68 at 6.

financial industry.[72] According to the Xinhua news outlet, Zhao called for in-depth inspections to cover political deviation of CCP committees and called on the inspectors to follow strictly "the eight point code on improving Party and government conduct" and perform their duties in accordance with regulations, discipline and laws.[73]

As noted above, the State Council established the FSDC to co-ordinate across different state agencies and ensure alignment of monetary, fiscal and financial policy. FSDC members include representatives from the PBOC, CBIRC, China Securities Regulatory Commission ("CSRC"), National Development and Reform Commission (the "NDRC"), and the National Council for the Social Security Fund.[74] The FSDC is currently chaired by Vice Premier Liu He, Xi Jinping's top adviser on economic issues. Leading small groups, such as the Central Leading Small Group on Financial and Economic Affairs (chaired by Xi Jinping and managed by Liu He) also play an important role in developing policy and coordinating the implementation of policy initiatives. The CCP and Xi Jinping are ultimately in charge.

Speaking at the Tsinghua PBCSF Global Finance Forum in 2019, Guo Shuqing, Chairman of the CBIRC, acknowledged the important links between the CCP and Chinese commercial banks: "The core leading roles of the [CCP Central Committee] have been fully brought into play in the five large banks . . . while learning from international experience, China is capable of proactively exploring good corporate governance models with Chinese characteristics."[75] The description provided in a 2005 interview with Caixin by Li Lihui, then the President of BOC, of the function of CCP committees within Chinese commercial banks and other companies is also instructive:

> At present, some members of the board of directors, supervisory board and senior management are Party members. The Chairman [of the board] is the Party Committee Secretary, and [the] head of the Supervisory Board and the President are Vice-Secretaries of the Party Committee. The [Party] Committee is to monitor macro-policy, firm

[72] Business Times, "China Starts Inspection of Financial Regulators, State Banks," October 13, 2021, available at https://www.businesstimes.com.sg/banking-finance/china-starts-inspection-of-financial-regulators-state-banks.

[73] Xinhua, September 26, 2021, "China's Anti-Graft Chief Stresses Inspection of Financial Institutions," available at https://www.news.cn/english/2021-09/26/c_1310211078_2.htm.

[74] Bisio, *supra* note 68 at 6.

[75] Guo Shuqing, May 25, 2019, "Rejuvenation of China is Unstoppable," Speech at Tsinghua PBCSF Global Finance Forum, at 7, available at https://www.bis.org/review/r190627m.pdf.

> direction, Party structure, as well as the structure of the Party membership, and monitor coordination among different departments. In China, it is very important to employ the political power of the Communist Party. Management arrangements can solve a majority of the problems, but not all of them. For example, if asked how to develop political ideology work or how to increase employees' ethical standards, and so on—these issues must be studied by the Party Committee.[76]

Why does this matter? It matters because this is quite different from the more distanced approach characteristic of relations between the U.S. branch and home country regulators and head offices of most other state-owned FBOs with U.S. operations. Every important aspect of U.S operations of the Chinese commercial banks is conducted in accordance with head office guidance and practices that are mandated by the CCP. As explained in one study of the Chinese banking system, this can be a challenge because "head office cultures are entirely oriented toward the domestic market and operations in a market socialist economy."[77] Key branch officers usually have a CCP rank as well as a business title and are expected to fulfill the dual responsibilities implied thereby. One or more branch officers typically reports to head office on a detailed, frequent basis. Accounting practices are generally aligned with head office practices as well as U.S. requirements. While each branch has a U.S. business plan, it is also expected to meet the objectives of the CCP and to report on U.S. developments in a manner that will contribute to head office understanding. Head office approves all significant U.S. business transactions and sets business goals for each branch.

Commentary about the role of the CCP in global operations of non-bank state-owned enterprises ("SOEs") might aptly be applied to Chinese commercial banks as well: The CEO of every major SOE has a red phone in his office that solely remits calls from the CCP.[78] As noted in another study, "There is . . . a real possibility that Chinese SOEs operating abroad will face direct pressure from the [party] to carry out overseas operations in a manner that

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[76] Howson, *supra* note 67 at 142–143, cited in Patrick Griffin, "CFIUS in the Age of Chinese Investment," 85 Fordham L. Rev. 1757 (2017), at 1772, available at https://ir.lawnet.fordham.edu/flr/vol85/iss4/9.

[77] James Stent, China's Banking Transformation, *supra* note 14 at 329 (digital edition).

[78] Richard McGregor, The Party: The Secret World of China's Communist Rulers (2010), at 9 (digital edition) available at https://www.harpercollins.com/products/the-party-richard-mcgregor?variant=32207545958434.

benefits Chinese state interests—and harms those of other states, especially powerful rivals like the United States."[79]

While such CCP and head office influence may result in challenges for U.S. regulators, it also suggests a path to achieve more effective U.S. regulatory policies. A greater awareness of the dual obligations of key branch officers and employees may lead to a more thoughtful U.S. analysis at the stages of bank entry, expansion and enforcement. Understanding that Chinese commercial banks are effectively acting as agents of the Chinese state and CCP, it is appropriate for U.S. regulators to engage in policy discussions with them. For example, U.S. bank regulators might engage in discussions with U.S. branch managers on issues such as U.S. dollar clearing, use of SWIFT and Chinese plans to develop alternative payment systems that will support internationalization of the renminbi. The U.S. operations of Chinese commercial banks present one of the few opportunities for direct, ongoing interactions between Chinese enterprises and United States regulators that take place on U.S. territory. An open dialogue between branch officers and U.S. regulators provides an opportunity for the direct, frequent communication that is increasingly difficult to replicate as China and the United States pursue divergent strategies.

Consequences of Failure to Analyze State Ownership and CCP Influence

Continued emphasis on strong enforcement actions and sanctions, which may frustrate branch management because they do not include suggestions for resolution of issues and fail to address underlying issues relating to state ownership and CCP influence, may encourage the disengagement of Chinese commercial banks from U.S. financial markets and exacerbate economic and political tensions between the United States and China. The failure to incorporate a thorough analysis of state ownership issues including CCP influence means that U.S. policies are ill-equipped to support the continued successful operation of Chinese commercial banks in a manner that is consistent with specific policy objectives such as supporting the U.S. dollar clearing system, maintaining the U.S. dollar's strength as the pre-eminent reserve currency, encouraging the use of SWIFT, and fine-tuning subpoena and sanctions regimes. It also means that the broader objective of managing financial competition with China on terms favorable to U.S. interests and values may not be met.

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[79] Griffin, *supra* note 76 at 1774; *see also* Ming Du, "When China's National Companies Go Global: Nothing to Fear but Fear Itself?," 6 J. World Trade 1127, at 1154 (December 2014), https://www.researchgate.net/publication/279320557_When_China's_National_Champions_Go_Global_Nothing_to_Fear_but_Fear_Itself.

A more effective policy might include a specific public acknowledgement that issues relating to state ownership and CCP influence are to be discussed by U.S. regulators in connection with the entry, expansion and ongoing supervision of the U.S. business operations of Chinese commercial banks. In addition to better supervisory outcomes, such an approach might reduce the need to rely on sanctions, subpoenas, penalties and enforcement actions.

Additionally, a more realistic approach to the entry, expansion and oversight of Chinese commercial banks, premised on a paradigm of national treatment that incorporates an open discussion of state ownership and CCP influence, might also serve a broader purpose of furthering communication and discussion between China and the United States on strategic economic and financial issues in a manner that would facilitate discovery of complementary objectives and interests and more effective management of strategic competition.

As discussed below, the flip side of Chinese investment in U.S. operations is U.S. investment in financial institutions operating within China. A better understanding of the role played by the Chinese state and CCP in managing the domestic and international operations of Chinese commercial banks might also have the beneficial spillover effect of tempering U.S. investor enthusiasm for investments in China with a more measured view of the political and economic risk that accompanies such investments. To date, U.S. investors have not focused sufficiently on the role of the CCP and Chinese regulatory agencies in encouraging or discouraging U.S. financial investments in China. Careful analysis of Chinese regulatory objectives might lead to a better understanding of the potential political and economic risks confronting U.S. entities with operations in China and U.S. portfolio investors in equity securities issued by Chinese companies. Recently, firms such as JPMorgan Chase, Morgan Stanley, Goldman Sachs and BlackRock have increased their investment in operations within China. Such investments are not immune to the political risk of abrupt Chinese regulatory measures. While the U.S. government traditionally has not commented on foreign investments by private companies or individuals, it may be appropriate to reevaluate that position in light of the systemic risks to U.S. and global markets that could accrue from abrupt adverse policy decisions of the Chinese leadership and the CCP.

CHINESE NBFIs IN THE UNITED STATES

The Case of Ant Financial

The entry and expansion in the United States of Ant Financial has to date followed a path distinct from that of Chinese commercial banks. Ant Financial's subsidiary, Alipay US, Inc. ("Alipay") was incorporated in Delaware in 2010 and has applied for money transmitter licenses from state regulators and has not

pursued a commercial banking presence or license. Initially, such a strategy represented "Plan B" because the preferred "Plan A" of acquiring an existing licensed money transmitter would have enabled Alipay to avoid the time-consuming and burdensome process of filing state-by-state applications for money transmitter licenses.

Alipay's U.S. strategy has been deeply affected not only by the regulatory burden of obtaining state-by-state money transmitter licenses and/or exemptions, but also by the U.S. regulatory actions described below. As of early 2016, Alipay U.S. was expected to expand use of the mobile phone apps developed by its affiliate, Alipay China, to facilitate business between Chinese merchants seeking to access U.S. customers and U.S. merchants wishing to reach out to international customers, including those in China. Subsequently, actions by CFIUS prevented this plan from being fully implemented.

In January 2018, Ant Financial was forced to terminate its plan to acquire a U.S.-based global money transfer company, MoneyGram International, Inc. ("MoneyGram"), after the proposed acquisition was rejected by CFIUS over national security concerns related to the possibility that the Chinese government, which held a 15 percent stake in Ant Financial, could access personal information (including financial data) about U.S. citizens and, in addition, possibly use such information to target anti-Chinese government activists and journalists.[80] Such concerns apparently prevailed despite Ant Financial's assurances that U.S. national security interests would be protected because servers storing the relevant information would continue to be maintained in the United States where they could be monitored by U.S. regulators.

The CFIUS action was somewhat surprising for two reasons.

First, Ant Financial had previously been permitted by CFIUS to acquire EyeVerify, a biometric security technology company. MoneyGram's SEC filing on Schedule 14A (May 8, 2017) included a statement that, "Ant Financial successfully completed a review by CFIUS last year when it purchased Kansas City-based EyeVerify."[81]

Second, MoneyGram was engaged in a global money transfer business that did not seem to be especially sensitive from a national security perspective.

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[80] *See, e.g.,* Bret McLannahan, "US Doubts on China Investments Sink Ant Financial-MoneyGram Deal," Financial Times (January 2, 2018), available at https://www.ft.com/content/b893d7e0-f012-11e7-b220-857e26d1aca4; *see also* Davis Polk Client Memorandum, January 16, 2018, "Trends and Updates in the CFIUS Space," at 1, available at https://www.davispolk.com/sites/default/files/2018-01-16_trends_updates_in_the_cfius_space.pdf.

[81] SEC filing available at https://www.sec.gov/Archives/edgar/data/1273931/000119312517168485/d396891ddfan14a.htm.

In addition, CFIUS involvement in Chinese NBFI investments in the United States raises an intriguing question. While Chinese commercial banks present the same types of national security and data privacy issues as NBFIs, to date the FRB (and relevant state regulators or the OCC) are charged with approving FBO branch entry and CFIUS has not been publicly involved. Should it be?

National Treatment and General Principles of Open Investment

Interestingly, the CFIUS treatment of Ant Financial in the MoneyGram case provides evidence of intense U.S. review of possible government involvement (though not specifically CCP involvement) as part of a review premised on national treatment. In the context of nonbanking activities, national treatment has long been described in terms of open investment. For example, at the conclusion of a U.S.-China Strategic and Economic Dialogue in 2014, a joint U.S.-China statement indicated that, "The U.S. side welcomes Chinese enterprises' investment in the United States and commits to maintain an open investment environment for various kinds of Chinese investors."[82]

Increasingly, CFIUS has focused less on principles of open investment and more on national security concerns. Further, while previously, despite the fact that it had the authority to review non-reported transactions, CFIUS generally reviewed only transactions that were voluntarily submitted for scrutiny, it became more assertive under the Obama Administration. This trend has continued under the Trump and Biden Administrations.[83] Although it still emphasizes an open investment environment based on general principles of fair treatment, CFIUS has applied intense scrutiny to Chinese investors over the past decade.

In the recent past, CFIUS has been particularly concerned about the link between national security and data privacy and has imposed new requirements for foreign investment if there are national security risks linked to sensitive personal data.[84] Among other changes, the final rules authorize CFIUS to

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[82] Press Release, U.S. Department of State, Joint U.S.-China Press Statements at the Conclusion of the Strategic and Economic Dialogue (July 10, 2014), available at https://2009-2017.state.gov/secretary/remarks/2014/07/228999.htm.

[83] *See* Alex Leary and Katy Stech Ferek, "Biden Builds on Trump's Use of Investment Review Panel to Take on China," Wall Street Journal, July 7, 2021, available at https://www.wsj.com/articles/investment-review-panel-gets-wider-role-under-biden-in-rivalry-with-china-11625650200.

[84] *See, e.g.,* the final rules issued by the Office of Investment Security, Department of the Treasury, to implement certain provisions of the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA"); at 85 Federal Register 3112 (January 17, 2020), available at

review certain foreign investments in U.S. businesses that maintain or collect, directly or indirectly, "sensitive personal data" of U.S. citizens. The final rules implement the changes made by the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA") to CFIUS's jurisdiction and processes with respect to foreign transactions that could result in foreign control of any U.S. business as well as certain non-controlling "covered investments" that afford a foreign person certain access rights or involvement in certain types of U.S. businesses.[85]

Regulatory Issues

Ant Financial and its holding company, Ant Group, have also faced pushback of a different kind in China. On November 2, 2020, Jack Ma and other senior management officials were summoned for meetings with China's top financial regulatory authorities just before a planned dual listing of Ant Group's shares in Shanghai and Hong Kong. The summons came just after Jack Ma's controversial remarks regarding traditional banks and innovation at the Bund Summit in Shanghai in late October 2020. Ma had argued in his October 24, 2020 speech that China needed "more regulators who are experts in policies rather than experts in documents" and had also commented that, "China's contemporary banks are simply a continuation of an outdated pawnshop mentality."[86]

As described by China's Global Times, the regulators present at the November 2020 meetings (including the PBOC, the CSRC and the State Administration of Foreign Exchange ("SAFE")) cited Ant Financial for poor governance mechanisms, weak legal awareness, defiance of regulatory and compliance requirements, and illegal regulatory arbitrage.[87] In related statements, President Xi Jinping urged financial regulators to "dare to" master their supervisory role.[88] At about the same time, various Chinese regulators

https://www.federalregister.gov/documents/2020/01/17/2020-00188/provisions-pertaining-to-certain-investments-in-the-united-states-by-foreign-persons and 85 Federal Register 57124 (September 15, 2020) available at https://www.federalregister.gov/documents/2020/09/15/2020-18454/provisions-pertaining-to-certain-investments-in-the-united-states-by-foreign-persons.

[85] *Id.*

[86] CSIS Blog, "Calculated Consequences: The Case of Alibaba," May 12, 2021, available at https://www.csis.org/blogs/new-perpsectives-asia/calculated-consequences-case-alibaba.

[87] "Ant to Embrace Makeover for New Starting Point," Global Times, December 27, 2020, available at https://www.globaltimes.cn/page/202012/1211099.shtml.

[88] According to commentary by an official at the CBIRC published on November 20, 2020 in the People's Daily, and cited in Bloomberg, Business Week, January 25, 2021, at 60–61, available at https://www.bloomberg.com/news/articles/2021-01-21/china-tightens-grip-on-fintech-after-jack-ma-s-ant-crackdown.

announced regulatory measures directed at Ant Financial, including the suspension of Ant Financial's initial public offering on the Shanghai and Hong Kong exchanges.

In April 2021, officers of Ant Group were summoned to a second meeting with Chinese financial regulators. According to a statement published by the PBOC, Ant Group would be required to transition its structure to a financial holding company to be supervised by the PBOC with the objective of overhauling its business operations and improving risk management. It was also required to remove the links between its payment business and consumer lending business, break its data monopoly and ensure personal and national information security.[89] A record-breaking fine of 18.228 billion yuan (approximately USD$2.78 billion), which represents about four percent of Alibaba Group's China-generated revenue for 2019, was imposed on Alibaba Group (a component of Ant Group) for "abusing its dominance" in China's retail platform services market since 2015.[90] As of June 2021, it was also reported that Ant Group was in talks with Chinese state-owned enterprises to create a credit-scoring company that would place consumer data under the purview of Chinese regulators.[91]

While the travails of Ant Financial in both the United States and China may present a special case, there are indications that greater CFIUS scrutiny and a less welcoming political environment have served to suppress direct Chinese investment in the United States in recent years. One major study indicates that Chinese investment in the United States was modest before 2010, usually below $1 billion annually, except in 2005 when Lenovo acquired IBM's personal computer division for $1.75 billion.[92] Chinese investment in the United States reached a peak of $45 billion in 2016, but then declined to $29 billion in 2017 and $5.4 billion in 2018. It was even less in 2019, when most of the investment was concentrated in non-financial sectors such as consumer products and services, automotive, real estate and hospitality. Restrictions imposed by the

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[89] Jing Yang, "Jack Ma's Ant Group Bows to Beijing with Company Overhaul," Wall Street Journal, April 12, 2021, available at https://www.wsj.com/articles/ant-group-to-become-a-financial-holding-company-overseen-by-central-bank-11618223482.

[90] "Alibaba was Fined 18.228 Billion Yuan for Monopoly," Lexology, April 14, 2021, available at https://lexology.com/library/detail.aspx?g=1e283485-c83a-48a6-a976-9d9f2382535a.

[91] Jing Yang and Xie Yu, "Jack Ma's Ant in Talks to Share Data Trove with State Firms," Wall Street Journal, June 23, 2021, available at https://www.wsj.com/articles/jack-mas-ant-in-talks-to-share-data-trove-with-state-firms-11624442902.

[92] Thilo Hanemann, Daniel H. Rosen, Cassie Gao and Adam Lysenko, "Two-Way Street: 2020 Update, U.S. China Investment Trends," May 11, 2020, Rhodium Group, at 18, available at https://www.rhg.com/research/two-way-street-us-china-investment-trends-2020-update/.

Chinese government, regulatory pushback from U.S. agencies including CFIUS and the pandemic accelerated the decline in 2020.[93]

Some Policy Lessons

As recent events have underscored, while Ant Financial is ostensibly a private company, it continues to be subject to Chinese state and CCP oversight. Nonetheless, at least until recently, its day-to-day activities seem to have been less closely monitored than is the case for Chinese commercial banks. Still, even before the recent crackdown, Chinese regulators expressed concerns about the data security and privacy issues presented by Ant Financial and other fintech companies and were known to intervene in Alipay's U.S. operations when AML issues involving offshore data were presented.

In any event, Ant Financial and Alipay present challenges to U.S. policymakers that are distinct from those presented by the Chinese commercial banks. Alipay has state regulators in the United States, but because it is not a "bank" as defined by U.S. laws and regulations such as the BHCA, it is not subject to the supervision of the FRB. For state regulators, the biggest challenge appears to be understanding the potential for AML violations and the extent to which Chinese regulators might make demands on Alipay and similar private payment platforms that are contrary to U.S. AML, privacy and data security laws and regulations. Recently, press reports have cited a heightened focus on compliance with Chinese data security and privacy laws, but the more difficult challenge for the longer term may be to strike a workable balance between conflicting demands of Chinese and U.S. AML, data security and privacy requirements.[94]

U.S. INVESTMENTS IN CHINESE MARKETS

Opening Up Chinese Markets

China remained largely closed to U.S. direct investment until the 1980s. Such investment generally amounted to less than $1 billion per year but grew to several billion dollars per year in the 1990s and early 2000s, with strong growth developing after China's accession to the WTO in 2001. By 2008, U.S. direct investment reached a high point of $20 billion, then dropped sharply during and after the 2009 global financial crisis, only to reach $13 to $16 billion per year before the pandemic resulted in another decline. U.S. direct

[93] *Id.* at 19–23.

[94] *See, e.g.,* "China's Communist Authorities are Tightening Their Grip on the Private Sector," The Economist, November 20, 2021, https://www.economist.com/business/chinas-communist-authorities-reinvent-state-capitalism/21806311.

investment in China was $8.7 billion in 2020.[95] Recent trends, however, suggest that China welcomes certain types of direct investment and participation by U.S. and other foreign investors in its capital markets. According to figures cited in China Daily, in 2020, China's total inbound foreign direct investment ("FDI") grew by more than 10 percent, to $212 billion, putting its share of global FDI at an all-time high of 25 percent, almost twice its share in 2019.[96]

Asset Management Business

Until recently, only a small fraction of total U.S. direct investment in China was related to the asset management or other financial services businesses. Regulatory changes that commenced in 2018 and are ongoing have dramatically increased opportunities for U.S. (and other foreign) investment. Guo Shuqing, Chairman of the CBIRC, noted in a keynote address to the Financial Street Forum on October 21, 2020, that "Since the 19th CCP National Congress, under the strong leadership of the CCP Central Committee and the direct guidance of the FSDC of the State Council, more than 50 opening-up measures have been introduced in the financial sector, including significantly easing foreign equity restrictions, expanding business scope, and exploring new areas for cooperation between Chinese and foreign financial markets."[97] Notably, in the same address, Guo Shuqing stated that, "Facing the profound changes in our internal and external environments, China's financial sector has unswervingly followed the guidance of Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era. . . ."[98] In sum, the message seems to be that U.S. participation in China's financial markets is to be welcomed as long as such participation is consistent with the interests of the Chinese state and the CCP.

The "opening up" of the asset management business has been carefully managed by the Chinese state and the CCP. The primary regulators for the asset management business include the FSDC, the PBOC, the CBIRC and the

[95] Thilo Hanemann, Daniel H. Rosen, Mark Witzke, Steve Bennion and Emma Smith, The Rhodium Group and the National Committee on U.S.-China Relations, "Two-Way Street: 2021 Update US-China Investment Trends," May 19, 2021, at 13, https://www.rhg.com/research/twowaystreet-2021/.

[96] Yu Yongding, "Beware Decoupling Becoming Self-Fulfilling Prophecy," China Daily, December 16, 2021, available at https://global.chinadaily.com.cn/a/202112/16/WS61ba8357a310cdd39bc7b9ba.html.

[97] Keynote speech, Guo Shuqing, Financial Street Forum 2020, October 27, 2020, available at https://bis.org/review/r201223b.htm.

[98] *Id.*

CSRC. MOFCOM and the State Administration of Foreign Exchange ("SAFE") also have jurisdiction when cross-border investment is involved.[99] Formerly, foreign asset managers were only allowed to sell investment products in China to a limited group of qualified investors such as institutions and wealthy individuals. In recent years, the CBIRC and the CSRC have removed restrictions on foreign shareholding percentages for banks, life insurance companies, securities firms, and fund managers, among other institutions, and generally expanded the types of entities open to cross-border investment.

The FSDC has assumed a leading role in liberalizing access to the asset management business. On July 15, 2017, when Xi Jinping ordered the establishment of the FSDC, he charged it with the broad task of tackling financial risk. The FSDC was officially established on November 18, 2017, and shortly thereafter introduced asset management product rules. Final implementing rules were issued jointly by the PBOC, CBIRC and CSRC on July 20, 2018.[100]

On July 20, 2019, the FSDC issued the Relevant Measures on Further Opening Up of the Financial Industry, which advanced from 2021 to 2020 the lifting of restrictions on foreign shareholding percentages in securities firms and fund managers, among other entities. On October 11, 2019, the CSRC announced that, as of April 1, 2020, restrictions on foreign shareholding percentages for fund managers would be lifted and that, as of December 1, 2020, restrictions on foreign shareholdings of securities firms would be lifted. Subsequently, the date for lifting the limits on foreign shareholdings for securities firms was advanced to April 1, 2020.[101]

U.S. asset managers have been quick to take advantage of the current favorable regulatory environment in China. On August 21, 2020, the CSRC approved the establishment in Shanghai of BlackRock Fund Management Co., Ltd ("BlackRock Fund Management"), making it the first wholly foreign-

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[99] Huaying Qi and Lin Zhou, Han Kun Law Offices, The Asset Management Review: China, September 27, 2021, available at https://www.thelawreviews.co.uk/title/the-asset-management-review/china.

[100] *See* timeline set forth in J. P. Morgan Asset Management, Building Stronger Liquidity Strategies: The Impact of China's Comprehensive 2018 Regulation of Asset Management Products, available at https://www.am.jpmorgan.com/content/dam/jpm-am-aem/global/en/liq/insights/liquidity-insights/The-Impact-of-Chinas-Regulations.pdf.

[101] Xinhua, "China Unveils New Financial Opening Up Measures," July 21, 2019, available at http://www.chinadailyhk.com/articles/224/31/246/1563691147521.html; "China Announces Timetable for Full Financial Sector Opening in 2020," Reuters, October 11, 2019, available at https://www.reuters.com/article/us-china-finance-opening-idUKKBN1WQ0zz.

owned public asset management entity in China.[102] In addition to BlackRock Fund Management, BlackRock has a 50.1 percent interest in a joint venture with CCB and Temasek (Singapore sovereign wealth fund).[103] Goldman Sachs, JPMorgan Chase and Morgan Stanley have also taken advantage of the new regulations. In April 2020, JPMorgan Chase agreed to take full ownership of its joint venture with Shanghai International Trust Co. In May 2021, Goldman Sachs announced a partnership with ICBC which utilizes ICBC's extensive domestic networks to distribute investment products. Like Goldman, JPMorgan has a stake in the wealth management subsidiary of a domestic Chinese bank (in JPMorgan's case, CMB) that should facilitate access to an affiliated bank's customers.[104] Similarly, in May 2021, Morgan Stanley announced plans to take full ownership of its China-based securities and mutual funds joint ventures.[105]

The Ukraine war may temper some of the U.S. enthusiasm for further direct investments in China. In his annual letter to shareholders in March 2022, BlackRock CEO Larry Fink stated that, "[T]he Russian invasion of Ukraine has put an end to the globalization we have experienced over the last three decades."[106] Other observers have stated the consequences of the Ukraine war in starker terms: "Globalization was once sold as a barrier to conflict, a web of dependencies that would bring former foes ever closer together. Instead, it has become a new battleground."[107]

Investments in Chinese Capital Markets

In addition to direct investment by prominent U.S. financial firms in China-based asset managers and other financial services firms, individual U.S.

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[102] "BlackRock gets regulators' approval to set up China mutual fund unit," Reuters, August 28, 2020, available at https://reuters.com/article/us-china-fund-blackrock/blackrock-gets-regulators-approval-to-set-up-china-mutual-fund-unit-idUSKBN25P06E.

[103] Aaron Back and Telis Demos, "American Banks Have What They Want in China," Wall Street Journal, October 29, 2021, available at https://wsj.com/articles/american-banks-have-what-they-want-in-china-their-fate-is-still-out-of-their-hands-11635499841.

[104] *Id.*

[105] "Morgan Stanley Nears Full Ownership of China Ventures with Stake Buys," Reuters, May 28, 2021, available at https://reuters.com/business/finance/morgan-stanley-nears-full-ownership-china-ventures-with-stake-buys-2021-05-28/.

[106] Larry Fink, 2022 BlackRock Chairman's Letter to Shareholders, March 24, 2022, available at https://www.blackrock.com/corporate/investor-relations/larry-fink-chairmans-letter.

[107] Valentina Pop, Sam Fleming and James Politi, "Weaponization of Finance: How the West Unleashed 'Shock and Awe' on Russia," The Financial Post, April 11, 2022, available at https://financialpost.com/fp-finance/weaponization-of-finance-how-the-west-unleashed-shock-and-awe-on-russia.

portfolio investors have increasingly become investors in China's equity markets. According to China scholar Nicholas Lardy, as of 2020, U.S. investors held well over USD$1 trillion in Chinese bonds and equities, up from USD$240 billion in 2007.[108] As Lardy noted subsequently, "Despite economic and financial tensions and a plethora of foreign restrictions on the transfer of technology to China, China continues to attract record amounts both of foreign direct investment and inflows of portfolio investment into listed onshore Chinese equities and Chinese government bonds."[109]

The 2021 USCC Report notes that U.S. holdings of Chinese equity and debt securities increased by 57.5 percent between 2017 and 2020, from $765 billion to $1.2 trillion.[110] In addition, U.S. mutual funds and ETFs have increasingly included Chinese securities among their holdings. For example, the MSCI, a major global index fund provider, had a 37 percent weighting in Chinese securities in 2020.[111] Interestingly, the investment figures noted above indicate a highly asymmetric relationship between U.S. portfolio investment in China and similar Chinese investment in U.S. securities. Some observers attribute this asymmetry to technology transfer restrictions the United States has imposed on China as well as China's tightened controls over certain kinds of outbound investments.[112]

VIE Issues. Many of the U.S. investments in securities are in fact made in entities using a so-called "variable interest entity" ("VIE") structure. A recent Congressional Research Service report (the "CRS Report") estimates that two-thirds of all Chinese firms listed in the United States, including such

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[108] Nicholas R. Lardy, "Memo to the Biden Administration on How to Advance Economic Talks with China," Peterson Institute for International Economics, October 20, 2020, available at https://www.piie.com/blogs/china-economic-watch/memo-biden-administration-how-advance-economic-talks-china.

[109] Nicholas R. Lardy, "Foreign Investments into China are accelerating despite global economic tensions and restrictions," Peterson Institute of International Economics, July 22, 2021, available at https://www.piie.com/blogs/china-economic-watch/foreign-investments-in-china-are-accelerating-despite-global-economic.

[110] 2021 USCC Report, *supra* note 3 at 243, citing figures provided by the Rhodium Group, Adam Lysenko et al., "U.S.-China Financial Investment: Current Scope and Future Potential," Rhodium Group, January 2021, available at https://rhg.com/research/us-china-financial/, at 12.

[111] Steven Schoenfeld, Americans are Investing More in China—and They Don't Even Know It, Foreign Policy, January 14, 2020, available at https://www.foreignpolicy.com/2020/01/14/americans-investment-china-emerging-markets-united-states-trade-war.

[112] Huang Tianlei, "Financial Decoupling Farfetched," China Daily Global, December 2, 2021, available at https://www.chinadaily.com.cn/a/202112/02/WS61a80ba9a310cdd39bc78c74.html.

well-known firms as Alibaba, Baidu and Tencent, use the VIE structure. The CRS Report states that there were approximately 248 VIE companies listed on U.S. exchanges as of May 2021. As more fully described in the CRS Report, a VIE structure involves the owners of a Chinese firm creating an offshore holding company (often located in the Cayman Islands) in which foreign investors can purchase an equity interest. The holding company is linked indirectly to the Chinese operating company through a series of contracts and revenue sharing agreements, but there is no specific ownership interest in the Chinese firm. For this reason, VIE arrangements do not provide investors with the type of ownership interest typically associated with purchases of shares of a U.S. company.[113]

Several studies of VIE arrangements have noted that their enforceability in China is uncertain.[114] While a draft proposal issued by the State Council in 2015 would have "legalized" certain types of VIEs, revised investment rules proposed in 2018 omitted the relevant provisions.[115] A further issue is that, even if China deems a VIE arrangement to be legal, Chinese tax rules could possibly be interpreted to subject payments to the listed entity to be subject to various taxes that would reduce the value of such payments by up to 50 percent.[116]

Since mid-2021, the SEC's Division of Corporation Finance ("CorpFin") has been issuing comments to China-based companies listed on U.S. exchanges that request more specific and prominent disclosure in order to highlight risks relating to VIE-linked investments. On July 30, 2021 Chair Gary Gensler issued a "Statement on Investor Protection Related to Recent Developments in China."[117] On December 20, 2021, CorpFin posted a sample letter to China-based companies that may be using the VIE structure that cited the need for clear and prominent disclosure regarding the structure of the company,

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[113] Michael D. Sutherland, CRS Report, "U.S. Capital Markets and China: Issues for Congress," Updated September 2, 2021, at 1, available at https://crsreports.congress.gov/product/pdf/IF/IF11803.

[114] *See, e.g.,* Li Guo, "Chinese Style VIEs: Continuing to Sneak Under Smog?" 47 Cornell International Law Journal 569 (2014), available at https://scholarship.law.cornell.edu/cilj/vol47/iss3/3; *see also* Jesse M. Fried and Ehud Kamar, "Alibaba: A Case Study of Synthetic Control," ECGI Working Paper Series in Law, Working Paper No. 523/2020, July 2020, at 15–16.

[115] *Id.*; *see also* Paul Gillis and Fredrik Oqvist, "Variable Interest Entities in China," GMT Research, Guest Series, March 13, 2019, at 1–2, available at https://www.chinaaccountingblog.com/weblog/2019-03-vie-gillis.pdf.

[116] Fried and Kumar, *supra* note 114 at 16, footnote 87.

[117] Chair Gensler, "Statement on Investor Protection Related to Recent Developments in China," available at https://sec.gov/news/public-statement/gensler-2021-07-30.

"including the relationship between the entity conducting the offering and the entities conducting the operating activities, risks associated with a company's use of the VIE structure, and the potential impact on the company's operations and investors' interests if such structure were disallowed or the contracts were determined to be unenforceable."[118]

Reflecting the SEC's concern about the legal enforceability of VIEs, a number of fund managers have issued supplementary statements to Chinese risk factor sections in relevant fund prospectuses. One example is a supplement dated August 31, 2021 to the institutional class prospectus of a group of Asia funds. Noting that certain of the funds invest a substantial portion of their assets through VIEs, the supplement acknowledged that VIEs are not formally recognized under Chinese law and also stated that under extreme circumstances, China might prohibit the existence of VIEs, in which case the market value of the Funds' portfolio holdings would likely decrease and substantial investment losses could result.[119]

HFCAA Issues. The SEC has also been active on the closely-related issue of audits of China-based firms listed in the United States. The HFCAA was enacted in 2020 in response to the difficulties faced by the Public Company Accounting Oversight Board (the "PCAOB") when it sought to inspect the audits of China-based U.S.-listed firms. Implementation of the HFCAA could result in the delisting of certain China-based companies by 2024.

On December 2, 2021, in a statement on the SEC's adoption of final amendments to the rules implementing HFCAA, Chair Gensler noted that the HFCAA mandated that, if governmental authorities (such as relevant agencies in China) do not allow auditors of foreign (e.g., Chinese) companies to open their work papers to PCAOB inspection for three consecutive years, the securities of companies audited by those firms could be prohibited from trading in the United States.[120]

In early March 2022, five Chinese companies with U.S.-listed ADRs (Yum China, Bei Gene, Zai Lab, ACM Research and HUTCHMED) were cited by the SEC for failing to adhere to the HFCAA when they filed their annual

[118] Sample Letter to China-Based Companies, available at https://sec.gov/corpfin/sample-letter-china-based-companies.

[119] Supplement, dated August 31, 2021, to the Institutional Class Prospectus of Matthews Asia Funds dated April 30, 2021.

[120] Statement by Chair Gensler on Holding Foreign Companies Accountable Act, available at https://sec.gov/news/statement/gensler-statement-hfcaa-120221.

reports with the SEC. None of these companies had complied with the audit rules implemented pursuant to the HFCAA and therefore could be delisted in the United States by 2024.[121]

Chinese Response to VIE and HFCAA Issues. Because substantially all Chinese companies with U.S.-listed ADRs would be forced to delist if they cannot comply with HFCAA audit requirements, it is not surprising that companies such as Alibaba, Baidu, Bilibili, Trip.com, Weibo and NIO have already been dual listed in Hong Kong as well as in the United States. Chinese regulators have also been concerned about compliance with the HFCAA audit rules.

In early December 2021, certain news outlets reported that the Chinese authorities were apparently planning to prohibit companies from listing their shares on foreign stock exchanges using the VIE structure and were also discussing possible actions in response to the HFCAA, perhaps even encouraging delisting rather than following the audit requirements of the HFCAA.[122] The CSRC promptly responded to refute the claims of these news outlets. A CSRC spokesperson had the following comment:

> We have taken notice of this recent development and the market's concerns over the audit oversight issues and the prospect of domestic companies delisting in the United States. The CSRC and relevant Chinese regulatory authorities have always been open to and fully respect Chinese companies' independent choices of overseas listing venues in compliance with relevant laws and regulations. Recently, some overseas media reported that Chinese regulators will ban overseas listing of companies with [the] VIE structure and demand Chinese companies to delist from U.S. stock exchanges, which is a complete misunderstanding and misinterpretation.[123]

On December 23, 2021, the CSRC issued the Provisions of the State Council on the Administration of Overseas Securities Offering and Listing by Domestic Companies (Draft for Comments) (the "Administration Provisions") and the Administration Measures for the Filing of Overseas Securities Offering

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[121] Robert Pisani, "Chinese Stocks are Down Sharply on Thursday. Here's What Could Be Behind the Decline." CNBC News, March 10, 2022, available at https://cnbc.com/2022/03/10/these-chinese-stocks-are-down-sharply-on-thursday-heres-what-could-be-behind-the-decline.html.

[122] Robyn Mak, "China's VIE Problem is Resolving Itself," Reuters, December 2, 2021, available at https://reuters.com/markets/asia/chinas-vie-problem-is-resolving-itself-2021-12-02/.

[123] State Council Information Office, "Chinese Regulators Respect Companies' Independent Choice of Overseas Listing Venues: Spokesperson," December 6, 2021, available at http://english.scio.gov.cn/pressroom/2021-12/06/content_77912630.htm.

and Listing by Domestic Companies (Draft for Comments) (referred to as the "Measures"). In a related document, relevant officials of the CSRC responded to questions and further affirmed support for continued discussions on audit issues and stated that, with respect to the VIE structure, "If complying with domestic laws and regulations, companies with the VIE structure are eligible to list overseas after filing with the CSRC."[124] At present, the outlook for resolution of VIE issues remains unclear.

However, actions taken by the CSRC on April 2, 2022 that would allow U.S. inspections of accounting papers indicate that some progress has been made on HFCAA issues. The CSRC agreed to delete a provision in Chinese securities regulations that had stipulated "on-site inspections will be dominated by domestic regulators or depend on the conclusion of inspections by domestic regulators."[125] However, it is not entirely clear how the information sharing made possible by this deletion will actually work on a practical level. The CSRC has proposed that a "cross-border regulatory cooperation mechanism" will conduct the inspections, but details have not been finalized.[126] As one observer concluded, "much still depends on whether U.S. regulators think they can gain adequate access under the new arrangements."[127]

The Potential Role of CFIUS and Similar Entities

A policy debate over a potential role for CFIUS or other similar entity in reviewing outbound U.S. investments into China has emerged in parallel with the growing interest of U.S. investors in Chinese securities and financial institutions. In 2018, Senators Cornyn (R-Texas) and Feinstein (D-California) and Congressman Pittenger (R-North Carolina) sponsored FIRRMA, bi-partisan legislation that was intended to revise and expand substantially the CFIUS review process. Among the changes included in FIRRMA as initially proposed was an extension of CFIUS review to cover certain outbound

[124] CSRC, "The CSRC Solicits Public Opinion on Rules Regarding Overseas Listings," December 23, 2021, available at https://www.csrc.gov.cn/csrc_en/c102030/c1662393/content.shtml; CSRC, Relevant Officials of the CSRC Answered Reporter Questions, December 23, 2021, available at https://www.csrc.gov.cn/csrc_en/c1020390/c1662398/content.shtml.

[125] "Double-Entry Book=Keeping: China's Regulators Warm to American Listings," The Economist, April 9, 2022, available at https://www.economist.com/business/2022/04/09/chinas-regulators-warm-to-american-listings.

[126] *Id.*

[127] Jacky Wong, "U.S.-Listed Chinese Firms Get a New Lease on Life—Maybe," Wall Street Journal, April 4, 2022, available at https://wsj.com/articles/u-s-listed-chinese-firms-get-a-new-lease-on-lifemaybe-11649073448.

transactions, including specified non-controlling investments involving critical technology companies.[128]

Subsequently, after pressure from certain U.S. companies with major business interests in China, CFIUS's jurisdiction under FIRRMA was limited to inbound transactions into the United States, and outbound controls and critical technology definitions were maintained (as in the past) at the Department of Commerce.[129] Ultimately, FIRRMA was paired with the Export Credit Reform Act of 2018 ("ECRA"), which provided broad legislative authority to the President to implement export controls on dual use goods, but did not extend CFIUS review to outbound transactions.[130]

More recently, Senators Robert Casey (D-Pennsylvania) and Cornyn co-authored the proposed National Critical Capabilities Defense Act of 2021 (the "NCCDA") which proposes a new interagency body, the Committee on National Critical Capabilities ("CNCC") to be chaired by the United States Trade Representative. The structure of the CNCC would be similar to CFIUS, with all CFIUS agencies represented in addition to the Departments of Agriculture and Labor and a number of ex officio members. Like CFIUS, the CNCC could review notified transactions and, if appropriate, submit a recommendation to the President to take action against the proposed transaction. CNCC would have authority to review outbound transactions that "shift investment, ownership or business activities" that relate to "national critical capabilities" into "countries of concern" or entities headquartered or listed in countries of concern. The legislation is drafted so that such countries and entities are limited to China and Russia or Chinese or Russian entities. Certain medical items, critical infrastructure inputs and military and intelligence items are identified as national critical capabilities. In contrast to CFIUS procedures, notification of covered transactions to the CNCC would be mandatory rather than mostly voluntary. The CNCC could block or modify a transaction based on a determination of "unacceptable risk to one or more national critical

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[128] Clifford Chance, "FIRRMA: Addressing the 'Weaponization' of Cross-Border Investment through CFIUS Reform," February 2018, available at https://www.cliffordchance.com/briefings/2018/02/firrma_addressingtheweaponizationo.html.

[129] David R. Hanke, Testimony before the USCC, Hearing on U.S.-China Relations in 2021: Emerging Risks Panel III: Assessing Export Controls and Foreign Investment Review, September 8, 2021, at 5, https://www.uscc.gov/sites/default/files/2021-08/David_Hanke_Testimony.pdf.

[130] Public Law 115-232–Title XVII, Subtitle B of which is the Export Control Reform Act of 2018 (ECRA), codified, as amended, at 50 U.S.C. Sections 4801–4852.

capabilities," which is broader than CFIUS's limitation to national security review.[131]

Various reports prepared by scholars at some U.S. think tanks have supported these attempts to create a "reverse CFIUS."[132] Other reports have noted signs of bipartisan support in Congress for review of outbound investment.[133] Both FIRRMA and the proposed NCCDA target transfers of critical technology and do not specifically address Chinese regulatory risks relating to the VIE structure or disclosure issues relating to the audit mandates of the HFCAA. They also do not address the possible risks to U.S. investors of Chinese measures to enhance controls over Chinese companies, including those in the financial sector.

Regulatory Changes Accompanying the Opening of Financial Markets

The 2021 USCC Report notes that, "while China's leadership claims that its economy is becoming more open, better regulated, and less dominated by the state, the opposite is true."[134] Despite the current welcome for U.S. asset managers and equity investments, there is countervailing evidence that various legal and administrative changes, together with the growing influence of the CCP, seem to be working together to increase government influence and CCP presence in Chinese financial services firms, whether or not they are "government-controlled."

First, Chinese law allows the state to exercise so-called "super-control rights," regardless of its ownership stake. Such rights are established under the authority of China's State-Owned Assets of Enterprises Law. For example, Article 5 of the State-Owned Assets of Enterprises Law defines "state-invested enterprises" as "wholly state-owned enterprises, state-controlled or majority state-owned enterprises, and any enterprise with minority state equity investment."[135] State shareholders, regardless of the size of their shareholding, are permitted by law

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[131] Sarah Bauerle-Danzman, "Is the U.S. Going to Screen Outbound Investment?" Econographics, January 10, 2022, available at https://www.atlanticcouncil.org/blogs/econographics/is-the-us-going-to-screen-outbound-investment/.

[132] *See, e.g.,* Thomas J. Duesterberg, "Economic Cracks in the Great Wall of China: Is China's Current Economic Model Sustainable?" Hudson Institute, December 2021, available at https://www.hudson.org/research/17443-economic-cracks-in-the-great-wall-of-china-is-china-s-current-economic-model-sustainable.

[133] Marik A. String, "Navigating the new China regulatory consensus," Reuters, October 4, 2021, available at https://reuters.com/legal/legalindustry/navigating-new-china-regulatory-consensus-2021-10-04/.

[134] 2021 USCC Report, *supra* note 3 at 215.

[135] 2021 USCC Report, *supra* note 3 at 217; discussed at 217–222.

to propose (and in some cases simply to appoint) candidates for a company's board of directors or senior management or to propose removal of directors or senior management.[136]

Second, there have been extensive changes in the CCP's role within individual firms, especially in connection with its ability to act through CCP committees. The constitution of the CCP requires that any firm with at least three CCP members must have a CCP committee.[137] In addition to traditional functions of overseeing personnel appointments and management decision-making, coordinating political education, monitoring employee behavior and reporting on any corrupt practices, China's 2015 Guidance Opinions on restructuring state-owned enterprises elevate the importance of CCP committees by prioritizing joint appointments for CCP members as board members.[138]

In practical terms, the changing and growing role of state investment and the CCP even in ostensibly private firms, means that all companies in China are expected to support the policy objectives of the state and the CCP. Under Xi Jinping's leadership these control trends have been accelerated. For example, according to one study, in 1998, 0.9 percent of nonstate (private) firms had CCP committees, a figure that rose to 73 percent in 2017 according to the CCP Organization Department.[139] In addition, as noted in the 2021 USCC Report, and consistent with provisions of China's Company Law that require all

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[136] Tamar Groswald Ozery, written testimony for USCC Hearing on U.S. Investment in China's Capital Markets and Military-Industrial Complex, March 19, 2021, at 7, available at https://www.uscc.gov/hearings/us-investment-chinas-capital-markets-and-military-industrial-complex.

[137] Tamar Groswald Ozery, "Unraveling China's Capital Market Growth: A Political Economy Account," University of Michigan Law School, Dissertation, June 2019, at 120–121, available at https://repository.law.umich.edu/sjd/9/.

[138] *See* Daniel H. Rosen, Wendy Leutert, and Shan Guo, "Missing Link: Corporate Governance in China's State Sector," Asia Society and Rhodium Group, November 2018, at 6–7, available at https://asiasociety.org/missing-link-corporate-governance-chinas-state-sector; CCP Central Committee and State Council, Guiding Opinions of the CCP Central Committee and State Council on Deepening the Reform of State-Owned Enterprises, August 24, 2015, Translation, available at https://english.www.gov.cn/policies/latest_releases/2015/09/13/content_281475189210840.htm.

[139] Margaret Pearson, Meg Rithmire and Kellee S. Tsai, "Party-State Capitalism in China," Harvard Business School Working Paper No. 21-065 (2020), available at https://www.hbs.edu/faculty/Pages/item.aspx?num=59229, at 9; Jude Blanchette, oral testimony for USCC, Hearing on What Keeps Xi Up at Night: Beijing's Internal and External Challenges, February 7, 2019, available at https://uscc.gov/hearings/what-keeps-xi-night-beijings-internal-and-external-challenges, at 13, 74; CCP Organization Department, Chinese Communist Party Internal Communique (2017), Xinhua, June 30, 2018, translation.

companies (domestic and foreign-owned) based in China to provide for CCP committees if there are three or more employees who are CCP members, the CCP has been seeking to establish CCP committees within foreign firms operating in China.[140] According to the 2021 USCC Report, 70 percent of foreign firms in China had such CCP committees in 2016.[141]

Risks and Challenges for the United States

While some observers have focused on the positive aspects of the changes in China's investment management and equity markets, others have commented on the significant risks of these developments. Among the more vocal U.S. critics has been George Soros: "Today, the U.S. and China are engaged in a life-and-death conflict between two systems of government: repressive and democratic . . . [BlackRock's investment] is a tragic mistake that could damage the security interests of the United States and other democracies."[142] While such comments may seem unduly pessimistic, it is important that U.S. policy on investments in China reflect an appropriate understanding of the role of Xi Jinping and the CCP (and related risks for the United States) in the investment management business.

First, it is possible that Xi Jinping and the CCP may favor "opening up" in order to allow Chinese financial and capital markets to benefit from the expertise of firms like BlackRock and Goldman Sachs in order to jump start the asset management business in China. It is well known that Chinese capital markets are not fully developed and depend too much on opaque deposit and real estate investments. It is possible that once a substantial transfer of detailed technical and operational knowledge about the asset management business has taken place, the Chinese authorities might find it find it appropriate to determine that the U.S.-owned firms are engaged in illegal or corrupt or similar activities that require intervention by the state. While such developments would arguably affect only U.S. businesses well-positioned to take on the risks of conducting business in China, any such government intervention would likely have adverse consequences not only for the China-based entity itself, but also for numerous U.S. investors in BlackRock, Morgan Stanley and similar firms and could involve substantial disruptions to global securities markets. Jake Sullivan, U.S. national security adviser, signaled a need for caution when he

[140] 2021 USCC Report, *supra* note 3 at 229.

[141] *Id.*

[142] George Soros, Op-Ed, "BlackRock's China Blunder," Wall Street Journal, September 7, 2021, available at https://www.wsj.com/articles/blackrock-larry-fink-china-hkex-sse-authoritarianism-xi-jinping-term-limits-human-rights-ant-didi-global-national-security-11630938728.

wrote in Foreign Policy, "Why . . . should it be a U.S. negotiating priority to open China's financial system for Goldman Sachs?"[143]

Other observers have also expressed concern that there could be abrupt, unexpected changes in Chinese policy. For example, a Financial Times article cited the comments of Richard Gray, a partner in wealth and asset management at Ernst & Young: foreign firms might eventually become "forced [sellers] of something [they] helped create" if they encounter unanticipated regulatory issues. According to Gray, "Entering a different market, you are very much at the mercy of the local regulators . . . when you are not part of the club, there is no political shield against regulators regulating you harder than some of the local players."[144] A similar view was expressed by Gregory Warren, senior equity analyst at Morningstar, who noted that, "In China, the rules and attitudes can change overnight."[145] Reports in other publications have described similar concerns. A November 2021 New York Times article cited six Wall Street banking executives, who were said to welcome China's latest steps toward financial opening even though they remained keenly aware that the Chinese government could at any time revoke their right to do business.[146]

Second, even if the Chinese authorities take a more circumspect approach, U.S. fund managers could find it difficult to conduct a China-based business over the longer term. For example, the CCP committees that are active within all Chinese commercial banks might be able to obtain access to highly sensitive commercial information on account of the role played by Chinese commercial banks in introducing customers. As explained by China scholar Elizabeth Economy, "In recent years those committees had only ill-defined roles, but thanks to a new requirement under Xi, management must now seek their advice—and in some cases, their approval—for all major decisions."[147] As a consequence, Ms. Economy argues that," In the past, Washington tolerated a

[143] Jennifer Harris and Jake Sullivan, "America Needs a New Economic Philosophy. Foreign Policy Experts Can Help," Foreign Policy, February 7, 2020, available at https://foreignpolicy.com/2020/02/07/america-needs-a-new-economic-philosophy-foreign-policy-experts-can-help/.

[144] Thomas Hale, Harriet Agnew, Michael Mackenzie and Demetri Sevastopulo, "Wall Street's New Love Affair with China," Financial Times, May 28, 2021, available at https://www.ft.com/content/d5e09db3-549e-4a0b-8dbf-e499d0606df4.

[145] *Id.*

[146] Lananh Nguyen, "Wall Street is Finally Getting Access to China. But for How Long?" New York Times, November 16, 2021, available at https://www.nytimes.com/2021/11/15/business/wall-street-china.html.

[147] Elizabeth C. Economy, "China's New Revolution: The Reign of Xi Jinping," 97 Foreign Affairs (May/June 2018), at 60, 64, available at https://www.foreignaffairs.com/articles/china/2018-04-17/chinas-new-revolution.

degree of intellectual property theft and unequal market access because it believed that China was making some progress toward market principles and the rule of law. With that logic off the table, there is no reason that the U.S. should not adopt more restrictive policies toward China."[148]

Third, there is a possibility that, unless extensive safeguards can be put in place, the CCP will strive to influence the day-to-day operations of China-based U.S. fund managers. Liu He outlined the basis for such influence when he discussed the CCP's role in the financial reorganization that led to the creation of the FSDC and enhancement of the policy responsibilities of the PBOC. He explained that this created a key building block for opening up China's markets in a manner that will serve the interests of the CCP and Xi Jinping: "Strengthening the [CCP's] overall leadership is the core issue."[149] Intoning Mao Zedong, Liu He further stated, "In the party, government, military and civil [society], in the east, west, south, north and center, the Party leads all."[150]

Liu He also emphasized the role of the CCP in conducting and regulating financial activities, noting that China's 40 listed banks (including the major banks that will work with U.S. fund managers to distribute mutual fund products), have been required to make changes to their articles of association to add CCP-sponsored in-house discipline inspection committees to root out "corrupt practices" and support internal compliance.[151] Such changes are consistent with a 2018 regulatory mandate making establishment of CCP cells a requirement for any company (including the Chinese commercial banks that will work with U.S. asset managers) to be listed on a domestic stock exchange. In September 2020, the CCP's top governing body released an opinion paper entitled, "Opinion on Strengthening the United Front Work of the Private Economy in the New Era," which calls for CCP cells to work harder to

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[148] *Id.* at 70.

[149] Keith Bradsher and Chris Buckley, "China's Communist Party Centralizes Power over Finance and Pollution Control," New York Times, March 12, 2018, at 1, available at https://www.nytimes.com/2018/03/12/business/china-consolidates-power-financial-industry.html.

[150] *Id.*

[151] Matthew Miller, Reuters, "China's Banks Embrace Risk Committees in Risk Crackdown," Reuters, June 27, 2018, available at https://www.reuters.com/article/us-china-banks-party/chinas-banks-embrace-communist-party-committees-in-risk-crackdown-idUSKBN1JN0XN.

understand and interact with private companies and to help improve their corporate governance structure.[152]

Fourth, there is a fundamental problem with the VIE investment structure. As noted above, VIEs may leave U.S. investors without recourse because of their lack of an ownership interest in the underlying Chinese company. Under Chinese law, foreign ownership of companies in many Chinese industries is prohibited. The VIE structure was developed as a way to circumvent such Chinese law restrictions, but the practical consequence is that the offshore investment vehicle holds as its only asset contractual agreements that purport to give it a claim on assets belonging to the Chinese operating company.

Fifth, there is a risk that foreign capital invested in China may inadvertently fund Chinese government and CCP objectives that are adverse to U.S. interests. The Chinese government and CCP have numerous ways of exercising oversight and influence that can evade the typical U.S. focus on exercise of control through simple measures of share ownership. As noted in the 2021 USCC Report, "Such analysis [of share ownership] is less meaningful when evaluating Chinese investors or investment targets, however, as the government is afforded special controlling rights ["super shares"] over any firm in which it invests, regardless of its ownership stake. Moreover, the CCP is expanding its influence in corporate decision making and regulatory enforcement via channels that are effectively above the law."[153]

Sixth, there is risk related to the difficulty of identifying Chinese firms with state and military ties in which U.S. investment is prohibited pursuant to various U.S. laws, regulations and executive orders. As noted in the 2021 USCC Report, unintentional investments in such firms may increase the risk that U.S. capital might contribute to improvements in China's military capabilities, surveillance technologies, human rights abuses or other activities adverse to U.S. economic and security interests.[154] While various executive orders under the Trump and Biden Administrations have attempted to identify entities that threaten U.S. policy interests, these efforts have been insufficient and incomplete, due in large part to the difficulty of identifying entities that

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[152] Scott Livingston, "The Chinese Communist Party Targets the Private Sector," October 2020, Center for Strategic and International Studies, at 1, available at https://www.csis.org/analysis/chinese-communist-party-targets-private-sector.

[153] 2021 USCC Report, *supra* note 3 at 231.

[154] *Id.* at 254.

should be subject to prohibitions and the challenge of coordinating lists developed by a number of different U.S. government agencies.[155]

Potential Delisting of Chinese Companies on U.S. Exchanges

While private U.S. investment in Chinese companies and securities has flourished in recent years, there is a countervailing trend that merits attention. Perhaps due to concerns about dependence on foreign markets, and also in reaction to U.S. audit requirements and legislation such as the HFCAA, the Chinese leadership has encouraged a number of leading Chinese companies (such as Didi and Ant Financial) not to list their securities on U.S. exchanges.[156] Noting that "the withdrawal of Chinese companies from U.S. stock exchanges would be a significant blow to the United States as an international financial center," the Committee on Capital Markets Regulation (the "CCMR"), an independent U.S. research organization, issued a comprehensive report (the "CCMR Report") in December 2021 on policy developments affecting U.S.-listed Chinese companies.[157]

The CCMR Report cited four policy issues that threaten Chinese companies' ability to list or remain listed in the United States:

- The HFCAA requires the SEC to delist Chinese companies from U.S. exchanges as soon as 2024 if Chinese officials continue to prevent U.S. regulators from reviewing audits of Chinese companies;
- U.S. Executive Orders issued by President Trump in 2020 and President Biden in 2021 ban trading by U.S. investors in firms with links to the Chinese military;
- Actions by Chinese regulators require that the Cyberspace Administration of China pre-approve foreign listings for certain Chinese companies; and
- Both U.S. and Chinese regulators may restrict ongoing use of the VIE

[155] For an extensive discussion of these issues, *see* Chapter 2, Section 4: U.S.-China Financial Connectivity and Risks to U.S. National Security, in 2021 USCC Report, *supra* note 3 at 240–286.

[156] *See, e.g.,* Shang-Jin Wei, "What if America Delists Chinese Firms?" Project Syndicate, July 21, 2021, available at https://project-syndicate.org/commentary/america-threat-to-delist-chinese-firms-by-shang-jin-wei-2021-07.

[157] Committee on Capital Markets Regulation, Assessing the Future of U.S. Listings by Chinese Companies: A Call for Structured Dialogue, October 2021, available at https://www.capmktsreg.org/2021/10/22/assessing-the-future-of-u-s-listings-by-chinese-companies-a-call-for-structured-dialogue/#.

structure that is commonly used by Chinese companies for U.S. listings.[158]

Another indication that the Chinese leadership may favor delisting as part of a broader China-centric financial markets focus (which some have called "asymmetrical decoupling") is the creation of a new Beijing Stock Exchange for technology-oriented small and medium-sized enterprises.[159] In addition, several Chinese companies that are listed in the United States have recently established cross-listings on Hong Kong or other exchanges.[160] While a focus on building up Chinese exchanges is an understandable component of developing robust Chinese domestic capital markets, such a transition would be more acceptable from a U.S. policy perspective if accompanied by a continued affirmation of the need for complementary U.S. listings.

CONCLUSIONS AND POLICY SUGGESTIONS

The Ukraine war provides a challenging test for a world in which engagement premised on globalization seems to have failed and economic sanctions have joined missiles as deterrents. As Richard Haass, President of the Council on Foreign Relations, has stated: "Sanctions are important tools, but no panacea . . . They can and will increase the cost to Russia of Putin's war . . . but for now what matters most is what happens on the ground in Ukraine."[161] In sum, the world needs military might to stop Russia's battlefield aggression and economic deterrents (sanctions) to supplement it and to warn China that its partnership with Russia has costs and limits.

What types of policies are appropriate for this new world order? How should they be framed? There have been a number of useful attempts to articulate approaches that might explain what needs to be done. A "new containment policy" has been suggested as one approach.[162] "Persistent competition leavened

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[158] *Id.*

[159] James T. Areddy, "China to Launch Beijing Stock Exchange to Steer Investment Into Innovation," Wall Street Journal (Sept. 2, 2021), available at https://wsj.com/articles/china-to-launch-beijing-stock-exchange-to-steer-investment-into-innovation-11630622825.

[160] CCMR Report, at 23; Rachael Johnson, "U.S.-Listed Chinese Companies Gravitate to Secondary Listings in Hong Kong," International Bar Association (2020), available at https://ibanet.org/article/fcf04a93-cff7-44ca-98c1-bcd5cb1a1d6c.

[161] Richard Haass, cited in "Ukraine War: China Exporters Wary of 'Secondary Sanction' Threat to Helping Russia Skirt Alumina Bank," South China Morning Post, March 24, 2022, available at https://www.scmp.com/economy/global-economy/article/3171693/ukraine-war-china-exporters-wary-secondary-sanction-threat.

[162] Michael Mandelbaum, "The New Containment: Handling Russia, China and Iran," 98

with calibrated cooperation" is another.[163] This paper's policy suggestions are designed for day-to-day financial interactions between the United States and China and are based on objectives of pragmatic containment in the absence of war between the United States and China. Competition and rivalry are core elements of the U.S.-China relationship, and appropriate instruments of regulatory deterrence can lead to practical solutions that should lessen the need to resort to escalatory sanctions. If the Ukraine war should lead to the imposition of comprehensive secondary sanctions on China, financial decoupling may be inevitable and new approaches will be needed. For now, the practical steps outlined below should be helpful.

To date, U.S. policy on Chinese commercial banks and NBFIs operating in the United States and on U.S. establishment of financial institutions in China and investments in Chinese capital markets has lacked sufficient focus on the role and implications of state ownership and CCP influence. As a result, U.S. policy is ill-prepared to address the "whole of society" approach that is intrinsic to Xi Jinping's vision for Chinese development. In dealing with the entry, expansion and oversight of Chinese commercial banks, U.S. policymakers and regulators need to broaden the concept of national treatment to include a full review of state ownership and dominant political party influence whenever an FBO is government-owned or controlled. The trend for CFIUS review of NBFI investments to temper an "open investment" concept of national treatment with an assessment of national security concerns is to be encouraged and suggests that a review of potential national security concerns might appropriately have a role in FBO branch entry and oversight.

With respect to U.S. investments in China, it is time for policy makers and regulators to require appropriate disclosure and discussion of the risks presented by direct investments in financial entities such as asset managers. Direct investments present risks including the possibility of undue CCP influence on operations in China, unintended transfer of expertise and data, possible Chinese fines and penalties for unsubstantiated claims of corruption and, should it be deemed necessary by Chinese authorities in times of open conflict and or disagreement, state intervention in U.S.-owned businesses. Additionally, while portfolio equity investments by individual investors in foreign companies have traditionally not been subject to U.S. government oversight, the wide-

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Foreign Affairs 123 (2019), https://www.foreignaffairs.com/articles/china/2019-02-12/new-containment.

[163] John R. Allen, Ryan Hass, and Bruce Jones, "Rising to the Challenge: Navigating Competition, Avoiding Crisis and Advancing U.S. Interests in Relations with China," Brookings, November 2021, at 1, https://www.brookings.edu/research/rising-to-the-challenge-navigating-competition-avoiding-crisis-and-advancing-us-interests-in-relations-with-china.

spread use of VIEs, super shares and similar measures to ensure state and CCP influence within Chinese companies may merit a more active U.S. government role to protect U.S. investors and markets. Finally, resolution of issues related to potential large-scale delisting of Chinese companies from U.S. exchanges should be pursued through active, ongoing discourse between Chinese and U.S. regulatory agencies. In sum, both inbound Chinese investment in the United States and outbound U.S. investment in Chinese financial institutions and securities need to be re-evaluated in light of the role of the Chinese state and the CCP.