Rising Tension Between U.S. and China Elevates Trading Issues

U.S. measures could increase oversight of Chinese companies

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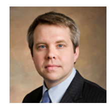
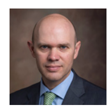


Chris Kushlis
Fixed Income Sovereign Analyst, Asian Markets



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KEY INSIGHTS

- "Tough on China" policies could limit trading of Chinese securities on U.S. exchanges.
- Pressure mounts to subject Chinese companies to the same accounting scrutiny faced by other public companies traded in the U.S.
- Federal and state government retirement funds are facing pressure to restrict investment in Chinese companies.

With China becoming a high-profile issue in the U.S. presidential election, much of the friction has centered on trade disputes and the coronavirus outbreak. Several efforts are also underway in the U.S. to address a longer-standing issue: whether Chinese companies are creating risks to investors and markets by skirting U.S. audits and regulatory oversight. How these legislative and regulatory issues evolve could have implications for financial markets, including potential limitations on the trading of Chinese securities.

Potential Ban of Chinese Securities on U.S. Exchanges

The U.S. Congress and U.S. regulators are furthering efforts to prevent companies in emerging markets, particularly those in China, from seeking to benefit from U.S. capital markets if they do not undergo the same level of oversight as companies in the U.S. and other developed market countries. An estimated 224 U.S.-listed companies with about USD 1.8 trillion in market capitalization could be impacted by the legislative and regulatory measures.[1]

Congress is considering legislation that could lead to the delisting of Chinese securities traded on U.S. stock exchanges unless the companies accept regular public review and oversight of their accounting practices. In addition, Nasdaq has proposed new rules that would codify its authority to apply more stringent listing criteria of companies in "restrictive markets" due to concerns about a company's auditor, inadequate disclosures, a lack of transparency from certain emerging markets, and a need for greater accountability and access to information.

[1] Source: *Fortune* magazine.

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> **— Katie Deal**
> *Washington Analyst, U.S. Equity Division*

These are long-standing regulatory concerns, as Chinese firms have raised billions of dollars by listing their shares on U.S. stock exchanges while avoiding the auditing scrutiny that other public firms must submit to. For years, the Public Company Accounting Oversight Board (PCAOB), which oversees the audits of public companies, has flagged "China Related Access Challenges" that have hindered the agency's capacity to gain "complete and timely access" for inspections and investigations of Chinese public companies.

In the U.S. Congress, the Senate has approved a bill aimed at tighter regulations, while the House is considering similar legislation. The Senate bill, Holding Foreign Companies Accountability Act, would require certain companies to disclose whether they are "owned or controlled by a foreign government" and would potentially prohibit the trading of securities of U.S.-listed companies audited by firms that the PCAOB cannot inspect.

The goal is to ensure that the PCAOB has access to inspect Chinese audit firms in the same manner as they inspect U.S. audit firms and those located in other nations. Thus, it would allow the PCAOB to audit their financials at least every three years. Companies that do not comply with these requirements could face delisting from U.S. exchanges.

"Though the measure's future is uncertain, key members of Congress are committed to heightening the regulatory risk profiles of Chinese firms," said Katie Deal, Washington Analyst, U.S. Equity Division. Any delisting would not happen until 2025, so affected companies would have time to relocate their listings or put in place the required measures to comply.

Several of China's largest technology firms are listed in the U.S., but they have the capacity to shift their listings as offerings in Hong Kong. In fact, most of T. Rowe Price's foreign holdings consist of Chinese American Depository Receipts (ADRs), which also have secondary listings on the Hong Kong Exchange, enabling the firm to exchange ADR shares for the Hong Kong listing with minimal impact to portfolios. However, several operational processes would have to be established with some clients to allow for trading on non-U.S. exchanges. In addition, custodian relationships may need to be set up on a global platform.

Eric Veiel, co-head, Global Equity, says the firm "continually monitors risks to our holdings, including regulatory factors. Predicting regulatory events is especially difficult; as a result, sentiment around regulatory risk can lead to large short-term movements in stock prices. Our team of analysts and portfolio managers draw upon deep industry contacts as well as their own experiences and insights to assess these situations. We continue to monitor this situation and its implications for individual companies."

Restricting Investment in Chinese Securities

Scrutiny of Chinese companies could also impact the retirement savings of federal and state workers. The U.S. Federal Retirement Thrift Investment Board (FRTIB), which manages federal government retirement funds, has decided to put on hold its plan to shift USD 593.7 billion from the Thrift Savings Plan's I Fund benchmark MSCI EAFE Index of developed markets to the MSCI ACWI ex USA Investable Market Index, which includes China and other emerging markets.

The Board cited concerns about the potential impact of the coronavirus on emerging markets "because those markets are going to be challenged and we're not sure what they're going to look like over the next two or three years," said Michael D. Kennedy, chairman of the FRTIB. However, the Board also was under heavy pressure from the Trump administration to reverse the earlier decision. On May 4, President Donald Trump nominated three people to the five-member Board that, upon Senate confirmation, could lead to a new majority. The Board also received letters from administration officials citing "national security and humanitarian concerns for the United States."

State retirement plans may face similar pressure. Florida Senator Marco Rubio and Congressman Michael Waltz sent a letter to Florida's governor and other officials demanding that they divest state retirement money from Chinese companies. Governor Ron DeSantis has said he may push for that in 2021.

"The reversal by the federal government is a symbolic move, but it is not expected to have a significant immediate financial impact on China," says Chris Kushlis, Fixed Income Sovereign Analyst, Asian Markets. "What could be more meaningful is if other public pension plans at the state and local levels in the U.S. also come under pressure to exclude Chinese securities. That's important to monitor."

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