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Protecting American Investors

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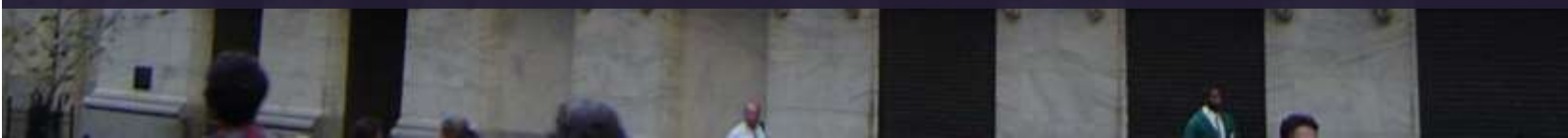

FOCUS

China is at the center of a worldwide crisis. Their actions clearly show their willingness to use deception for their gain. They have emerged as a big player on the world stage over the last 25 years but all along the way have shown how deep their deception is rooted.

Deception is not compatible with transparency. With China's entry into the American stock markets, they have subversively challenged the roots of financial transparency, a strength of the American free-market system. The Securities and Exchange Commission (SEC) issued rulings in the 1990s which seemed appropriate for that time but did not anticipate the entry of a new form of a corporation, Chinese state-owned enterprises (SOE's) in which the government, the regulators and the beneficiaries are all one entity. As a result, SOE's can sell securities on the New York and NASDAQ stock exchanges without complying with the disclosure rules that American and other country's enterprises are required to follow. Adding the full control of SOE structures to deception destroys transparency.

At the time of the original rulings, the SEC stated they found no evidence of the incompatibility of laws but noted that they need to monitor the result. This was at the infancy of the emergence of foreign regulated corporations onto the American exchanges. It's time for the SEC to revisit their 1990's rulings to address the current laws and circumstances.

The growth of China as the supply chain to the world required more capital and SOE's to fulfill demand and to continue to build the enterprises. To meet that goal China started many SOEs and raised investment capital through the American stock markets. This has perpetuatedthe problem and placed many American investors in peril for reasons they do not understand.

Without the understanding of the disclosure and regulatory differences, the stock index makers saw the allure of a new market and felt the pressure of the Chinese government to include their SOE stocks as recommended holdings. This intensified the demand for SOE stocks and led to automatic purchases by pension funds, including most of the funds for both federal and state public employees. In some cases, this included using the retirement funds of military and pentagon employees to fund Chinese companies developing military technology that could be used against these same people.

The COVID19 pandemic and the stock market reaction is a strong indicator of the level of panic that exists worldwide. The COVID19 virus originated in Wuhan, China and put the Chinese

government to the test of how they handle something that threatened their global financial position. They failed!

China hid facts from their own doctor's findings to the point of forcing him to state that the information was false. This isn't the first virus to originate from China but despite prior knowledge of how the virus spreads they allowed a food festival to occur in Wuhan that openly spread the virus. They deferred virus testing to manipulate facts (something they may be engaging in today) and they used their position as the primary supply chain source for pharmaceuticals to control the narrative about the truth by threatening the United States with the possibility of cutting off our supply of all drugs.

Connecting all the dots on these facts compels the immediate need to either force all companies trading on U.S. exchanges to comply with U.S. securities laws or to be delisted. This fact is particularly striking at this moment in time when we will see Chinese companies reporting their financial results following a complete shut-down of their economy.

Without qualified independent auditor reports being issued after full audits conducted in accordance with generally accepted auditing standards, the investors have no assurance of the accuracy of the numbers. It is not a long stretch for the Chinese government, in their full control capacity, to direct Chinese companies to report glowing numbers to showcase their desire to be the leading power in the world. If we allow this to happen they will lead the world down a precarious path at the expense of the American investors and the reputation of U.S. securities laws and the American stock markets.

Immediate actions are warranted by the SEC, the Department of Labor (DOL) and the Department of Justice (DOJ). This document is a call to actively engage the forces of the American system to protect the American stock markets and the American investors and will lay out the history of what led us to this precarious position, a staggering list of the stack of related risks caused by the current situation, and immediate recommended actions.

EXECUTIVE SUMMARY

American companies that sell securities on U.S. exchanges must comply with U.S. securities laws. No matter where headquartered or incorporated within the United States, the U.S. securities laws are applied uniformly.

The SEC is tasked with protecting investors, maintaining fair, orderly, and efficient markets, andfacilitating capital formation. Their mission is accomplished through the issuance of rules and regulations, which they monitor with market oversight, regulatory actions, and enforcement.

Transparency is at the core of U.S. Securities laws. Without transparency, individuals cannot invest their funds with acceptable levels of risk.

The SEC reviews the rules that it enforces and adjusts them from time-to-time to ensure that the laws are sufficient to protect investors and markets. This oversight cannot anticipate all circumstances and it is clear from all of the regulatory actions of the SEC since the 1960's that they have walked a long path to internationalize the regulations governing stock markets.

Along this path, the SEC enabled the emergence of Chinese SOEs on U.S. exchanges without requiring them to comply with American security laws but rather to allow for the securities laws of China to dictate their behaviors.

Unfortunately, the SEC's actions didn't anticipate the emergence of such a worldwide player that would so blatantly ignore and circumvent the laws of other countries and work openly to exploit other countries' shareholder protections in favor of their own government's investments. As a result, the rationalization of regulatory internationalization is a flawed objective, causing American investors and markets to be subjected to levels of risk set by foreign governments that cannot be easily understood.

Many investment funds that are open to all levels of investors are based on market indexing set by independent investment firms such as MSCI. Without a regulatory process to govern their selection, these firms have bowed to the pressure of the government of China and included the Chinese SOE stocks in their index weightings, causing a multitude of independent funds to buy these stocks automatically.

Many of the independent funds are pension plans, including Public Employee Retirement System plans (PERS) which are organized in all states. These plans include options for the waiver of federal social security taxes in favor of directing those funds to their account. In a catastrophic meltdown of Chinese stocks, these workers could lose their retirement assets without social security as a backstop.

Pension funds are governed by the Employee Retirement Income Security Act (ERISA) administered by the DOL. The DOL has not issued advisories to steer investment assets away from this risk, leaving the U.S. government-owned Pension Benefit Guarantee Corporation (PBGC) at risk.

It's time for the United States government to react to the developing storm before the risk factors combine to cause a catastrophic meltdown in the stock markets that would harm the assets of the American people.

The world values American financial leadership. The U.S. dollar is considered the safest and therefore the reserve currency of the world. American leadership must rise to address this crisis.

RACE TO THE BOTTOM

In the late 1980s, the Japanese stock market soared, reaching an all-time high on December 29, 1989. The U.S. stock markets were still reeling from the Friday, October 13, 1987 "Black Monday" meltdown resulting from a failed leveraged buyout of United Airlines. Later, as markets were stabilizing, they faced additional headwinds when Iraq invaded Kuwait in July 1990 and the ensuing war cast a long shadow on U.S market decisions and long-term recovery.

Needing capital and seeking the best pricing, American corporations turned to the Japanese exchanges. The SEC rules and regulations did not specifically address whether U.S. based corporations were required to register such transactions when the offerings were placed overseas and not directly offered to American investors.

Reacting to the circumstances the SEC issued Regulation S on May 2, 1990, which obviated the need for SEC registration when offerings are placed on foreign exchanges and no efforts are made to sell to U.S. investors. The SEC later clarified Regulation S with stated exemptions that made it possible for securities sold in foreign markets to then be sold on U.S. exchanges after a prescribed period.

The original Regulation S and the follow-on exemptions created an opening for fraudulent and manipulative schemes whereby securities in thinly capitalized companies were sold without the disclosures that could have alerted investors. However, the original crack in the wall started long before the SEC's actions in the 1990s.

At the center of the SEC's actions were Felicia H. Kung, Chief, Office of Rulemaking at the SEC. In 2002, not long after the rulings relating to Regulation S, Kung described the SEC's history of changes leading up to what she described as "Regulatory Internationalization." In 1963, seeking to reduce the outflow of capital from corporations looking to take advantage of the lucrative European debt markets the Presidential Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad recommended that U.S. issuers of debt for sale in overseas markets be provided an exemption from the registration requirements of the SEC. In 1964 the SEC issued Release No. 4708 which formalized the exemption citing the fact that none of the securities would be sold to U.S. investors.

Not long after liberalizing the requirements for U.S. companies to raise funds through offshore debt there was a demand by foreign corporations to raise capital through equity sales on U.S. exchanges. To entice the demand the SEC modified Section 12(g) of the Securities Exchange Act of 1934 (the Exchange Act) to remove registration requirements from foreign issuers if they meet certain reasonable size requirements.

In 1967, the SEC further opened the crack in the wall by modifying Rule 12g3-2(b) of the Exchange Act to provide an exemption in which foreign issuers of equity instruments who met a limited list of qualifications could be exempted from registration in the U.S. if they provided the SEC with the same information, they provided their domestic regulator.

Over the intervening years between 1967 and the Regulations S actions in the 1990s, the SEC continued to ease the process for offshore offerings by U.S. companies in foreign markets and foreign companies to

list on U.S. exchanges. The Regulation S and S Exemption's "safe harbors" completely internationalized the securities regulations as accepted by the SEC in its' rulemaking and enforcement role. Whether the changes were a lighthouse beckoning foreign investors who could not otherwise meet the stringent rules imposed on U.S. companies or the timing was merely precipitous, China was seeking to emerge as a financial player on the world stage and this was an invitation.

In her 2002 "The Rationalization of Regulatory Internationalization" Kung noted two primary issues regarding internationalization.

"…it contravenes the principle of national treatment; wherein foreign issuers are accorded treatment similar to that provided to domestic issuers. While there may be some deviation in the regulatory scheme that is applied to foreign as opposed to domestic issuers in some jurisdictions, as a general matter regulator try not to put their domestic issuers at a competitive disadvantage vis-a-vis foreign issuers. With mutual recognition, a foreign issuer may be able to access the capital markets using the less stringent requirements of its home jurisdiction, to the disadvantage of the domestic issuers in that market."2

"…a system of mutual recognition that is applied globally without the contemporaneous institution of high-quality disclosure standards that are accepted worldwide would encourage regulatory arbitrage and a *"race to the bottom"* in the quality of regulation. Corporations would choose as the primary regulator the jurisdiction with the least demanding regulations by incorporating in that jurisdiction. They could then make offerings in other countries without complying with the stricter disclosure requirements of the jurisdictions in which the offerings are being made. Investors in the markets in which the offerings are made would be harmed by the reduced disclosure, and domestic corporations in that jurisdiction would suffer a competitive disadvantage compared to foreign issuers. To rectify the discrepancy between the requirements applicable to domestic and foreign issuers, regulators might well feel pressure to reduce disclosure standards to the level of the least regulatory jurisdiction."2

In "Final Rule: Offshore Offers and Sales (Regulation S)" the SEC noted, "While the Commission remains concerned with the potential for abuse, it has determined not to extend, at this time, the new requirements to the securities of foreign private issuers, regardless of the relative size of their U.S. markets to their worldwide trading."

In making this judgment the SEC created the perfect scenario in which a foreign-led capital campaign targeting U.S. investors on American stock exchanges could lead to Felicia H. Kung's predicted "race to the bottom".

DIAMETRICALLY OPPOSED TRANSPARENCY

Writing in 2011, Simon Fong, Founder & President of Snowball Finance, noted 4 principal reasons why Chinese companies go public in the United States.

1. If a 'Chinese' company takes foreign investment using a VIE structure, it can only list abroad.

2. Many companies don't meet the strict financial standards for a Chinese listing.

3. China's listing process is lengthy and opaque, a torturous examination compared with America's speedy registration.

4. China's regulatory agencies perpetually over-regulate, rather than letting the market decide.

Although oversimplified and biased, Fong's views capture the thinking of the Asian markets in 2011. Most striking is the viewpoint of the "speedy registration" process in America which provides a favorable foreign perspective of the welcoming of the SEC's regulatory internationalization actions.

In 2005, Bingbin Lu, Instructor of Business Law at the Shanghai Business School, authored "International Harmonization of Disclosure Rules for Cross-Border Securities Offerings: A Chinese Perspective". Lu noted; "The Chinese stock market deserves international attention since China is different from any western country, even its East Asian neighboring countries."

In a surprisingly open discussion about China's market and supervisory landscape Lu further noted; "Poor regulation and supervision of the securities market is a long-existing problem in China. A swaying regulatory culture, massive market manipulation and insider trading, as well as poor corporate governance and little minority investor protection-with the root of all these problems being the State-owned Enterprises (SOEs). Nearly all the listed companies are SOEs. Many are making heavy losses. The government's role in the market is problematic. It is a regulator, lawmaker, and the greatest beneficiary."

Lu's description of China's supervisory landscape is blunt and alarming. These conditions are the perfect nutrients to grow high risk companies. In the United States companies are built as independent entities that must stand on their own under strong transparency laws and stringent independent auditor examinations with full disclosure. Chinese SOEs would not survive in the American market environment yet these companies are being sold to unsuspecting investors and fiduciaries on U.S. stock markets.

China's business culture is based on "Guanxi", which is characterized by the Chinese government as having discretionary power and a controlling role in large scale production and planning. This is complemented by an accounting system that prefers secrecy to provide maximum flexibility. Their internal customs and principles are diametrically opposed to the United States.

Below the surface, there are more differences between the regulatory landscape of China vis-a-vis the United States. At the primary level is transparency and it's best differentiated in the events surrounding Enron in 2001.

Despite rigid reporting requirements and the guiding principles of generally accepted accounting principles (GAAP), Enron's management covered up off-balance-sheet transactions that shielded increased risk from the eyesight of investors. When the scheme blew-up and the company collapsed the stock value disappeared and subjected market investors to complete loss. Even worse, the company maintained an Employee Stock Ownership Plan (ESOP) that invested employee retirement funds in Enron stock exclusively. Employees lost all of their retirement assets.

This all occurred in the full SEC regulatory environment causing the U.S. Congress to pass modifications to the securities laws as part of the Sarbanes-Oxley legislation (SOX). SOX heightened disclosure requirements for company management and, for the first time in the history of the American accounting profession, imposed an oversight board to review the quality of the work of independent auditing firms thorough the Public Company Accounting Oversight Board (PCAOB). All of these actions increased the transparency standards that protect investors.

In the same timeframe, China's CSRC enacted the Circular of Future Strengthening the Management of Stock Issuance and Listing Outside Territory rules in 1997 and the Measures on Promoting Standardized Operations and In-Depth Reform of Overseas Listed Companies rules in 1998. Both focused primarily on regulations for Chinese companies who seek to offer securities on exchanges foreign to China and both moved to decrease transparency, thus providing a situation in which Chinese SOEs trading in the U.S. cannot comply with the disclosure requirements of SOX and SEC laws in general. These governing rules also do not allow Chinese independent auditing firms to subject their work papers to the stringent PCAOB reviews.

China's moves to close transparency caused two enforcement actions. Investors of the China Life Insurance Company Limited initiated a class action suit in 2004 against this company for their failure to comply with U.S. securities laws. Also, the disallowance of PCAOB independent auditor work paper reviews has called attention to 156 Chinese companies that are listed on America's stock exchanges and had a combined value of $1.2 trillion in June 2019.

The obvious resolution is requiring all companies, foreign and domestic, to comply with all U.S. securities laws as a condition of being allowed to sell securities on all U.S. based stock exchanges. Senators Rubio, Menendez, Cotton and Gillibrand introduced Senate Bill S. 1731 on June 5, 2019, for this purpose. Cited as the "Ensuring Quality Information and Transparency for Abroad-Based Listings on our Exchanges", or the "Equitable Act". S. 1731 requires compliance with U.S. security laws as a condition of listing and amends the gap in the Sarbanes-Oxley Act of 2002.

Senator Rubio stated in a Wall Street Journal editorial in June 2019 "SEC and PCAOB negotiators should use this opening to engage with their Chinese counterparts to bring China into line with international norms."

The United States has led the world in defining financial transparency. It's now time to lead the world in maintaining the strong financial controls and transparency requirements on the largest stock markets rather than allowing any loosening of controls.

THE PERFECT STORM OF RISK

Free markets can only serve and protect investors if all sellers abide by the same principles and standards so investment choices among alternatives can focus on the competitive differences of how certain companies fulfill the demands of the markets they serve and in which the risk factors are transparent. When risk factors are unknown or purposely hidden from view investors are uniquely unprotected.

The road to security regulation internationalization was based on the principle that all sellers played by the same rules. The continuing emergence of Chinese SOEs on the American based New York and NASDAQ exchanges is stacking the deck against American companies and intensifying the risks that investors are taking. The knowledge of China's security standards and methods to offshore valuable American capital is wildly confusing. Even seasoned Wall Street investors and investment firms are not aware of the regulatory and motive differences.

This is a perfect storm for a catastrophic meltdown due to the collection of broad risk factors that now exist.

- Chinese SOEs do not comply with SOX and are structured by Chinese law to hide information.
- The same Chinese laws prevent the PCAOB from examining the quality of the independent auditor's work.
- Although identified under worldwide known names, Chinese independent audit firms are organized following the rules and laws of China. Without the examination of the work papers of these firms, it is not possible to determine if their audits are conducted following generally accepted auditing standards.
- China does not recognize U.S. based, and globally accepted, generally accepted accounting principles (GAAP), making it difficult to understand the financial results reported to the public.
- Chinese laws do not allow for the disclosure of information following GAAP.
- Chinese SOEs are typically majority owned by the government of China. Management decisions are made to serve the government's plans rather than to serve the demands of the markets being served or to act in the best interest of all the shareholders exclusive of the Chinese government.
- Some of the Chinese SOEs trading on American stock exchanges are developing products for the Chinese military. In a perverse irony, the pension funds from the federal government's PERS plan include military and Pentagon employees whose retirement money is being invested in a company owned by the Chinese government who is building technology to battle them.
- Major stock investment indexes are continuing to weigh Chinese SOE stocks heavier and heavier, causing automatic market indexing buys to the peril of the innocent investors and beneficiaries.
- The fiduciaries of some of the largest PERS have conflicting arrangements and relationships with the

Chinese government and weight Chinese SOE stocks higher in their portfolios.

- Pension plan participants in government-sponsored PERS plans have provisions to opt-out of Federal Social Security (FICA) taxes in favor of defined contribution plans that accumulate their funds. When their plan's fiduciaries direct these funds to Chinese SOE stocks, their funds are subjected to extreme risk in which a catastrophic loss would leave them with no personal retirement funds and no social security for their retirement. At a minimum, this would curtail their retirement security.

- To the extent that the U.S. Pension Benefit Guarantee Corporation ensures the assets of pension fundsthat are invested in Chinese stocks, the American taxpayers would have to cover the losses and are exposed to unknown risks.

- With the Chinese government-owned and controlled enterprises trading on U.S. exchanges, the opportunity exists for the Chinese government to execute malign plans to harm the United States by purposely driving market values down using companies they control.

American companies must comply with all U.S. securities laws which render the playing field unevenby setting up a double standard. Ignoring this situation will not improve or change these risk factors andwill compact the risks the average American investor faces.

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CONCLUSION

This is a unique time and the world is currently dealing with a once-in-a-generation crisis caused by the Chinese virus known as COVID19. The effects are exposing all the weaknesses in stock markets, credit, money flows, and international supply chains.

What has been astoundingly in the full view of the world is China's actions to cover-up the virus as a deception to protect their business climate and to use threats of cutting off medical supply chains during a vulnerable time if the United States doesn't act by their instructions. We've also observed as China nationalized the Chinese operations of American company 3M to keep the production of surgical masks in China for their use.

The pattern of lies and deception by China casts a shadow on everything else the government does. In an environment where corporate disclosures are used to determine the value of companies on equity markets, how can any of the information Chinese state-owned enterprises release be trusted?

Left unchecked, the exiting situation in which Chinese SOE stocks are allowed to trade at parity with the rest of the world will cause a "race to the bottom" by either; 1) lowering the security regulation standards of the markets overall as more and more Chinese SOE stocks enter the U.S. markets or assume a larger portion of the markets as their values grow artificially, or 2) crash the markets when the weaknesses in the Chinese governance and transparency fail, which will ultimately happen just as it did with Enron in 2001.

The U.S. stock markets are the largest and most respected in the world because of the quality of the regulatory governance and transparency that surrounds them. It is our responsibility to uphold those strengths and our obligation to ensure that these markets remain strong for the future generations of Americans.

Uniquely challenging times call for strong action;

- The SEC must reverse course and immediately issue new rules requiring any company that does not comply with Sarbanes-Oxley and US securities laws to be delisted from the U.S. stock exchanges within the shorter of 12 months or their next annual reporting time.

- The DOL must issue a risk advisory to pension plan fiduciaries regarding the additional risks related to foreign stocks that are not compliant with U.S securities laws.

- The DOJ should pursue action against PERS plan fiduciaries who have conflicts of interest with the government of China. Such actions will send a signal to warn others.

The current low-value market conditions offer a unique immediate opportunity to address these changes . Announcing a path to the delisting of non-compliant stocks would be shrouded in the market effects of the COVID19 virus. The pension funds that hold Chinese stocks can sell them with a lower impact and the funds can be used to fuel investments in U.S. stocks to provide a stronger market uplift after the virus has subsided.

When the SEC issued Regulation S, the integrated discussion outlined the arguments for and against the

rule. In an ominous notation describing the lack of evidence showing foreign entities trying to exploit the rules in 1999, the SEC stated, "The Commission agrees that absent a showing of abuse, imposing significant new restrictions on the offshore offering practices of foreign companies is not warranted. *However, the Commission will monitor practices in this area, and will revisit the issue if abuses occur*."

In the twenty-one years since this became law, the amount of abuse has risen in a slow crescendo and the time to act is now before the full onslaught of the storm hits U.S. markets and investors.