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

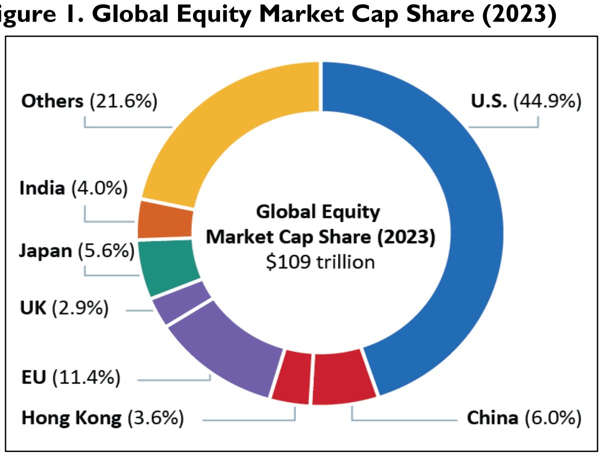
Financial ties between the United States and the People's Republic of China (PRC or China) have been contracting since 2020, due in part to China's economic slowdown, reinvigorated PRC capital controls, and U.S. government and business concerns about the potential risks of investing in China. According to the Department of the Treasury, as of September 2024, U.S. investors held $361 billion in PRC (mainland China and Hong Kong) securities; PRC total holdings of U.S. securities, excluding PRC offshore holdings, were $1.8 trillion. The PRC was the second-largest foreign holder of U.S. Treasuries ($1.0 trillion) after Japan ($1.1 trillion). Investments in China by U.S. private equity (PE) and venture capital (VC) firms fell from $140 billion in 2019 to $4 billion in 2023, according to Preqin. S&P Global reports that U.S. PE/VC investments in China fell to $650 million in the first half of 2024.

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

Capital Markets Investments

The United States has the largest capital market in the world, far surpassing the European Union, the second largest market (**Figure 1**). The U.S.-China gap in market capitalization reached a record high in July 2024, according to Ernst and Young (EY), with U.S. market cap valuation at $56.2 trillion, compared to $10.1 trillion for mainland China and $4 trillion for Hong Kong (the Eurozone's market cap valuation was $7.9 trillion). While U.S. capital markets are surging, investor confidence in China's equity markets has declined. Initial public offerings (IPOs) in the PRC were down by 74% in the first nine months of 2024—falling from 266 to 70 offerings—over the same period in 2023, according to EY.

Figure 1. Global Equity Market Cap Share (2023)



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

Beijing has encouraged PRC firms to buy back shares while tightening margin financing, in which investors borrow from brokers to invest. Similar to efforts in 2012 and 2015, Beijing has directed a "national team" of state firms and China's sovereign wealth fund to buy shares to stabilize the market. In September 2024, the PRC government moved to let institutional investors tap $43.7 billion in central bank financing to buy stocks, created a market stabilization fund with $70.6 billion in liquidity, and planned to leverage offshore funds held by PRC state firms to boost the market.

Access to U.S. capital markets offers PRC firms capital and paths to build brand recognition, and expand in China and overseas. PRC and PRC-tied firms listed on U.S. exchanges include firms in sectors prioritized in PRC industrial plans. In 2023, the average size of U.S. IPOs by PRC firms fell by 93% from 2021 levels, marking the lowest level in 20 years, according to EY. In 2023, 24 PRC firms raised about $656 million in U.S. IPOs. In the first half of 2024, two PRC firms listed on the New York Stock Exchange (NYSE) and 38 PRC firms listed on NASDAQ. According to the U.S.-China Economic and Security Review Commission, 265 PRC firms were listed on U.S. stock exchanges as of January 2024, with market capitalization of about $848 billion. These firms constituted about 1.6 % of U.S. equity market capitalization. Alibaba accounts for about 25% of this total.

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

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

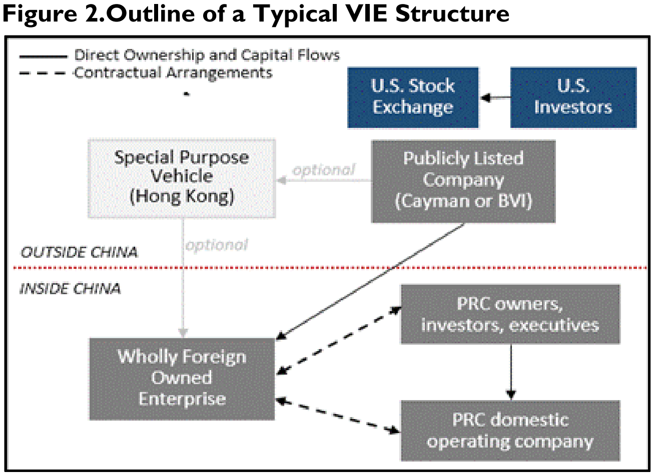
At the same time, China is taking steps that appear aimed at shifting U.S.-PRC investment activity to PRC, enhancing PRC control, and channeling economic benefits to PRC exchanges. Since 2016, China's securities regulator has directed PRC firms to list on PRC exchanges and in Hong Kong. As of January 2023, all PRC firms managed by China's State Council had de-listed from U.S. exchanges.

Since 2021, Beijing has enhanced controls of overseas listings. In December 2021, Beijing pulled back the U.S. listing of DiDi Global, part of China's largest ride-sharing service, citing the need for a data security review. The PRC government has assumed a new shareholding position in several firms, and since 2023, has required national security reviews for all PRC firms listing overseas. In 2024, PRC regulators permitted some overseas listings. For example, Zeekr, a spinoff of PRC auto firm Geely, has raised over $7 billion from its NYSE listing; PRC firm Midea Group listed in Hong Kong for $4 billion.

PRC Corporate Structures

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

Figure 2.Outline of a Typical VIE Structure



Source: CRS, with information from multiple sources.

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

Issues Before Congress

Some Members hesitate to restrict financial flows, noting the benefits of an open investment climate. Other Members are concerned about U.S. investments, including passive financial investments, being used to support China's military and strategic sectors, noting some U.S. index funds include PRC military and state-tied firms. In 2024, the House Select Committee on Strategic Competition with the Chinese Communist Party found that several U.S. VC firms invested over $3 billion in PRC firms tied to the military and industrial policies, and engaged in human rights abuses.

The U.S. government has taken several actions since 2020 to address risks that U.S.-PRC investments may pose:

2020: The Holding Foreign Companies Accountable Act (HFCAA, P.L. 116-222) requires PRC firms to meet U.S. statutory audit requirements, disclose state and military ties, and delist from U.S. exchanges if terms are unmet.

2020: U.S. officials convinced the U.S. government's Thrift Savings Plan board to defer a decision to tie its international fund to an index that includes PRC firms.

2021: Executive Order (E.O.) 14032 prohibits U.S. persons from investing in named PRC military firms.

2022: A U.S.-China initial auditing framework is to allow U.S. review of the work of PRC-based accounting firms that audit PRC-based firms listed on U.S. exchanges.

2023: E.O. 14105 directs Treasury to create a program to regulate certain U.S. investments in China (e.g., advanced semiconductors, artificial intelligence, and quantum computing). H.R. 6349 would codify the E.O. in statute and expand the sectors it covers. The SEC issued guidance on disclosure obligations for PRC firms.

2024: The Department of Defense listed a PRC investment firm, IDG Capital, as a military firm.

Congress could consider proposals that would restrict certain investment in China and PRC firms and whether to: a) require PRC firms to provide more details on beneficial ownership and state ties; and/or b) require the SEC to make the U.S.-China auditing deal public, report on HFCAA implementation, and issue China investment bulletins.

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