CHINA'S INFORMATION CONTROL PRACTICES AND THE IMPLICATIONS FOR THE UNITED STATES

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

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WASHINGTON: September 2010

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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CHINA'S INFORMATION CONTROL PRACTICES AND THE IMPLICATIONS FOR THE UNITED STATES

WEDNESDAY, JUNE 30, 2010

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC

The Commission met in Room 124, Dirksen Senate Office Building at 9:01 a.m., Chairman Daniel M. Slane, Vice Chairman Carolyn Bartholomew, and Commissioners Robin Cleveland and Jeffrey L. Fiedler, (Hearing Co-chairs), presiding

OPENING REMARKS OF COMMISSION ROBIN CLEVELAND HEARING COCHAIR

HEARING CO-CHAIR CLEVELAND: Good morning, everyone, and welcome to this year's seventh hearing of the U.S.-China Economic and Security Review Commission.

Today we'll examine China's information control practices and the implications for the United States. Specifically, our panels will address information about U.S. listed Chinese companies, developments in China's "state secret" laws and regulations, and freedom of information on the Internet with emphasis on the search engine Baidu.

Chinese firms increasingly raise capital by listing on U.S. exchanges. This means more than ever that corporate governance standards and the management structure of Chinese companies have direct serious implications for U.S. investors.

There are three areas of concern I hope our witnesses will address today. First, what information is available to U.S. investors about a listed company's management team and practices? There have been a number of thoughtful studies done on the frequency of state

interventions in the daily operations of commercial entities including the placement of political figures in business positions.

I'm interested in whether this influence is fully disclosed and the impact it may have on the viability and profitability of listed enterprises. When political interests trump commercial interests, does the U.S. investor have the right to know?

Second, I hope we will explore the quality and availability of information in U.S. SEC filings about ongoing relationships between listed Chinese enterprises and their parent or partner state-owned enterprises. There are credible reports that the government has restructured more successful and profitable subsidiaries of SOEs in order to list them on international exchanges, and while that may make good business sense and may not present a problem, the question arises as to whether the nature of the ongoing relationship should be disclosed?

SEC filings clarify loans and transactions between the two enterprises, and what's the review process for that relationship? We know all too well from Enron and other cases that off-book loans and internal transactions within a conglomerate represents a dangerous risk for U.S. investors, and just as we've seen an increased effort by the SEC to assure adequate controls and review of U.S. corporate transactions, U.S. investors should have confidence that a parallel effort is in place with regard to foreign enterprises.

Finally, we look forward to hearing our expert witnesses' views about recent changes in Chinese "state secrets" and trade secrets framework. State secrets, as well as trade secrets, are of special interest to the Commission because clear standards and enforcement practices are essential to the free flow of commerce. The market functions best when there is certainty and clarity about the operating rules.

Unfortunately, what is increasingly clear is that the rules are ambiguous. China's concern about state secrecy and national security not only affect the free flow of commerce but also information. So I also look forward to hearing from our witnesses about how these policies are affecting the flow of information and the use of the Internet.

Before we begin, I'd like to extend the Commission's thanks to Congressman Smith who will be joining us later. On logistics, he'll be here at ten, so we'll break at that point, assuming he's here at ten, and yield to his presentation and then return to Mr. Dudek's presentation.

With that, Commissioner Fiedler, I'll turn to you.

OPENING REMARKS OF COMMISSION JEFFREY L. FIEDLER
HEARING COCHAIR

HEARING CO-CHAIR FIEDLER: Thank you. Good morning and thank you for joining us today.

With this hearing, the Commission intends to directly address two important areas of our mandate:

The first is the United States capital markets, the extent of access to and use of United States capital markets by the People's Republic of China, including whether or not existing disclosure and transparency rules are adequate to identify People's Republic of China companies engaged in harmful activities.

Adequate disclosure is absolutely essential to the integrity of our securities markets. U.S. investors must have material information about companies in order to weigh the risks associated with investing in them. But serious questions remain about whether Chinese companies and Chinese state-owned enterprises, particularly, provide adequate and accurate information for U.S. investors to make appropriate decisions.

Monitoring disclosure of U.S. companies is difficult enough. Today, we will explore some of the unique challenges of monitoring Chinese companies.

This hearing will address another element of our mandate: freedom of expression--the implications of restrictions on speech and access of information in the People's Republic of China.

Our final panel of the day will consider the Internet in China, specifically the search engine Baidu. In wake of Google's partial withdrawal from China this year, Baidu has arguably become the most significant arbiter of information available to China's Internet users. That Baidu has extensive American roots makes careful consideration of its activities all the more important.

Finally, as we begin our first panel of the day, I would like to thank the Securities and Exchange Commission for agreeing to allow Mr. Dudek to testify, and we look forward to his testimony.

Mr. Dudek has been Chief of the Office of International Corporate Finance in the Division of Corporation Finance at the U.S. Securities and Exchange Commission since 1993.

He joined that office as an attorney fellow in 1990. Prior to that, he was with the New York Office of Cleary, Gottlieb, Steen & Hamilton, where his practice involved representing a wide range of foreign and U.S. companies and financial intermediaries in capital market transactions.

Mr. Dudek is a graduate of New York University School of Law and Fordham University, and is an adjunct professor of law at Georgetown University School of Law. He has received numerous

awards from the SEC.

Mr. Dudek, as you know, we'll suspend when Congressman Smith arrives, and I would ask you to push talk so that she can record and we can hear you.

Thank you very much, sir.

PANEL I: SECURITY AND EXCHANGE COMISSION PERSPECTIVES

STATEMENT OF MR. PAUL M. DEDEK, CHIEF OFFICE OF INTERNATIONAL CORPORATE FINANCE DIVISION OF CORPORATE FINANCE U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

MR. DUDEK: Sure. It's a pleasure. Good morning, Co-Chairs Cleveland and Fiedler, and members of the Commission.

I'm Paul Dudek. I oversee the office that deals with foreign companies that are listing or selling securities in the U.S. public capital markets. And it's really a true pleasure to be here today since my personal assistance to the U.S.-China Commission staff goes back almost ten years describing the application of the federal securities laws to foreign companies and the SEC's role in administering those laws.

And before I outline the general securities regulatory scheme and how it applies to Chinese companies, I should note that my remarks are my own personal remarks and don't necessarily represent those of the SEC, the individual commissioners, or my colleagues on the SEC staff.

One fundamental purpose of the federal securities laws is to promote investor protection by requiring issuers of securities that are publicly sold in the United States to provide complete and accurate information upon which investors can make informed investment decisions.

Whether a company is domestic or foreign, it must generally file a registration statement, an offering prospectus, with the SEC before it publicly offers and sells securities in the U.S. capital markets. After its offering, the company must comply with ongoing reporting requirements through which it provides periodic information about its business, operations, risks, financial performance and prospects.

Although the filing and disclosure requirements for companies that are registered with the SEC are largely the same for domestic and foreign companies, the SEC has adopted registration and reporting requirements specifically for foreign companies that recognize the potential conflicting and multiple reporting burdens that foreign companies can face when their home country disclosure requirements

differ from SEC disclosure requirements.

For example, instead of requiring foreign companies to file the same quarterly and current reports that U.S. companies file, the SEC requires foreign companies to file the same information that they disclose under their home country or home exchange requirements such as press releases, earnings announcements and interim reports.

Despite these minor accommodations, like domestic companies, foreign companies must provide full and fair disclosure to investors. In providing disclosure, a foreign or domestic company must consider whether based upon the facts or circumstances, a particular fact would be material to a reasonable investor.

Information is material if there is a substantial likelihood that the disclosure would be viewed as important to a reasonable investor and significantly altering the total mix of information available to that investor.

The SEC's Division of Corporation Finance has the primary responsibility for overseeing disclosures by issuers of securities. On average, the Division reviews filings of approximately 4,000 of more than 10,000 public companies that report to the SEC each year.

The purpose of this review function is to monitor and enhance compliance with applicable disclosure and accounting requirements. As required by the Sarbanes-Oxley Act, the Division undertakes some level of review of each reporting company at least once every three years, and it reviews a significant number of companies more frequently than that.

To give you some idea of scale, out of those 10,000 public companies, approximately 950 are foreign companies that make filings with the SEC, and about a dozen of these foreign companies are state-owned enterprises from China.

There are also many other foreign and U.S. companies with substantial operations in China. All of these companies are subject to the Division's review.

The heart of the Division's review of filings is the staff reading through disclosure documents and asking questions and giving comments. It is through this comment process that the Division engages in a dialogue with the company about the financial and nonfinancial information that it presents in annual reports, offering prospectuses and other documents.

While the responsibility for complete and accurate disclosure lies with the company and others involved in the preparation of the company's filings, in its comments, the Division will question disclosure decisions and seek enhanced disclosure where that seems warranted.

To provide complete transparency of its comment process, at the end of a review, the Division makes this back-and-forth correspondence public by posting it to the Commission's Web site through the EDGAR

electronic filing system.

When it comes to investor protection and eliciting appropriate disclosure, the Division staff doesn't treat companies incorporated or having substantial business operations in the People's Republic of China or any other foreign company differently from other companies. All companies must provide full disclosure about their business, the historical results, the prospects they seek, and the risks that they face in the locations in which they operate, including the risks that home country government, economy or business laws might pose.

Through the review program of the Division of Corporation Finance, the staff will ask companies to revise filings when it believes that they have not complied with both the letter and the spirit of the SEC's disclosure requirements.

Thank you, and I look forward to your questions.

[The statement follows:]

Prepared Statement of Mr. Paul M. Dudek, Chief Office of International Corporate Finance, Division of Corporate Finance, U.S. Securities and Exchange Commission, Washington, DC

Chairman Slane, Vice Chairman Bartholomew, and members of the Commission:

My name is Paul Dudek. I am Chief of the Office of International Corporate Finance in the Division of Corporation Finance at the U.S. Securities and Exchange Commission (SEC). The SEC is responsible for administering the U.S. federal securities laws. One fundamental purpose of these laws is to enhance investor protection by requiring issuers of securities that are publicly sold in the United States to provide complete and accurate information upon which investors can make informed investment decisions.

I am pleased to have the opportunity to discuss the SEC's role in overseeing the disclosure of public companies incorporated in, or having substantial business operations in, the People's Republic of China that seek to sell their securities in U.S. public capital markets. Before I outline the general regulatory scheme and how it applies to Chinese companies, I should note that my remarks represent my own views and not necessarily the views of the SEC, the individual Commissioners or my colleagues on the SEC staff.

Whether a company is domestic or foreign, absent an exemption from registration, it must file a registration statement with the SEC before it publicly offers and sells securities in the U.S. capital markets. After its offering, the company must comply with ongoing public reporting requirements through which it provides periodic information about its business, operations, risks, and financial performance and prospects. Although the filing and disclosure requirements for public companies that are registered with the SEC are largely the same for domestic and foreign companies, the SEC has adopted registration and reporting requirements for foreign companies that recognize the potential conflicting and multiple reporting burdens foreign companies can face when their home country disclosure requirements differ from SEC disclosure requirements. Furthermore, instead of requiring foreign companies to file the same quarterly and current reports that domestic companies file, the SEC requires foreign companies to file the same information they are required to disclose under their home country or exchange

requirements, such as press releases, earnings announcements, reports of transactions by insiders, and interim reports. Despite these minor accommodations, like domestic companies, foreign companies must provide full and fair disclosure relating to, among other things, their business, their operations, the risks they face, and their financial performance.

In addition, regardless of whether a company is domestic or foreign, in providing disclosure, it must consider whether, based on the facts and circumstances, a misstatement or omission of a particular fact would be material to a reasonable investor. The Supreme Court has held that information is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. Companies and their representatives have a strong incentive to make appropriate judgments about materiality in that they may face significant federal securities law liability for disclosure that includes material misstatements or omissions that make the information provided materially misleading. Furthermore, although the SEC does not permit companies to omit from their filings material information investors need to make informed decisions, it will consider requests for confidential treatment of other information, such as that which would competitively harm the company, and in turn, its investors, if the information were made public.

The SEC's Division of Corporation Finance has primary responsibility for overseeing disclosures by issuers of securities. On average, the Division reviews the disclosure of approximately 4,000 of the more than 10,000 public companies that file with the SEC each year. The Division conducts a full legal and financial review of nearly every initial registration statement filed with the Commission, whether under the Securities Act of 1933 or Securities Exchange Act of 1934, to monitor and enhance compliance with applicable disclosure and accounting requirements. In addition, the Division selectively reviews other registration statements, business combination transactions, proxy solicitations, and periodic reports. The staff's review presence does not stop there. As required by the Sarbanes-Oxley Act of 2002, the Division undertakes some level of review of each reporting company at least once every third year and it reviews a significant number of companies more frequently. The Division's review of foreign companies is part of its regular and systematic review of every company that files with the SEC.

The Division performs its primary review responsibilities through eleven offices, each of which has specialized industry, accounting and disclosure expertise. The Division assigns companies to one of these offices based on the company's predominate industry focus. This system allows Division's lawyers and accountants to develop industry expertise to better identify issues that are of particular concern to companies within an industry. The other offices of the Division are specialized by function rather than industry to support the Division's review responsibilities. For example, the staff of the Division's Office of Mergers & Acquisitions assists in the review of business combination transactions. Most relevant for this hearing, my own office, the Office of International Corporate Finance, assists in the review of registration statements and reports filed by foreign companies and foreign governments. Staff in my office will participate in the Division's review of an offering document filed by a foreign company and will evaluate the disclosure with a view towards the home country aspects of a particular foreign company. Otherwise, the review of foreign companies is no different than the reviews of domestic companies.

At the heart of the Division's review of filings is the comment process. As part of the review and comment process, the Division issues comments in the form of a letter to a company about the disclosure made in the company's filings and the comments may take into account other relevant publicly available information. The Division does not independently audit a company under review or examine its operations and the reviews do not include interviews with management or site visits.

Through the review and comment process, the Division may ask a company questions about its disclosure or for information to support the company's disclosure decisions. The Division may ask the company to

enhance or clarify certain disclosures, to address inconsistencies within the document or with other publicly available materials, or to revise its disclosure to comply with the specific disclosure standards in the federal securities laws and regulations. Based upon the nature of a company's disclosure and the staff's comments on that disclosure, the staff may ask the company to change or add to disclosure in its publicly filed documents by amending its filings or may ask the company to provide additional disclosure in a future filing.

A company generally responds to a comment letter by providing a written response to the Division and, if appropriate, by amending the document under review. The staff relies on the company's responses to its comments and on the company's legal obligations to respond in a truthful manner. It is important to note that the legal, financial and accounting professionals who are involved in preparing and auditing the company's disclosures have professional obligations and may be subject to legal liability if the disclosures contain material misstatements or omit material information. While a company's response to staff comments will often satisfactorily resolve those comments, the staff will issue additional comments if further explanation or revision is appropriate or required.

When the Division completes its filing review, it will advise the company, by letter, that its review is complete or, if the filing is a registration statement the Division will, at the company's request, declare the registration statement effective, which means that the company is permitted to engage in the transaction covered by that filing and sell the registered securities. The staff will not take this action where it believes the disclosure is not materially complete, accurate, and meaningful. To provide complete transparency about the comment and response process, not less than 45 days after completing a review, the Division makes the filing review correspondence public by posting it to the SEC's Electronic Data Gathering, Analysis, and Retrieval system (EDGAR).

When conducting filing reviews, the Division does not evaluate the merits of a transaction or make any determination as to whether an investment is appropriate for any investor. Rather, the Division focuses on critical financial and non-financial disclosures that appear to conflict with SEC rules or applicable accounting standards or on disclosure that appears to be materially deficient in explanation or clarity. It is very important to note that the Division's review process is not a guarantee that the disclosure is complete and accurate. Responsibility for complete and accurate disclosure lies with the company and others involved in the preparation of the company's filings – those that have full access and knowledge to the full scope of information which the company uses to make its disclosure decisions.

If, at any time during a review, the Division has significant concerns or becomes aware of information that suggests that a company may have violated the securities laws, staff in the Division of Corporation Finance may refer the matter to the SEC's Division of Enforcement. The Division of Enforcement has broad authority to investigate possible violations of the securities laws and may bring actions against a company if information in a filing proves to have been materially false or misleading.

This is the basic structure that governs the Division's review of filings by any domestic or foreign company that seeks to offer and sell publicly its securities in U.S. capital markets. Now that I have given you an overview of the Division's filing review process, I will discuss the topic you are most interested in, filings made by companies incorporated or having substantial business operations in China. As I noted earlier, more than 10,000 companies file annual and other periodic reports with the SEC. Approximately 950 of these companies are incorporated outside the United States, including about a dozen large companies incorporated in China and several dozen smaller companies that are incorporated in a foreign country outside of China (typically in the Cayman Islands) that conduct substantially all of their business operations in China. Some of these companies disclose substantial ownership by the Chinese government.

The Division's review of filings by companies based in China is consistent with its reviews of any other reporting company. Companies based in China are no less responsive to the staff's comments than other companies. Similarly, companies based in China are no less committed to defending their disclosure decisions. In the Division's view, a company based in China is just another company seeking to take advantage of the unsurpassed depth and liquidity of the U.S. markets and the role of the Division is to seek full and complete disclosure in accordance with the SEC's disclosure requirements.

The comments provided to Chinese companies are similar to those the staff gives to other companies, and in all instances, are designed to elicit improved disclosure on a number of matters, including material trends affecting the company's financial results and material risks to the company's business, such as foreign currency fluctuations and seasonality concerns. While risk discussions often address industry specific factors that could apply to any domestic or foreign company, companies from China typically address other factors as well, such as risks associated with state ownership, the increased role of the Chinese government in the Chinese economy, Chinese regulations restricting foreign ownership of a Chinese company in certain industries, and the less developed state of legal principles and the civil law structure governing business in China. As appropriate, the staff will issue comments to elicit better disclosure on the ongoing changes to Chinese business regulations.

In reviewing company disclosure, the Division of Corporation Finance does not generally reach out to the home country regulator for assistance in conducting the review. As I noted earlier, the Division's work is based on the documents filed with the SEC and the staff assesses compliance with the applicable accounting and disclosure rules; the assistance of a foreign regulator is not necessary. However, when the Division of Enforcement conducts an investigation, there can be extensive assistance from a foreign regulator, since the SEC's compulsory processes are not effective in foreign countries. The SEC has information sharing arrangements with many foreign securities regulators, including those in China, which provide a framework for the sharing of information between regulators in their efforts to enforce their own securities laws.

In conclusion, I want to make clear that the U.S. federal securities laws require public companies, or companies seeking to become public companies, to provide full and fair disclosure that is materially complete and accurate so that investors in the U.S. markets can make informed decisions. While the SEC has, to a very limited extent, made certain accommodations in its disclosure requirements for foreign companies, these accommodations are not at the expense of investor protection. When it comes to investor protection and eliciting appropriate disclosure, Division staff does not treat companies incorporated, or having substantial business operations, in the People's Republic of China any differently than other companies – domestic or foreign. These companies must provide full disclosure about their business, their historical results, the prospects they seek, and risks they face in the locations they operate, including the risks the home country government, economy or business laws pose. And through the full disclosure program within the Division of Corporation Finance, the staff will ask companies to do so when it believes that they have not complied with both the letter and spirit of the SEC's disclosure requirements.

Thank you and I look forward to answering any questions you may have.

PANEL I: Discussion, Questions and Answers

HEARING CO-CHAIR FIEDLER: Thank you very much for your testimony.

I'd like to ask the first question, and one of the central issues that

I have and would like to examine is not so much treating Chinese companies differently from any other company, whether it be U.S. or Russian or French, under the law, as much as what are the uniquenesses of circumstances in China that require different disclosure?

For instance, in 2007, McKinsey and Company in their quarterly publication, and McKinsey interviewed John Thornton, on good corporate governance in China. Mr. Thornton is, as you know, chairman of Brookings and a former co-president, I believe, of Goldman Sachs, a professor at Tsinghua University, and on the Board of China Netcom, and he was talking about his role as an independent director on China Netcom, and he said:

We defined specific roles for the Communist Party and left the rest to the board. For example, the Party participates and votes on key matters through nominated directors on the Netcom board, but fewer than half of the board members are Party-designees. We clearly defined the boundaries of Party mandates for senior executive appointments, company strategy development and key investments. We gave authority to nominate and approve the CEO and CFO candidates back to the board--presumably from the Party.

I looked at China Netcom's disclosure going back past 2007, and there are a couple of things I didn't see. First question is, if the board has defined the Party's mandate, is it interesting enough--I don't want to be unfair to you and ask you is it material because that's a legal determination.

I would say to you, is it important enough a matter for the Commission to look at, to wonder if that should be disclosed, in the first instance?

MR. DUDEK: To the extent that there is disclosure about internal board organization, and how the board manages itself, that's getting fairly "nitty" into the disclosure that an investor would see. You would see very general disclosure, for example, in the risk factor section and in sections about who owns the company, that the state owns "x" percent.

And I think for all of the SOEs, it's all, it's above 50 percent; it's either 70 or 60. And that they are able to control the board of directors, and that their interests may differ from the interests of other shareholders because they are a state and they control the company. I don't know if that was what you were getting at or--

HEARING CO-CHAIR FIEDLER: Well, there's the state and the Party. So, for instance, in the disclosure documents for CNOOC, Sinopec, China Petroleum, there's excruciatingly detailed disclosure in the bios of the Party positions of the executives and the directors.

Mr. Thornton, in this case, made reference to key items, their role in senior executive appointments, company strategy and key

investments, and there's no disclosure about the Party relationships in, for instance, China Netcom, as well as a number of other state-owned enterprises.

So do we or not think the role of the Party versus the state is important enough for full disclosure or different treatment? Let me just, I don't, again, don't want to be unfair. Different treatment. Is the Party to be ignored? Because apparently it's not to be ignored at any other level.

MR. DUDEK: I don't think that that's necessarily the case. I mean that is something that I think should be explored. You know, one looks at the line item disclosure requirements for foreign companies which are different from U.S. companies.

But it clearly goes to not only the sort of business and experience with the company, but also the important relationships outside the company should be disclosed as well, and, you know, some companies would be, seem to be disclosing that. Whether that should be done in every case might depend upon the influence of the Party or something else with respect to operation of the company.

HEARING CO-CHAIR FIEDLER: Well, then it gets to the question of, let's just take the China Netcom issue. So, Mr. Thornton discloses it in an interview, and it seems it's important enough to disclose in an interview, but it is not disclosed in the SEC filings. How does the Commission know whether or not the dynamic between the company and the Party is important to disclose in the first instance--right--if the company doesn't disclose it themselves?

MR. DUDEK: We are looking at many information sources. I'm not familiar with that interview, but certainly on an industry basis, we look at analysts' reports, we look at a number of sort of publicly available sources, and the same thing is true with respect to foreign companies.

We, in my office, focus on foreign companies. We have experts who deal with Chinese companies all the time, and sort of, you know, digging down and sort of trying to become familiar with areas where investors should have, you know, better information.

HEARING CO-CHAIR FIEDLER: Thank you very much. My time has expired.

Mr. Wessel.

COMMISSIONER WESSEL: Thank you for being here this morning and thank you for your help in the past, as well, and these are, of course, enormously important issues, and as we all know from turmoil in markets, there's increasing attention on materiality, transparency and other issues.

Let me continue, if I can, with Commissioner Fiedler's questions just to gain some more knowledge of how the SEC looks at this. And

let me also say I'm a director of a public board.. I file or complete roughly a 30-page questionnaire that is required for SEC disclosure purposes, which has rather in-depth questions on everything that goes to director independence, to a number of other things, all the things that I'm sure you're aware of that a public company normally asks for.

But these also go to the questions that Jeff is asking. Do you--in terms of transparency, you mentioned that there were 12 state-owned firms, 950 foreign companies, 12 state-owned firms, and without going into the specifics of any one of those, in your every three-year examination, are you able to go through and look at some of those core documents, like the questionnaire I fill out, to determine whether director independence, which goes, of course, to what committees they can serve on and many other issues--management, non-management, et cetera--how transparent is the Chinese system in terms of SEC oversight?

Do you have confidence that you're able to get at the organic documents to determine whether our investors and other investors have the information they need?

MR. DUDEK: Our review certainly isn't an audit. It is a review. We read the document and we tap into a number of publicly available sources of information. Sometimes we will ask a company to supplementally support its decision. Generally those D&O questionnaires, which in my private practice days I remember preparing, are something that the company uses to fulfill its own disclosure obligations.

It's the company's responsibility together with its advisors, with the help of its advisors, to provide full and fair disclosure, and the SEC reviews and looks for inconsistencies and looks for clarification and looks for enhanced disclosure, but, for example, getting a copy of a D&O questionnaire--

COMMISSIONER WESSEL: Right.

MR. DUDEK: --it's not generally the type of thing that we would do.

COMMISSIONER WESSEL: Unless you had a reason to look deeper?

MR. DUDEK: Yes. Yes.

COMMISSIONER WESSEL: And going again to the Thornton issue, if those kind of publicly available interviews spark any of those kinds of questions, does your staff look deeper, have they looked deeper, in terms of Chinese companies, to look for those inconsistencies?

You know we've had problems, and it's a CFIUS issue, it goes to not only some of our basic securities laws but basic security issues, as to control, as to state-owned enterprises, access to capital, et cetera.

How do we look through this system and determine that our shareholders here, our investors, really have full information?

MR. DUDEK: Yes, and we do that through asking lots of questions and sort of reading documents and trying to become experts. As my testimony describes we're mainly divided by industry groups, and so we have lawyers and accountants and engineers who become very expert, and also sort of on a functional basis internationally or with M&A, in terms of having experts, and so we try to build it up.

In preparing for today's hearing, I looked at the annual reports from a number of Chinese companies and did look at the management information, noted that some had ministry information Party affiliations, and I thought that interesting, said, wow, people were interpreting this.

I haven't done an exhaustive search but going through and seeing what kind of disclosure is provided with respect to companies.

COMMISSIONER WESSEL: And have you been able, therefore, to look at a lateral disclosure? If one Chinese company views its Party affiliations as material are you looking at what the other Chinese companies are doing to determine whether it's sort of a common platform?

MR. DUDEK: That is certainly something that we do, and that is certainly something that we try to do across industries to make sure that there's consistency, and there's always a rising level of disclosure because you get a piece of information from someone, and then you can argue a little better for the same disclosure from another registrant.

COMMISSIONER WESSEL: One quick last question. CD&A and other new post-Sarbanes-Oxley increased disclosure, have the Chinese companies lived up to the SEC's mandates in a timely way?

MR. DUDEK: Yes. With respect to CD&A, which is compensation disclosure and analysis, which was a requirement put in place for U.S. companies the past year or two, foreign companies generally aren't subject to those executive compensation disclosure requirements.

That is an accommodation that dates back years and years. Executive compensation was one of those areas where it was considered too sensitive for sort of foreign companies to sort of provide that information--a lot of European companies and Latin American countries, at the time.

Times have changed and I know, for example, that I think there is more of an international consensus for executive compensation information. The International Organization of Securities Commissions, IOSCO, has a subcommittee that focuses on disclosure, and certainly executive compensation is sort of one of those areas that they're looking at. The OECD, as well, and the Financial Stability Board, are involved

in the global efforts relating to executive compensation.

COMMISSIONER WESSEL: All right. Thank you. If there is another round, please.

MR. DUDEK: Sorry.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR FIEDLER: Mr. Wortzel.

COMMISSIONER WORTZEL: Thank you very much for your help in the past and for today's testimony.

I have two linked questions, and they're really right down the same line as the previous two, maybe a little more direct. Does the SEC ask Chinese companies to disclose the positions that corporate officers and directors hold in the Chinese Communist Party? And do you think such Party positions are material?

MR. DUDEK: With respect to the first question, I did look through the comments that we have raised over the last few years with respect to the SOEs, and that comment has not been raised. I think it's something, when focusing on that disclosure and seeing the differences between companies' disclosure. I find it sort of something that sort of we need to consider as to, is it important in every case or is it only important in some cases?

Materiality is like that. It's sort of a unique determination so I wouldn't want to sit here and say, yes, it always is. The same thing in any country, as to whether you're a Republican or Democrat or Tory or Liberal or Green or something else. Now, understanding that, in the People's Republic of China, the Communist Party is not--

COMMISSIONER WORTZEL: One party state.

MR. DUDEK: --just a Green party. That's right. It's not just another political party, and so that, I think, is sort of something that we need to sort of look at and consider and kind of think about in terms of, full and fair disclosure of management for U.S. investors.

COMMISSIONER WORTZEL: Thank you very much.

HEARING CO-CHAIR FIEDLER: Mr. Shea.

COMMISSIONER SHEA: Thank you very much.

I started out as a corporate lawyer, and one of the things I was told to do is just look at precedent, so you would get the prospectus that was used by the last client and give it to word processing, they'd pump it in, and then you'd just amend it and change it and update it and make it apply to the particular client for which you're working. And that's why I left being a corporate lawyer because I didn't want to spend my life doing that.

But one of our colleagues, Jeff Fiedler, sent around some of the risk factor analysis of some of the large state-owned enterprises that are registered on stock exchanges in the United States, and it seemed, just the language seemed very much like boilerplate, and it seemed like a

tremendous reliance on precedent, just use what the last guy did.

This is following up on a question that Commissioner Wessel asked--how do you negotiate that language?

MR. DUDEK: It's done on a case-by-case basis, and it is something that is not unique, and a lot of issues we sort of talk about here aren't unique to foreign companies or to Chinese companies. The staff continually is in discussions, you could use the word "harangue," the corporate bar reporting companies not to have boilerplate.

Through the years we have focused, for example, on risk factors, making sure that they are meaningful, making sure that they provide relevant information to investors, that they disclose risks, that they don't sort of say, well, here's a problem, but you know it's not really a problem. And so, it is an issue that we continually address with listed companies, be they foreign or domestic. It's not just germane to foreign companies.

COMMISSIONER SHEA: If I may have the liberty. I just read this book, and I would recommend it to you as well. It's called The Party: The Secret World of Chinese Communist Rulers, by Richard McGregor, and it's a lot of reportage. He's a Financial Times reporter, and he talks a lot about the Communist Party influence within state-owned enterprises, and there are a number of examples in here of how the Party would meet before the board would meet, and the Party, whatever the Party decided would be what goes, and the board decisions would be after the fact.

But may I read just a little section here?

MR. DUDEK: Please.

COMMISSIONER SHEA: I think it's very illuminating. It says:

On the desks of the heads of Chinese 50 odd biggest state companies, amid the clutter of computers, family photos and other fixtures of the modern CEO's office life sits a red phone. The executives and their staff who jump to attention when it rings know it as the "red machine," perhaps because to call it a mere phone does not do it justice.

When the "red machine" rings, a senior executive of a state bank told me, you had better make sure you answer it. The "red machine" is like no ordinary phone. Each one has just a four-digit number. It connects only to similar phones with four-digit numbers within the same encrypted system.

For the chairmen and women of the top state companies, who have every modern convenience communications device at their fingertips, the red machine is a sign that they have arrived, not just at the top of the company but in the senior ranks of the Party and the government. The phones are the ultimate status symbol.

And it goes on here. It says:

The red machine gives the Party apparatus a hotline into multiple arms of the state including the government-owned companies that China promotes around the world these days as independent commercial entities."

So I just throw that out. I think that, I know, the decision of whether something is material is a case-by-case situation, but it seems to me that the decision-making of a CEO of a state-owned enterprise could be affected by a phone call from someone at the central committee would be a material.

I don't know if you have any comments on that.

MR. DUDEK: No, other than I do remember, it must have been excerpted in the FT. I do remember hearing about the red phone, I guess, in reading that story.

COMMISSIONER SHEA: Okay. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman, and Mr. Dudek, thank you for being here. In your testimony, you talk about companies even from the Republic of China, and you say, "These companies must provide full disclosure about their business, their historical results, the prospects they seek, and risks they face in the locations they operate, including the risks the home country government, economy, or business laws pose."

So you say you require all of that?

MR. DUDEK: Yes.

COMMISSIONER MULLOY: So I guess the question that I think has been discussed is Chinese Communist Party as something that should be disclosed if they're a state-owned or influenced company. And my understanding is you've said right now you don't require that to be disclosed; is that correct?

MR. DUDEK: There is no with respect to those items that were specifically mentioned in the testimony, there's no line item requirement for that, those. The line item requirement is disclose the risks that the company is subject to, and through practice, through precedent, through discussions there are enumerated risk factors, very often industry specific. U.S. companies have the same competitive position as everyone else.

With respect to foreign companies and Chinese companies, in particular, I know risk factors relating to state ownership and that the state's interest may not be consistent with shareholders' interests, the increased role of the Chinese government in the Chinese economy, you know, it's not a market economy, still very much controlled, and so, you know, prices aren't kind of what you expect.

Questions about the legal principles, the less-developed state of the business law, the civil law structure, that you see there, and so

those are the things that through a course of practice, and, as has been mentioned, sort of course of practice sort of develops, you know. So, maybe this is something where we need to explore.

COMMISSIONER MULLOY: Good.

MR. DUDEK: In terms of, are there, risk factors, are developed over time as does all disclosure, and I think that this is an area, along with other areas, that, you know, the staff is, always on a learning curve and sort of trying to improve disclosure for U.S. investors.

COMMISSIONER MULLOY: Commissioner Shea just quoted from that book by Mr. McGregor. I remember back some years ago when CNOOC Limited was going to make the purchase, I think it was Unocal--wasn't it--yes--my understanding of that, I remember reading a lot about it at the time was that CNOOC Limited decided not to make the bid, and then there was a--and that the board had said that we don't want to make that bid, and then there was a decision, and I think it was influenced by the Party, that they should go ahead and make the bid.

And the American media often covered that as if, as Commissioner Shea just pointed out, that these were private companies operating out there. I personally think McGregor is right, that the Party has an awful lot of influence on these companies, and I think that's something that Americans who are invested in these companies probably would benefit from knowing, but I mean I hope you guys would take that into consideration.

MR. DUDEK: Yes. There's a great deal of disclosure of that, the government is involved that they control these companies, they control the board, you know, it's very clear.

Do you go sort of a layer further, a level sort of beyond that, and, well, the government is really, the Communist Party, if that is the view, that I guess is worth exploring.

COMMISSIONER MULLOY: One of our witnesses is going to come in, Mr. Friedman, I think--he's with Akin Gump. And he says in his testimony, quote:

"Many Chinese companies are also reluctant to disclose that the Chinese government may provide certain incentives or subsidies to companies that engage in emerging technology industries. The government can take these incentives and subsidies away at any time. But Chinese companies will either choose to not disclose that they receive these subsidies so as not to tip off competitors."

Would you think it would be material and should be reported if a Chinese company investing here or seeking registering here is getting subsidies from the Chinese government?

MR. DUDEK: Again, assuming it's material, that would be an important factor because subsidies can lead to, uncompetitive practices, unbalanced competition in the home market, much less in the

international market.

So assuming that they were significant, and subsidies to the extent that they are significant, if they're revenue to the companies would be reported in the audited financial statements. There would be a money stream. To the extent that there is state involvement in the company, if it was one of the SOEs, it could be picked up in disclosure with related party transaction disclosure.

COMMISSIONER MULLOY: Thank you very much.

HEARING CO-CHAIR FIEDLER: Commissioner Videnieks.

COMMISSIONER VIDENIEKS: Good morning.

Could you please walk us through, me particularly, in how the process works? Let's say a disclosure statement is submitted, to whom is it submitted? Several times you mentioned that the Division makes a decision, yet you are one of 11 offices. Maybe you could discuss staffing. Are there teams that review individual disclosure statements? What do these teams consist of? How many people?

You mentioned also in your testimony that, in general, there are like 10,000 submissions and 4,000 are looked at. How would this pertain to foreign submissions, and how is it determined--quantitatively or qualitatively--which disclosure statements are looked at? Randomly? That's a kind of general question. I don't exactly know how you all work.

MR. DUDEK: Yes, I'd be happy to describe. The short answer to how we do our reviews is we read documents filed with us, and then we ask a lot of questions. In terms of sort of how we're organized, mainly by sort of organized into 11 offices that are categorized by industry. So all the drug companies in one office, all the resource companies in another, financial institutions, and on and on.

And those offices are made up of mainly lawyers and accountants, some engineers in the Natural Resources Office. And when a filing comes in, it's assigned to the industry group, and for an initial public offering, it would be assigned to a team of accountants and lawyers, sort of a senior and a junior on each side. And they are charged with reviewing this document from cover to cover and--

COMMISSIONER VIDENIEKS: Four people. It's basically a team of four people roughly?

MR. DUDEK: Yes. And sometimes there's a senior manager involved, but, yes, the team, team of four people, and they read it from cover to cover, and they develop comments.

With respect to specialized offices, mine would get involved in a foreign company. As I said, M&A would get involved if it was a business combination.

And we develop questions, and then we mail them out or fax them to the company or its advisors, and then they respond to us in a formal

response letter saying, here are the questions you have and here is our response to your comments. They just say we have revised the documents in accordance with your comments or they take issue with us saying, you know, you know, we think we have applied this accounting principle correctly, and here's why.

We don't take their objections on face value. They need to demonstrate to us here's the accounting literature, here's the precedent, here are our facts, and we think we got it right.

COMMISSIONER VIDENIEKS: The two acts go back to '33 and '34. The legislation. The regulations you mentioned, line item requirements and so forth. Are those regulatory or statutory?

MR. DUDEK: They are mainly regulatory. Those have been developed by the SEC over the decades based upon the statutes from '33 and '34.

COMMISSIONER VIDENIEKS: How are disputes resolved? Referred up--well, even deviations if they occur? If some action dealing with China would require a deviation from regulations?

MR. DUDEK: It's done when a company is doing an IPO, we have a lot of leverage because essentially we have to clear the document. There's a process called "going effective." It's not an approval, but it is a sort of a vetting and saying, okay, we're done with this, and you know that leverage sort of gives companies an incentive to sort of say yes you want this information, we provide that information.

COMMISSIONER VIDENIEKS: So of the administrative weapons that you have, that would be one of them?

MR. DUDEK: Yes.

COMMISSIONER VIDENIEKS: Are there other such administrative actions that you can take without going to the legal route?

MR. DUDEK: The main way is the comment process, and going through our reviews and the fact that we make our reviews public so this back-and-forth, you know, will be available for sort of all investors to see.

COMMISSIONER VIDENIEKS: Thank you.

MR. DUDEK: Aside from the legal process. I mean eventually if we thought there was fraud we would pursue an enforcement action.

COMMISSIONER VIDENIEKS: One thing I forgot. How do you select which submissions to look at?

MR. DUDEK: Yes. I believe you asked that question.

COMMISSIONER VIDENIEKS: Yes.

MR. DUDEK: One thing is just matter of time. Sarbanes-Oxley requires every company to be looked at every three years especially with respect to their financial statements, and so some of the smaller companies would just be on that cycle.

The larger companies we are, I mean we have publicly stated in accordance with direction from Sarbanes-Oxley, to look at them more frequently. There are some companies that we look at every year. There are some every two years, and it kind of depends upon how big they are.

Just to point it out, sometimes we also sort of focus on a particular area. We talked about CD&A, executive compensation disclosure. We had new rules in place the year before, and so we had a focus of, okay, we're just going to take many, many companies, U.S. companies, and look at their compensation disclosure and kind of see where, you know, if we can give guidance in terms of, you know, improving that disclosure for the next year.

COMMISSIONER VIDENIEKS: Thank you, sir.

HEARING CO-CHAIR FIEDLER: Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thanks very much, and thank you, Mr. Dudek, both for coming here today and for leaving what must have been quite a lucrative practice to work at the SEC and provide some benefit for all the people in this country.

Like Commissioner Wessel, I serve on a board of a publicly traded company, and, in fact, he and I were both out at Stanford last week for their directors' training, so while governance is always on my mind, it is certainly uppermost on my mind right now, and if I could just take you a little bit perhaps outside of your SEC role but within this.

When we look at this "red phone" issue and the whole issue of the role of the Chinese Communist Party in these corporations, probably in most of them, do you think that that provides or that it compromises the independence of the directors?

As directors, we have a fiduciary responsibility to our shareholders, but if I'm on a board, and I'm also a member of the Chinese Communist Party, and that red phone rings, what happens to my fiduciary responsibility to my shareholders?

MR. DUDEK: Well, certainly, your fiduciary responsibility is a matter of local law, and, Chinese corporate law, has these concepts of fiduciary duty, but it's probably not the same as you would find under Delaware law in the United States, focusing on you might see disclosure with respect to what are directors' duties under Chinese corporate law.

The question of independence is a separate one since you have directors who could be insiders, but certainly if you have a director who is claimed by the company to be independent, but there is some sort of relationship there, perhaps they're CEO or CFO of a completely different company, so it's pretty clear they're independent in all ways, but there is this sort of affiliation there, it could raise a question.

One looks at the independence rules that sort of apply in the United States, family relationships, business relationships, questions,

As to whether party affiliation changes that independence analysis I think is a fair question to raise.

VICE CHAIRMAN BARTHOLOMEW: Well, let me take you also--I have to say that reading your testimony, I was quite taken aback and a little uncomfortable about the statement that the SEC requires foreign companies to file the same information they are required to disclose under their home country or exchange requirements rather than having to file what our companies do.

The SEC in some ways really serves as a "Good Housekeeping seal of approval," all of the problems that have happened in the past aside. Do you think that American investors are aware of the fact that there are differing standards for foreign companies that are filing with the SEC and domestic companies that are filing?

MR. DUDEK: I certainly hope so. When you look at an annual report and certainly in offering prospectuses, they often say we are a foreign private issuer a defined term under our rules, and as a result, we are not required to comply with the proxy rules or Section 16 insider reports and other things.

With respect to that statement, it mainly went to periodic reports, those during the year. Once a year annually, a company must provide audited financial statements in accordance with U.S. GAAP or IFRS, audited by, a PCAOB authorized auditor, but it's during the year, so you don't have the quarterly reports and the current reports.

VICE CHAIRMAN BARTHOLOMEW: And as we move towards IFRS, do you see that there may be, or as we don't move toward IFRS, but we'll presume as we move towards it--

MR. DUDEK: Well, that's another hearing.

[Laughter.]

VICE CHAIRMAN BARTHOLOMEW: --do you see that there may be more of a harmonization on filings, too, so that we know that a Chinese company is filing essentially the same kinds of things that an American company would need to be filing?

MR. DUDEK: Certainly the move to IFRS will facilitate our review of disclosure. When we had, before IFRS, we had UK companies under UK GAAP and French companies under French GAAP, and whatever else--Chinese companies under Hong Kong GAAP, and those companies provided a reconciliation, sort of a tie sheet to U.S. GAAP.

We could comment on the U.S. GAAP, but we're not experts on UK GAAP or French GAAP or anything else, but with the move to IFRS, we are building up and have a very good expertise, on IFRS, and as Chinese companies or any other companies file an IFRS, that is an area where we feel we're able to raise comments and also have discussions sort of on a global basis with securities regulators in terms of improving sort of IFRS disclosure.

VICE CHAIRMAN BARTHOLOMEW: All right. Thank you. And if there's a chance for another round, I'll have another question. Thank you very much.

HEARING CO-CHAIR FIEDLER: Chairman Slane.

CHAIRMAN SLANE: Mr. Dudek, thanks for coming this morning.

And my question is, is there anything that you would like to see us recommend to Congress that would help you do your job better? And you may want to think about it, and we're happy to take a letter from you later if you have some after-thoughts, and, specifically, you might consider the areas of enforcement or other areas that might be helpful to you.

MR. DUDEK: Okay. Thank you.

Off the top of my head, our review program, I think, works fairly well. We have very good relations in terms of from an enforcement point of view with the CSRC. In terms of information exchange, we're able to send information requests and get information from them.

So I think the legal framework in terms of sharing of information is available to the SEC, with not only for China but other foreign securities regulators, but that is something that we'll certainly think about and respond to you.

HEARING CO-CHAIR FIEDLER: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: I agree with everybody. Thank you very much for appearing here this morning. Difficult issues.

I've got three questions. The first is how does the SEC view, in light of Enron; the inter-corporate lending between a U.S. listed company and its parent or partner state-owned enterprise?

MR. DUDEK: We don't make any judgments. We make sure that those are disclosed. If there is a loan to a related party either up the chain or down the chain or across the chain, there are two sources of this disclosure.

One is, as I said, our line item requirement, describe material, related to party transactions, and that includes loans, and foreign companies are subject to this disclosure as well. And also there is an accounting requirement both under U.S. GAAP, as well as under IFRS, with respect to related party transactions, and there's a discussion saying we have these transactions with a related party and here's the amount and here's what they are.

Related party transactions also would give rise to filing the actual agreement that is filed. It would be a material contract, and one looks at filings of any companies, including Chinese SOEs, and you'll see the material contracts that they've entered into with their parent company.

HEARING CO-CHAIR CLEVELAND: You've raised the next two questions that I have--what happens if, in that instance, those

agreements or arrangements are not disclosed? What's your recourse? What are your counterpart enforcement arrangements in terms of courts or legal partners in China?

I read with great interest in some of the clips the staff gave us of a mainland company that was listed on the Hong Kong Exchange, and in 2008, it had over $700 million Hong Kong dollars in cash, in 2009, it was declared bankrupt, and Ernst & Whinney was assigned the responsibility for liquidating, and after many, many months basically said the management team had disappeared, the books had disappeared, the cash had disappeared, and the courts in China and their counterpart entities in China were basically unwilling to cooperate.

So if there's that kind of challenge between Hong Kong and the mainland, I guess my question is what hope do we have in terms of follow-on enforcement if, as you say, this requirement to assure full disclosure isn't met?

MR. DUDEK: And certainly as I said, we ask questions, but what if they stop, what if they stonewall, what do you do? We have brought actions against Chinese-based companies, enforcement actions. Those are a completely different league from our review questions.

Those are some formal investigations legal process, and proving to a judge that the securities laws were violated, that there wasn't full and fair disclosure. Generally those don't turn on specific line items. Those are generally based on claims that the materiality standard wasn't met. There was a material omission in a document or there was a material misstatement in a document, and those are those broad anti-fraud claims.

In terms of how we do it, yes, there are challenges. You know, I think our enforcement director, Linda Thomsen, was here a couple of years ago in a different context talking about the sovereign wealth funds, but saying there are challenges to any foreign action, language, time, distance, so there are challenges in the enforcement area. So I won't belittle those.

HEARING CO-CHAIR CLEVELAND: Let me ask one last question. You mentioned the Public Company Accounting Oversight Board which Sarbanes-Oxley established to review auditors. A recent article in CNBC indicated that the PRC has barred PCAOB from examining the auditors of 217 U.S. listed companies. Are you aware of that, and does it cause you any pause?

MR. DUDEK: Yes. We are aware of that. The PCAOB has put on its Web site sort of a list of companies not only in China but other jurisdictions where they say that they are not able to completely fulfill their inspection process, which is what Sarbanes-Oxley requires.

This is something that we are certainly aware of, and we were aware of it before the article the difficulties, and we are in many

discussions sort of with our fellow securities regulators around the world, China, in Europe.

So through a dialogue, we are hoping to reach to satisfy their concerns that need to be addressed privacy laws in Europe are very different from the United States, and so they have concerns in China--I think it's a different concern, but working with our fellow securities regulators in hopes of reaching, you know, some accommodation here so that the PCAOB can fulfill its statutory function, and they can fulfill and uphold their law and their concerns as well.

HEARING CO-CHAIR CLEVELAND: What would happen if we made it a requirement of listing on our stock exchanges that the PCAOB had access?

MR. DUDEK: I suppose you may have withdrawals from companies. We have a fairly sort of open capital market for everyone to come here. It has been claimed that Sarbanes-Oxley has driven foreign companies away.

I'm not sure that that's true. I don't subscribe to that. I think Sarbanes-Oxley has improved our markets dramatically in terms of financial reporting, but there are some who say that you impose requirements, and companies just will leave or--and they won't come in the first place so it could raise barriers, but there is always that concern out there, people who say that you're walling off your market from the global competition.

My colleague from the Office of International Affairs is much more involved with the PCAOB matters. There's a legislative fix for the PCAOB powers to share information. Part of the problem is based on the provisions in Sarbanes-Oxley and what the PCAOB can do with its information. Its ability to share information is not as complete.

So there could be a legislative fix there with respect to sharing of information that the PCAOB obtains in connection with its inspection reports.

HEARING CO-CHAIR CLEVELAND: Thank you very much.

HEARING CO-CHAIR FIEDLER: Our second round will start with Commissioner Wessel who must leave.

COMMISSIONER WESSEL: Thank you, Mr. Chairman.

I'd like to ask some questions about lateral information, if you will, and you just raised a little bit of that, but let's take an issue where there is a major state-owned enterprise in China that engages in dumping or is subject to our countervailing duties laws because of subsidies. They're found under our laws to have violated the internationally prescribed rules and norms, et cetera.

They didn't list those subsidies on their disclosure. They didn't view it as material. They didn't put on an 8-K or anything on any of the reports. What happens then? Are they only sanctioned under our

antidumping and countervailing duty laws or--because in many ways this could be a huge amount, oil country tubular goods or any of the other issues--does the SEC then go back in and look at the disclosure of those companies and say this was a material event that should have been disclosed?

Has that happened in any case? That would also be Section 482 of the tax laws that relates to transfer pricing. The things that you would want or an investor would want to know about in terms of exposure, that when they're found guilty under our laws, does the SEC then go back and look at an enforcement action to have, if you will, some cross fertilization of our efforts?

MR. DUDEK: Yes. I think in the first instance, in that case, it would be the company and its auditors saying, okay were our financial statements sort of wrong in terms of how we characterize income, how we can characterize some expense that was found to be characterized in a different way by whatever trade tribunal might be out there?

COMMISSIONER WESSEL: I'm sorry. Let me just stop you there. Let's say the Department of Commerce, and we go to the ITC, they impose a countervailing duty law. The administration does because it finds a violation. Do you go back and say what were the disclosures? Obviously, it was material for many of these cases because they're huge amounts, billions of dollars at stake.

Rather than the Chinese firm going and saying, yeah, we should have done something, do you take that legal matter here and then go back and review it?

MR. DUDEK: That would be something that if the company came up for review or of the staff said, gee here is something that we would, look at and say, you know, we should look at their disclosure. Say, okay, what have they said about this in the past? What have they said about their sales practices? What have they said about something else?

And then we don't make findings. We ask questions. We would say why haven't you done this; shouldn't you have done that? And the company would respond, do they need to revise their disclosure? If it were significant enough, it would be an enforcement case.

We may say, when you filed your annual report, a year ago or two years ago, you know, you said this, but there has been a finding that you were actually dumping and you didn't provide the correct information to investors. So that is certainly sort of something, we look at market developments out there judicial cases, and, apply them.

COMMISSIONER WESSEL: So are there situations where we have AD/CVD decisions coming out on monthly, sometimes daily, basis, and certainly have over the last years. Have you cross-checked those against the companies? Is that a regular activity of your division?

MR. DUDEK: Off the top of my head, I don't know. I don't

believe it is. But that would be something that we could, if there is a data source out there that we should be looking at, we could certainly do that.

COMMISSIONER WESSEL: Okay. Thank you. I see the Congressman has arrived. Thank you.

[**PANEL I to be continued]**

PANEL II: CONGRESSIONAL PERSPECTIVES

HEARING CO-CHAIR CLEVELAND: Congressman, welcome. Would you join us? Good morning. It's nice to see you again.

MR. SMITH: Thank you. Good to see you again. Thanks for inviting me.

HEARING CO-CHAIR CLEVELAND: Congressman Smith has represented the Fourth Congressional District of New Jersey since 1981, as I recall, elected when you were 27. That's not in my notes so that's good memory.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Just a mere few years ago. During his time in office, he has been a leading advocate of human rights issues in China and around the world. Congressman Smith is the Ranking Member of the House Foreign Affairs Subcommittee on Africa and Global Health and a member of the Congressional Executive Commission on China.

He's the author of many pieces of legislation, but of most importance in my mind is the landmark Victims of Trafficking and Violence Protection law of 2000, the nation's first law that deals specifically with human trafficking.

Today, our distinguished guest is continuing the fight against the policies of repressive governments. The Congressman was outspoken in support of Google's decision to stop censoring its Chinese search engine, and he's the lead sponsor of the Global Online Freedom Act, which will prevent governments like China and Iran from using Internet and information technologies purchased from U.S. companies against their citizens.

Congressman Smith, it's an honor to have you with us, and we look forward to your testimony.

STATEMENT OF CHRIS SMITH, A U.S. REPRESENTATIVE FROM THE STATE OF NEW JERSEY

MR. SMITH: Thank you so much, and I want to thank the Commission for the invitation to be here. This is an extraordinary opportunity, and thank you for focusing on this very important human rights issue.

I'd like to concentrate my testimony on the control of the Internet, since the Chinese government more than any other has developed and deployed the methods and technologies that it and other governments use to transform the Internet into a tool for surveillance and censorship.

In the world of Internet repression, the Great Firewall of China sets the standard for worst practices. Reporters Without Borders documents that in China alone at least 72 people are imprisoned for Internet postings. The Chinese government's injustice to these people and their sufferings is only the tip of an enormous iceberg.

The Chinese government subjects an uncountable number of people to Internet-related human rights violations, from Falun Gong practitioners tracked down through the Internet and, once found, subject to unspeakable abuse, to Tibetans and Uyghurs denied all Internet access for extended periods, to democratic reformers intimidated and stifled, to religious believers unable to express their faith and communicate with others freely.

In the end, the victims of Chinese government's information control practices include the entire Chinese people--denied access to information and ideas, denied their right to free expression, spied on, maliciously spied on by their own government, and self-censoring in an intentionally created atmosphere of fear.

Even beyond this, the Chinese government's victims include many peoples in other countries tyrannized over by governments with which the Chinese government shares its technologies and techniques of repression. There are solid reports that these include Cuba, Vietnam, Burma, Belarus and Sri Lanka, and almost certainly there are other victim countries as well.

The implications of this for the United States are grave. The Chinese government coerces U.S. IT companies doing business in China to participate in its Internet repression. This has been notorious, and we highlighted that in a hearing in 2006, which I chaired, which we called "The Internet in China: A Tool of Freedom or Repression?" Sadly, it is a tool of repression.

The hearing responded to Yahoo's cooperation with Chinese Internet police in the tracking down of journalist Shi Tao, who is still serving a ten-year prison term for disclosing so-called "state secrets,"

that is e-mailing, to the U.S., a Chinese government order not to report on the 15th anniversary of Tiananmen Square. He sent that to a group in New York.

Google, Yahoo, Microsoft and Cisco, among others, testified at that hearing, which broke new ground on the issue of Internet freedom. At that hearing, the world learned the extent to which some of America's most prestigious companies were cooperating with the Chinese government in gross human rights violations.

This has implications for all of us. U.S. companies and U.S. citizens are involved in the Chinese government's human rights violations, however unwittingly, in denying people their freedom of expression, and this can only degrade the standards of American businesses.

If this isn't changed, and I believe our government has a responsibility to protect and promote freedom of expression, it will eventually affect the kind of country we live in. If we accept these business practices as normal, we'll become desensitized, shrug our shoulders at violations of a basic right, freedom of expression, that has always been a hallmark of who we are as a people.

I also want to point out that the Chinese government's Internet repression threatens our own freedom in a more direct way. For many countries in Asia and Africa, China has become the new model. People throughout Asia and Africa admire China's economic growth, but their dictators also admire and are setting out to imitate the Chinese government's ability to combine growth with one-party control.

China is actively promoting its system among these governments, including its system of Internet repression. Since 2006, the technology of Internet repression has grown more sophisticated and freedom of expression is in retreat. This is a long-term threat to our own freedoms.

We have also learned some positive lessons since 2006. We have seen that many U.S. IT companies really want to do the right thing. Google's transformation has been remarkable. Since 2006, I have been meeting with Google's executives, and its statement in January that it's no longer willing to continue censoring results of Chinese search engines was remarkable and thrilling--especially thrilling to the hearts of millions of Chinese human rights activists and political and religious dissidents.

Despite what some critics have said, Google's decision this week to stop automatically redirecting Google.cn searches to google.com.hk, but to require that users now click a link to continue to google.com.hk, in my opinion, does not diminish what the company has done. Google never promised to automatically redirect any searches, but said it would not continue censoring.

Google has not had enough support, I am sorry to say, from our

own government, and that is unfortunate. And I think most of us expect that it will be pushed out by the Chinese government although that probably will be done gradually.

Difficulties in China make it clearer than ever that, however well-intentioned, American IT companies are not powerful enough to stand up to the repressive governments, especially the Chinese government.

The Global Online Freedom Act is legislation that I've introduced, and I thank you for mentioning the Trafficking Victims Protection Act because we took the lessons learned from the TVPA of 2000, and Frank Wolf's International Religious Freedom Act of 1998, in crafting the Global Online Freedom Act, establishing an office that would be wholly dedicated to working IT issues.

Each year, just like those two previous laws, there would be a designation as to what countries are Internet Restricting Countries, and hopefully our government would then work robustly to try to overcome that, to work with them to try to change that kind of behavior. There would be a "naming and shaming" of repressive countries with regards to their restrictions of the Internet.

U.S. IT companies would also have to store personally identifying information outside of Internet restricting countries so that repressive governments would not be able to get their hands on it so as to track dissidents.

U.S. IT companies--let me say parenthetically that Yahoo, and I've met with them continually--I'm not the only one--when they moved into Vietnam, learned that lesion and put personally identifiable information for their e-mails outside the reach of the government. Vietnam is also almost like China, and has used the Internet to find, apprehend, incarcerate and then torture dissidents. I've met with, in Hanoi, several of those people who have been so repressed, especially their loved ones, in one case, the wife of Dr. Pham Son.

So, thankfully, even without legislation, some good things are happening, but I do believe we need to move on this legislation.

This legislation is backed by Google itself, which we're glad to see, Reporters Without Borders, Amnesty International, the Laogai Research Foundation--which you know a little something about, Mr. Chairman--Human Rights Watch, Committee to Protect Journalists, International Campaign for Tibet, and many, many others.

In the last Congress, it was passed by three committees. Unfortunately, it was never brought to the floor. There was an active lobbying situation against it, or effort, but my hope is, just like the Foreign Corrupt Practices Act, there will be a realization that this is a very pro-business approach. This sets parameters, minimum standards, if you will, on what is expected of our IT companies. And I do think if we pass this, and the sooner, the better--they will be able to do business

without the taint of enabling dictatorships around the world.

Thank you.

Panel II: Discussion, Questions and Answers

HEARING CO-CHAIR FIEDLER: Thank you, Mr. Congressman.

Can I ask a quick question?

MR. SMITH: Sure.

HEARING CO-CHAIR FIEDLER: I know you have to run, too. Later this afternoon, we're going to be discussing Baidu, and in looking at Baidu, while there may be many Chinese who operate Baidu on a day-to-day basis, and they're located in Beijing, much of the money behind Baidu is American money.

Huge profits, hundreds of millions of dollars made off of this; Americans on the board of a company that continues to censor. What are your views of the responsibility of American citizen businessmen being complicit in such censorship?

MR. SMITH: I think, first and foremost, they have to be made aware, those who are buying the stock, those who list the stock for sale here. I remember when we tried to de-list certain Chinese companies because of their complicity in Sudan and the killing fields of the Bashir government--and that legislation went through my committee--it ran into a brick wall. We were unable to go that extra step.

But I do think that both those who own the stock and those who are on the board need to, one, realize they're aiding and abetting a dictatorship that is so unbelievably lethal to its own people. You know, as we all know, the laogai is filled to overflowing with political prisoners, with those who are trying to form labor unions, women who fight against the one-child-per-couple forced abortion policy. It is very comprehensive repression, and Baidu is now very much a part of that, as, you know, having been birthed, in a way, by Google.

But it's never too late because the next generation of repressive tools are always just around the corner, and you can put a tourniquet on that kind of aiding and abetting at some point.

So I would hope that, you know, hearings like this, work that you do, work that hopefully we do in Congress, hopefully if we get Global Online Freedom Act enacted, will finally, at long last, say, let's end this because it does put, as I said, our own freedoms at grave risk, but above all, it puts some of the best and the bravest and the brightest in China, in Belarus--I met with, for example, I was Minsk last year, right around this time--several of us--and I'm the author of the Belarus Democracy Act, and Lukashenko was apoplectic about that legislation. He has now learned the lessons from China. There are reports that Chinese advisors are helping him and his secret police, which is

reminiscent of the Securitate in Romania, and, you know, he's got a very horrible and lethal secret police. Torture is endemic if you're arrested. And they're using the Internet, and they're borrowing all of the ideas from those who perfected them, and that's the Chinese cyber police.

And the same goes for other countries obviously around the world. So the bad infection is being replicated, and we need to let our IT companies know that the intermediate and long term for them is bad, but they're putting people in prison.

I remember in one of our follow-up hearings, chaired by the great chairman Tom Lantos, we had Jerry Yang sitting right behind Shi Tao's mother, and believe me Tom minced no words in saying, Mr. Yang, please look behind you at this mother whose son is spending ten years in prison. And they did work out a deal, as you know, with Harry Wu to try to at least help some of the suffering, left-behind family members, but that doesn't change the fact that he remains incarcerated, probably is being tortured.

Manfred Nowak made it very clear--the U.N. Special Rapporteur on Torture--that if you're arrested, especially for a political crime, if you're a Falun Gong, Tibetan Buddhist, or underground Catholic or Christian, or a person trying to create a political or a labor union in China, and there are many on the front line on that, or a democracy advocate, you will be tortured. And in the case of the Falun Gong, there's a percentage of everyone who is tortured in that group that dies as a result of torture.

And the Internet--you know, at the opening of my hearing, and I would encourage members of the panel and the Commission to read--there's a book called *IBM and the Holocaust*.

HEARING CO-CHAIR FIEDLER: I've read it.

MR. SMITH: A very well documented book, and it talks about how the IBM back then enabled the Gestapo always to have that list of where the Jews were. We're doing it now. You open up an e-mail account, and you get everyone they've spoken to, all the back and forth, and you just get your list, and you go and arrest those people next.

HEARING CO-CHAIR FIEDLER: Thank you very much, sir, and it's good to see you again.

MR. SMITH: Good to see you too, chair.

HEARING CO-CHAIR CLEVELAND: Thank you. Any more questions? Go ahead.

VICE CHAIRMAN BARTHOLOMEW: Congressman Smith, thank you for your leadership on all of these issues over the years. I, like Robin, have known of your work and have worked with you over the years and would like to say thank you particularly on Human Trafficking. I actually sit on the board of the Polaris Project--

MR. SMITH: Great.

VICE CHAIRMAN BARTHOLOMEW: --which works very closely with your office on trafficking, but just a question on these Internet issues.

As China is exporting some of its tactics, do you have some sense of how much of the hardware and the software that they use and that they are exporting, along with the lessons that they've learned, originated here in the United States?

MR. SMITH: I don't have a percentage on that. Harry Wu has provided us with information, as have members of the Falun Gong, who can pierce the firewall. They have some very excellent technologies. But it would seem that there's such a critical mass of knowledge, started here, but it has been perfected there as well. And it just keeps building on itself which is why ongoing complicity means that they're ahead of the curve rather than behind it, and so it's hard to say.

I don't have a percent, but I would say, seeing is believing. When Frank Wolf and I went right before the Olympics for a visit to raise, we brought a list of 732 political prisoners. We raised all the human rights issues. We also raised, obviously, their suppression of people via the Internet.

We went to a cyber cafe, and I typed in all kinds of things and block, block, block. I typed in my own Web site. That was blocked. Frank's Web site was blocked. Radio Free Asia was blocked. Everything about the Dalai Lama was blocked. Torture--that wasn't blocked. It went right back to what the Chinese, the Japanese did to the Chinese, which was horrific, during World War II, and to Guantanamo.

You know what it was like--you get scads of information in that regard, nothing about what they do on an everyday basis. And I even did Manfred Nowak, and I got his Guantanamo report in China but nothing about his report on the PRC.

VICE CHAIRMAN BARTHOLOMEW: And is your office working with the Global Network Initiative?

MR. SMITH: We are.

VICE CHAIRMAN BARTHOLOMEW: Do you have any sense how they're doing?

MR. SMITH: I think it's well-intentioned, but I think they need the tools that only Congress can craft. You know that very organization was announced pretty much as we were holding our first hearing, and that was good, but for me, it was kind of like a déjà vu.

When I did the Trafficking Victims Protection Act in 2000, and it took two years to get that enacted, as soon as we introduced the bill and started having the hearings, there was an organization. It was an interagency group, and they did wonderful work, but that was not in lieu of the legislation and the real significant protections it provides to the IT companies, provides to, obviously, those that we want to help in the

end, and that would be the human rights activists and everyday persons in China.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

MR. SMITH: Thank you.

HEARING CO-CHAIR FIEDLER: Thank you very much.

MR. SMITH: Thank you. I appreciate the opportunity to be here and thank you so much.

HEARING CO-CHAIR FIEDLER: Good to see you.

We will resume the questions and answers with Mr. Dudek. Commissioner Wessel.

PANEL I: CONTINUATION

COMMISSIONER WESSEL: Just to complete the questioning--and thank you, Mr. Dudek--for a U.S. company that is engaged in activities, and I understand you're looking more at the foreign companies, but most companies here when they look at investments, whether it's China or anywhere else, they're going to do either IRR, ROI, or some other computation of whether the investment is going to have a fair return to it.

All that information, you know, again, is part of a corporate long-term--the minutes, et cetera, et cetera. Do you look at any of that or do your colleagues look at any of that to determine as we look at the competitive posture of the U.S. and how that affects the shareholder ultimately in terms of investment returns, et cetera? Have you looked at any of that as part of your enforcement actions?

MR. DUDEK: In terms of--

COMMISSIONER WESSEL: And again, it may be one of the other divisions, but for a U.S. multinational corporation that is investing overseas, when it makes those investments, it's going to do some calculation as to whether it's going to yield a proper return, you know, on their capital, return on capital. Is that something that the SEC will look at to determine whether, in fact, the shareholder's interests are being properly disclosed? Does the shareholder have access to that information to determine whether their interests are being fulfilled?

MR. DUDEK: Yes , I don't think that we would be looking at that. One, we're not merit regulators.

COMMISSIONER WESSEL: Right.

MR. DUDEK: We provide information or we help assure that companies provide information to investors so that they could do those analyses. Return on investment, that is looked at that in any number of ways, and, you know, sort of draw information, you know, from a company's financial statements, but that's for investors--if that's what

your question is.

COMMISSIONER WESSEL: Yes. So the ability of an investor to determine whether their company is in fact using their funds appropriately, that I assume would be material and something that an investor would want to be able to have access to, and from the SEC's transparency, you know, flowing back to the '34 Act, shouldn't a shareholder have access to that off-the-balance sheet disaggregated in some way?

MR. DUDEK: I think if it were significant enough. If a company has significant investments, and there's a definition for this.

COMMISSIONER WESSEL: Understand.

MR. DUDEK: A U.S. company would, in fact, include audited financial statements of an affiliated entity if it was significant at a certain percentage--20 percent, ten percent, 20 percent, 30 percent. So that information could be available in the right situation.

COMMISSIONER WESSEL: And the SEC would, without judging a specific transaction, where it is significant, the SEC would want the investor to have that information?

MR. DUDEK: Yes.

COMMISSIONER WESSEL: Okay.

MR. DUDEK: Yes, that's a material to investment decision.

COMMISSIONER WESSEL: Okay. Thank you.

HEARING CO-CHAIR FIEDLER: Thank you.

Mr. Wortzel.

COMMISSIONER WORTZEL: Thank you again.

Commissioner Mulloy and I were handing your testimony back and forth, and then as I listened to it, the concept of materiality is a very important one. Yet, even in your testimony, I mean you say that the concept of materiality eludes precise definition. It's really sort of an ephemeral concept.

Can you suggest ways to better define materiality? Could Congress help with that? Can we make suggestions as we go along so that it becomes a more cogent concept to which you as an organization can react?

MR. DUDEK: I think this concept of materiality is key and it underpins as we've been talking about all disclosure. Materiality and difficult judgments of materiality aren't unique to Chinese companies or foreign companies. U.S. companies deal with these questions everyday.

And there is no bright line test. There are practitioners out there who would love a bright line test--yes, it's five percent of assets; yes, it's ten percent of revenues. The difficulty of that is that it's 9.5 percent, well, then you say, well, I don't disclose it. You sort of go with a free heart.

And having a flexible concept without bright lines, I think has

served investors well. I think it has served the capital markets well because it's something that evolves, and I think it's clear so there's not only a quantitative aspect to it you sort of say, okay, yes, this is six percent of revenues, so kind of almost prima facie maybe, but there's also the sort of this qualitative sort of information, where it's not just numbers on a balance sheet or income statement. You think what is the effect of this transaction on a company? What does it mean in the market? What does it mean perhaps to its competitors? What does it mean to the company at large?

So I think having this materiality concept, which is court-defined--the Supreme Court has addressed this saying it's an objective standard, reasonable investor--I think it has served the investors well. I think it's served the US capital markets very well.

COMMISSIONER WORTZEL: We explored this once one or two years ago in a hearing with the idea that, let's just take two percent, which generally is not a material interest, but suppose six separate Chinese companies each of which has some connections as we've established to the Chinese Communist Party and then government, each buy two percent of a major American defense contractor. Now suddenly you have the ability of some entity of the Chinese Communist Party or government to control 12 percent of an American company. Then it becomes material; doesn't it?

MR. DUDEK: That does. Just for that example with respect to ownership positions of companies we have a concept of group, is there some sort of, understanding, arrangement, whether, oral or written, with respect to, sort of purchases, and so I think there, you know, would say, or, explore, okay, is a group formed and do they own more than five percent of a U.S. listed company?

COMMISSIONER WORTZEL: So that probably applies domestically to family interests, things like that?

MR. DUDEK: Yes.

COMMISSIONER WORTZEL: Have you ever tried to apply that group concept to groups of Chinese companies?

MR. DUDEK: I don't know whether that's there. You know that would be something--it is interesting--I'll just note, from the role of the Chinese government. We receive, sometimes information from companies. They know but they don't know who their shareholders are because of the way shares are held, and, if they believe that there's a group out there, they'll bring it to our attention.

They'll say, gee, we think this hedge fund or this private equity fund or this vulture fund has bought our securities and we don't see the filing; we think you should pursue it.

And, that might be something that, we pursue. So it's something people bring to our attention every day, and we try to look into that.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Shea.

COMMISSIONER SHEA: Again, I want to add my voice to everyone who has thanked you for being here and for what you do at the SEC.

As you know, the Chinese government has a "state secrets" law, and we're going to have a panel on this subject later this afternoon. It recently amended that statute. The State Assets Supervision and Administration Commission, which oversees the SOEs, Chinese SOEs, recently enacted a trade secrets law, which has been described as vague and extremely broad, but that was more recently in March of this year.

I was just wondering has the Chinese trade secret law or the Chinese "state secret" law or the trade secret concept under SASAC ever been invoked by the lawyers that represent the Chinese companies seeking to list in the United States? Have they ever said we can't disclose that because it's a state secret or a trade secret? Is this something on your radar screen at all?

MR. DUDEK: It would be on our radar screen if someone raised that as an issue. I'm not aware of it having been raised as a defense saying we can't disclose this. I'll offer a comment: disclosure, and what we've been talking about are the heart and soul of the capital markets here, and I think a Chinese company or any foreign company or U.S. company that comes to the capital markets does so with a hopefully mind-set that, yes, I'm going to be providing full and fair disclosure, forever, as long as I'm in the market.

I'm not quite sure as sort of what the "state secrets" act gets to, but, there is extensive disclosure in filings with the SEC. Anything could be a state secret; resource companies provide extensive information about reserves. Telecom companies provide extensive information about customers and capacity, and so do power supply companies; that is all disclosed, and I don't think from a standpoint of U.S. investors, that you could say this is state secret. You're taking advantage of the markets; they need to provide the disclosure that's required.

COMMISSIONER SHEA: Okay. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Mr. Dudek, thank you again being here.

Despite having served on the staff of the Senate Banking Committee for many years, I never got into the securities. That was in the securities subcommittee. So this is tremendous, the education you're giving us here this morning.

I wanted to follow up on two issues: one raised by Commissioner Cleveland with regard to the PCAOB. My understanding, that was

created by Sarbanes-Oxley, and was it because that the American accounting--it was someone to oversee the accounting industry in this country?

MR. DUDEK: Yes, yes.

COMMISSIONER MULLOY: And to make sure that they were getting accurate accounting when companies file with the SEC?

MR. DUDEK: Yes, the PCAOB. What was in existence before was a self-regulatory structure, the AICPA. American Institute of Certified Public Accountants had their own peer reviews so you had the Big Five or whatever they were at the time.

They would review each other's work in terms of quality control, and after the Enron scandal, it was determined that peer review was not working, and that you needed an independent organization which would, one, register accounting firms and show that you're qualified and that does inspections.

So they sort of go in, almost like a bank examiner, and say, okay, you were supposed to audit you audited this company let's see your books and records. How did you carry out the auditing standards? And how did you apply accounting principles?

So the PCAOB is on the ground, sort of independent organization, that oversees U.S. accounting firms.

COMMISSIONER MULLOY: Commissioner Cleveland, I think, asked about companies from China that want to register, public companies, with the SEC.

MR. DUDEK: Yes.

COMMISSIONER MULLOY: Does the PCAOB look at the accounting of those companies in China?

MR. DUDEK: It is supposed to have the authority that any company that is traded in our markets has to be audited by an audit firm that is registered with the PCAOB. So, the accounting firms that sign the audit, based in Beijing or Hong Kong, are registered with the PCAOB, and they are subject to inspection by the PCAOB.

And again that inspection involves looking at audit papers on-the-ground, and it's that question, being on the ground and doing that inspection that has led to a dispute in terms of access to those records.

COMMISSIONER MULLOY: If the PCAOB is unhappy with what they're getting from China, who do they complain to? To you, to the SEC? And would that make a difference on whether you permitted the company to register?

MR. DUDEK: Yes. We oversee the PCAOB, and it is handled, at the moment through disclosure. The PCAOB has a list saying these are areas, these are countries where there have been difficulties of obtaining information for these reasons. So at the moment there is no bar to companies from any country with respect to registering in the U.S.

markets.

COMMISSIONER MULLOY: Okay. A second quick question. The CFIUS process, Commissioner Wessel mentioned the CFIUS process. When I was in the Antitrust Division, we looked at foreign acquisitions of U.S. companies mainly related to the antitrust laws. Does the SEC review foreign acquisitions of U.S. companies?

MR. DUDEK: Only if it involves a solicitation of U.S. shareholders. To the extent you're asking shareholders to vote on a particular transaction, then it would go through our disclosure review process. To the extent they're receiving shares of a foreign company, it would go through our disclosure review process.

COMMISSIONER MULLOY: Do you sit on--does SEC sit on the CFIUS?

MR. DUDEK: No, the SEC is not part of CFIUS.

COMMISSIONER MULLOY: Okay. Thank you very much.

MR. DUDEK: Sure.

HEARING CO-CHAIR FIEDLER: Just two more--Commissioner Bartholomew, and I have one.

VICE CHAIRMAN BARTHOLOMEW: Thanks again.

To get back to this issue of disclosure, you know, Commissioner Shea mentioned state secrets, the withholding of basic economic data as a potential state secret. We know that there have been instances--it's still unclear to me exactly what happened in the Rio Tinto case--but that information can be withheld for any number of reasons including a negotiating advantage, and we also know that Chinese local and provincial governments have incentives to fudge their numbers because there are government targets that they need to meet.

And I guess what I'm wondering is with state-owned and state-controlled enterprises, which are part of the economic growth and the economic development plan and the economic development strategy that the Chinese government puts together, can we trust the numbers that they report on their disclosures? Can we trust the numbers that they're using?

MR. DUDEK: Yes, I would hope so but they are subject to the same sort of audit process that U.S. companies or other foreign companies that are here, and it is a fairly rigorous process. If you speak with an auditor in terms of how do you show that those numbers on the income statement and balance sheet and extensive footnote disclosure that gets into details of how a company operates, auditors undertake audit procedures for that information and go through to verify that information.

They do an audit, and they do verify, and they do have procedures. It's not what the SEC does, but that's what the independent auditors are supposed to be out there doing.

VICE CHAIRMAN BARTHOLOMEW: It is what they're supposed to be doing, Mr. Dudek, and I don't want to cast dispersions on any companies, but we've seen, over the course of the past ten years, that auditing firms have fallen down on their job over certain circumstances, and what I wonder and what I question is whether if it's--what is it--we no longer have a Big Five. It's down to a Big Three or Big Two?

MR. DUDEK: Big Four. No. Big Four. Big Four still.

VICE CHAIRMAN BARTHOLOMEW: Big Four. Okay. A Big Four. A number of them, of course, are interested in getting their foot firmly in the Chinese market like a lot of other companies are--whether there is pressure applied on the auditors to go along with some things or not? I mean do you think that we can trust, as people are trying to expand their own business operations in China, that independent audits are indeed independent?

MR. DUDEK: Yes. We, the law and the Commission's rules sort of try to set up a framework for independence so that you're only focusing on the audit. There were certainly concerns before Sarbanes-Oxley that you'd have a large accounting firm that was receiving an income stream on software consulting and so, they would look the other way on the audit.

You're talking about an incentive to do more audit business. That's a keen question. I mean, hopefully, which is why the oversight by the PCAOB is so important because they oversee the accountants, as you say, making sure they do their jobs.

We have seen with Enron, WorldCom, you know, what gave rise to Sarbanes-Oxley, the importance of having a firm, robust financial reporting infrastructure for listed companies in the United States.

VICE CHAIRMAN BARTHOLOMEW: All right. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Videnieks, you had a quick question?

COMMISSIONER VIDENIEKS: Mr. Dudek, you mentioned that you are not a regulatory agency. I seem to have heard that. And yet you do review disclosure statements. Do you approve them? By taking certain actions is, in effect, approval taking place? You have certain line items, format, etc..

MR. DUDEK: Yes. We, the SEC, is a regulatory agency. We regulate broker dealers in the U.S. capital markets and issuer disclosure. We don't do, merit reviews. We don't say a company is good enough. We don't say it's worthy. We don't say it's a good investment or bad investment.

We, back in the SEC's early days tried to make it fairly clear that the SEC vetting process was not an approval. If you look at an IPO prospectus, it says the SEC has not approved the offering or the disclosure in this document. We have the document for a short period

of time compared to the amount of time that goes into the preparation of it.

We don't interview management. We look at the document that's given to us and use publicly available information in order to do our work.

You asked one thing about staff reviews, and I did want to say one thing. What the SEC brings to the table is our experience because, you look at the accountants and lawyers who issue comments. They, look at numerous filings that's their bread and butter everyday, they come into the office looking at a 10-K annual report, an IPO prospectus, and they know their industries incredibly well.

So over the course of a few years they become very experienced in risk factors and accounting problems.

COMMISSIONER VIDENIEKS: Thank you, sir.

HEARING CO-CHAIR FIEDLER: Thank you.

I have a quick question and a comment. The quick question is if a purchaser of a ADR for a Chinese state enterprise that was on the IPO only, not on regular reports, on the prospectus, if a shareholder thought that there was a failure to disclose, a material failure to disclose, they have a private right of action, but that is they can go to court.

MR. DUDEK: Yes.

HEARING CO-CHAIR FIEDLER: They don't have to go to you. And, but it's hard to get at the Chinese company, number one, and they have no assets in the United States. So, therefore, what is the legal responsibility, and may the shareholder also sue the underwriter, as in Goldman Sachs, UBS, whatever, Credit Suisse?

MR. DUDEK: In the IPO context, yes. The underwriters are responsible for that offering prospectus to the same extent as the company: no misstatements, no material omissions. Subject to what's known as the due diligence defense.

HEARING CO-CHAIR FIEDLER: Right.

MR. DUDEK: In that the underwriters can say we did as much as possible. We asked questions, we kicked tires, we did all this work, and we thought that that document was correct, that it didn't contain any material misstatements or omissions, and that's where due diligence comes in, as some of you may know, is an extensive process that underwriters go through in bringing companies to market in order to establish that due diligence defense.

HEARING CO-CHAIR FIEDLER: Thank you. I want to thank you for everything that you've said today and your willingness to spend a little extra time with us and to be interrupted. And I think that you get--we have witnesses come before us all year long in various fields of endeavor who--but the most consistent complaint is the lack of transparency in China, whether it be with the government, with the

Party, and so, therefore, it is difficult for us to believe, on a common sense basis, that--in the credibility of the disclosure, and therefore when uniquenesses of the system are not taken into consideration, it seems to me, at least, that the possibilities for misleading disclosure are amplified.

And so I would only ask that the Commission continue to think about these issues, and we will, of course, as well, and I want to thank you very much again.

MR. DUDEK: Thank you.

HEARING CO-CHAIR FIEDLER: Thank you.

We will take a break until 11 o'clock.

[Whereupon, a short break was taken.]

PANEL III: INFORMATION FOR INVESTORS

HEARING CO-CHAIR FIEDLER: We're about ready to get started. For our third panel of the day, we have two legal experts who have, each made valuable contributions to the relatively slim body of literature on disclosure as it relates to U.S. listed Chinese firms.

First, we have James Feinerman, professor at Georgetown University Law School. Professor Feinerman received his J.D. from Harvard Law School and a Ph.D. in East Asian Languages and Literatures from Yale, both in 1979.

He subsequently studied and lectured in China, practiced law, and completed a number of prestigious fellowships in the U.S. and abroad.

Mr. Peter Friedman is currently a member of the New York Bar and a practicing attorney working on financial restructuring issues.

Prior to his current firm, in 2009, Mr. Friedman was a Yale China Teaching Fellow at Sun Yat-sen University in Guangzhou, China, and previously worked as an investment banking analyst in Hong Kong, specializing in technology companies throughout Asia.

Gentlemen, we have a rule where you have seven minutes of testimony, and then we open up to questions by the Commissioners, and I would urge you to push "talk" on your microphones when you're ready, and could we start with Professor Feinerman?

STATEMENT OF MR. JAMES V. FEINERMAN
PROFESSOR, GEORGETOWN UNIVERSITY LAW SCHOOL

MR. FEINERMAN: Well, thank you, members of the Commission for inviting me to speak with you today about the topic of information problems for U.S. investors in PRC companies.

I'm going to be speaking today, and you have my written testimony which amplifies some of the remarks I'm going to make in response to several questions that you asked me to consider, which I'll review very briefly in a second, but based on my work and experience as someone who has studied not only the Chinese legal system generally, but also looked at specific problems with Chinese corporations, corporate law, and corporate governance. And so that informs the remarks that I'm going to make.

As a matter of background, I would just note that obviously the number of listed PRC companies in the United States has been growing by leaps and bounds since the first entrants to the marketplace about a decade or so ago, and it's worth noting as well that they're listed not only on the New York Stock Exchange but on the NASDAQ, and other lesser markets, as well.

Just to review the questions that I've been asked to consider, let me speak about them in order. The first was questions about unique problems of country risk disclosure that PRC companies present when they list on U.S. stock exchanges.

Obviously, there are country specific questions with regard to risks of investment in the PRC, and one of the most disturbing things that I found is that there's a relatively formulaic statement made by all PRC-listed companies, almost a kind of mantra that's repeated in every listed company, which has changed very little over time, and, as a result, the country risk disclosures may fail to reflect current realities in the People's Republic of China, as well as some global events that have occurred that put Chinese investments in context in a very different posture than they were when the initial formulation was made.

Now, I understand the reasons why lawyers who realize that one thing has previously passed muster with the SEC want to employ the same thing again if they think it will similarly get them past the review process, but it means that we may not be getting the fullest disclosure that we might expect about the current circumstances, not only of investments in the PRC generally, but the particular aspects of investments in this specific Chinese company, which some more specific disclosure might provide.

I've also been asked to consider the problems of materiality, and I know that this is something that other speakers have addressed as well, and here the problem is one that's a little bit beyond the ambit of my expertise, although I do teach courses in corporations and corporate

finance, so I'm familiar with the relevant standards that are spelled out in the statute and the regulations that empower the SEC to deal with this question, this legal matter.

And here the problem is the distinction between material information and soft information and whether or not information, in general, about country risks falls into one category more prominently than the other, and because of the paucity, actually the nonexistence, of case law in this area, it's very difficult to say how it might be possible, for example, to prosecute a registrant for a failure of disclosure with respect to country risk where it's a violation of the materiality standard that's spelled out in the SEC rules because this has never come up before with respect to any other country's country risks.

Obviously, if some signal event occurs with regard to China or with another country where country risk disclosure proves to have been material and wasn't properly disclosed, that might change the landscape with regard to this question.

I've also been asked to look at the question of "state secrets" laws, and how that relates to the PRC state-owned companies that list and make disclosures under SEC rules, and here the problem, which I think is rather well-known to you, is that China's state secrets laws are very broad reaching.

They are almost constantly amended and almost never to narrow them, but rather to broaden their reach, and there's a particular sensitivity with regard to financial information, including the financial information that's collected and provided by outside companies, that is foreign companies that are based outside of the PRC.

Just a few years ago, a consortium of Bloomberg, Reuters and Dow Jones had to threaten to bring an action in the WTO in order to get China to make good on its promises that were part of the expectation with regard to PRC accession that would allow them to act outside of the Chinese state-run Xinhua News Agency in collecting financial information. If they can't do that, the questions about the reliability of the information are very much compromised.

I've also been asked to address the question of adequacy of disclosure about Communist Party posts and the appointment process for other managers, officers and directors of Chinese companies and the Communist Party's involvement in that.

And here with the exception of one company, the Chinese oil giant, Sinopec, there's a deafening silence with regard to those disclosures. Although there is extensive disclosure of state government positions and previous business posts that have been held by these personnel, there's with the exception of the Sinopec offering almost no mention ever made of their current or former Communist Party involvement or the involvement of the Communist Party in the choice

process for the senior leadership of Chinese corporations.

My time is about to expire, but let me just mention the last two issues that I've been asked to address.

One is the monitoring of the accuracy of disclosure of government subsidies. This is a problematic aspect for two reasons. One is that as a result of China's WTO accession, this was supposed to have ceased or subsided, and it obviously hasn't.

Secondly, it's very difficult to separate out not only the overt subsidies but also covert subsidies that happen, and there's a well-known dialogue here in Washington about Chinese currency and the renminbi and whether or not it constitutes a disguised subsidy.

Finally, I've been asked to address, and you've just heard from Paul Dudek, about cooperative programs between the SEC and its PRC counterparts. Obviously, this is an important way in which I think institutional learning can take place, but it depends a lot on the willingness of the Chinese counterpart of the SEC to take advantage of what the SEC has to offer.

If there's going to be a dialogue, it can't be a one-sided one, and it remains to be seen if the Chinese CSRC has taken complete advantage of everything that the SEC and, I should mention, other foreign securities regulatory agencies outside the United States have proffered to Chinese securities regulatory authorities in the 20 or so years of recent economic reform that's led to creation of a company law and the securities regulation inside China.

My time is up so I should probably cease, but if you have further questions, I'm happy to answer them.

[The statement follows:][1]

HEARING CO-CHAIR FIEDLER: We will after Mr. Friedman testifies. Thank you, sir.

STATEMENT OF MR. PETER M. FRIEDMAN
ATTORNEY, NEW YORK, NEW YORK

MR. FRIEDMAN: Good morning. My name is Peter Friedman. It's an honor to be up here today. Thank you for having me in. Also, thank you for the questions you provided ahead of time. I tried to address them both in my written testimony, throughout the entire testimony, and I'll take the same approach in my testimony here today to try to address as many of those questions as possible.

[1] Click here to read the prepared testimony of Mr. James V. Feinerman

I'm going to talk specifically about U.S. investor access to information about Chinese companies that are listing on U.S. stock exchanges and IPOs. And a lot of what I'm saying can be applied to forward disclosure and ongoing disclosure under the Exchange Act, but I'm really going to be focused on the 1933 Securities Act. So I'm going to be looking at country risk disclosure and IPO prospectuses.

And I just want to start off by talking a bit about this materiality standard, something that Mr. Dudek talked about and something that Professor Feinerman mentioned as well, is that it's really something that has been in the statute since 1933, this idea of materiality, and this concept, but it's never been defined, and it's been up to case law and the courts to define it.

And the Supreme Court in 1976 in TSC Industries kind of gave investors and everybody else the seminal definition of materiality as an omitted or misstatement of fact that is material if there's a substantial likelihood that disclosure of this omitted or misrepresented fact would have been viewed by the reasonable investor as significantly altering the total mix of information made available.

There's a lot of subjective terms even in that definition. And I just want to sort of say off the bat as I go forward in my testimony that it's kind of the duty of materiality that it is viewed on a case-by-case basis, and it varies from sector, as well as by company, and as by geography.

But I want to talk a bit about materiality in the context of a Chinese company that's listing on a U.S. stock exchange, and one of the first things I want to point out, and some of the questions that were raised by you guys were, you know, state-operated enterprises, the SOEs.

What's happened in recent years is there have been more privately-owned companies that have been listing on American stock exchanges. And if you look at companies, you know, since I wrote my paper in 2005 about this very issue, most of the companies that have been listing in the U.S. are actually privately owned. A lot of the large SOEs listed in the late 1990s and early 2000s, PetroChina, CNOOC, China Telecom, China Mobile, China Unicom.

So there are definitely different concerns that are raised when we're looking at private companies versus SOEs. You know one of the issues that I'd like to point out is this idea of the ownership structure, which is opaque, because what's usually listing on U.S. stock exchanges is an offshore entity that's registered somewhere in the Cayman Islands, Bermuda, or some other jurisdiction where it's pretty easy to do your paperwork and get your company registered.

However, the operating company is still onshore, and it's very difficult to verify the ownership structure of these onshore entities and

to know who really controls what because we can't do any sort of--there's no publicly available database. There are no searches that can be done to check the ownership structure of these onshore entities. So that's the first thing to keep in mind when we're discussing materiality.

Second, I'd like to talk about the reasonable investor, and this is a very subjective term, but it means different things depending on the sector that you're looking at, as well as the geography.

Chinese investors or U.S. investors investing in Chinese companies are somewhat aware of the risks that they're taking. It's like any emerging market company, and it's something you have to keep in mind when trying to define or peg what's material for an investor in a Chinese company listing on an American stock exchange.

Another factor I think that should be taken into consideration is the availability of public information, and this addresses things such as the Communist Party's involvement and the idea of state appointment to directorships. While not specifically disclosed in SEC documents, it's very well known that the Communist Party reaches into all aspects of Chinese life.

This has been written about in the media. It's written about in books, and courts have actually taken publicly available information and what's available in the media when examining this concept of materiality.

So the question is what to do and how do we address the problems that arise in the context of Chinese companies listing on American stock exchanges?

I'd like to put forth the recommendation that what the SEC should be doing is looking at company-specific country risk factors. As I said early on, disclosure has improved since I wrote my paper in 2005. But prior to that, as Professor Feinerman pointed out, the disclosure for country risk has been static. It's pretty much boilerplate language that sort of gives vague statements that the renminbi may fluctuate in value, the Chinese legal system is arbitrary and capricious, and these are all things that we know.

Open up any newspaper and the renminbi is usually front page news. So the problem has become that you need to tailor your country risk factors to the specific company that is listing on an American stock exchange.

Now, what's happened to lead to this increased disclosure are three things:

We have more informed professionals, which includes the accountants, lawyers and investment bankers. But also there's been better SEC dialogue. SEC staffers who are reviewing these prospectuses have become more savvy and more knowledgeable about Chinese companies and know what questions to ask in order to get

better disclosure.

Secondly is just the mere number, the fact that this shift from state-operated enterprises to privately-owned companies has taken place, which also changes the mix, and also these companies have less constraints in terms of things like the state secrets laws. They kind of fall under the radar because they're not necessarily viewed as strategic industries. They might be an industry such as travel and leisure or other service industries.

And finally, if you look at recent prospectuses of Chinese companies, there has been this blurring of company risk and country risk, and that within the country risk section, there's actually a lot of disclosure about specific laws and regulations that affect that company such as noncompliance with environmental laws, or issues involving labor laws, or perhaps if you're a hotel operator--we all know there's no private property in China yet--so you lease your property, and there's a chance that the underlying property, you may not have ownership over that, and that could be taken away from you or bulldozed without a moment's notice.

Now, some of the problems to consider when switching this regime to something more specific, to company-specific country risk disclosure, are that if we look at SEC disclosure, it's precedent-based right now. What professionals tend to do is they gather all of the prospectuses or whatever document you're filing, if it's a 10-Q or 10-K or 20-F, and they look at what's been done beforehand, and they gather all the risk factors and they pull out those that are not relevant and then they put those in that are, they feel were used prior, and then give it to the SEC to review, and the SEC comes back, and they say, oh, we want more information, and all the professional really needs to do is say, look, this is what was done in 20 other instances.

And because it's precedent-based, what you have is a race to the bottom in terms of disclosure, and that is a problem that needs to be addressed.

But second is that Chinese companies don't fully understand disclosure, and this is something that falls upon the professionals as well as the Chinese securities regulator. They look at disclosure not as helping them or helping U.S. investors, but as pointing out the flaws in the company.

Savvy professionals can actually make clear and point out to these companies that it's important to disclose not only to protect U.S. investors but to protect their own hides in the process of listing on U.S. stock exchanges.

So the solution I propose, and I'll summarize in brief, is that company specific country risk disclosure, and what this does is it allows for a new regime which takes care of the precedent-based issue because

then if we have a new regime put forth by the SEC for country risk disclosure, companies can't come back and say this is what was done in the past. It creates a cutoff point.

Secondly, the disclosure becomes more narrowly tailored to address the specific laws, policies and activities that affect the issuers.

And finally, the SEC through its either the Office of International Corporate Finance or some other part of the Division of Corporate Finance should bring on more China-specific experts or China-specific people who are familiar with the laws, rules, and regulations in the country to review these prospectuses to ensure there's more narrowly tailored disclosure.

I would just like to finish on this point. It's very important when crafting a new disclosure regime to avoid politicizing that regime, and I won't point out specific examples, but the one thing about U.S. security laws is that it's remarkably--they've remained remarkably apolitical.

If we all remember--and those of us who look at history--the securities laws were created in the depths of the Great Depression. It was very easy to create laws that could have been, you know, cater to the whims of the time, but instead what was created were laws that have remained remarkably apolitical throughout time.

So I urge the SEC, Congress, and when making recommendations, the Commission, to avoid politicizing this disclosure and make sure that it applies to all foreign issuers and not just Chinese issuers, but also to not just target China, but recognize that China poses unique problems and address those unique problems when requiring certain disclosure.

So, in conclusion, the purpose of SEC disclosure rules and regulations and laws is for full and fair disclosure for U.S. investors. It's a two-way street. They both protect U.S. investors, but also are supposed to protect Chinese issuers. We should avoid politicizing this disclosure and ensure that U.S. investors have access to all the information they need to make their investment decisions.

Thank you.

[The statement follows:][2]

PANEL III: Discussion, Questions and Answers

HEARING CO-CHAIR FIEDLER: Thank you.

Let me make a comment on your latter point. First of all, the only reason we're concerned about China is because we're the U.S.-China Commission, and we can talk about Russia--I think the Wall Street Journal had an article the other day on its front page about disclosure

[2] Click here to read the prepared testimony of Mr. Peter M. Friedman

issues with Russian companies--but we're really talking about tailoring examination of disclosure to particular uniquenesses of countries as opposed to treating countries the same.

But I am mindful of your point about politicizing. It is the role of other government agencies, not the SEC, to determine whether or not a Chinese company should be listed in the first instance.

So we're not really politicizing it beyond the fact that there are political considerations in other countries. So, for instance, I don't know if you were here when Mr. Dudek was beginning to testify, and I asked him the question--I used the example of Mr. Thornton's interview with McKinsey saying that the board of that company, China Netcom, defined the role of the Communist Party in certain areas: strategic planning, key decisions, what decisions the Party would make, what decisions the Board would make. And, yet, there is no disclosure in the China Netcom bios of the board of any party people, nor is there actually any--I as a non-lawyer commonsensically think that if you define the role of the Party in the company, it's probably material to tell the shareholders in the United States that you've done so.

We had a robust discussion about the Party with Mr. Dudek. Let's start that discussion a little bit with you who are not constrained by government position.

What, do you think that, for instance, China Netcom should have disclosed that it defined the role of the Chinese Party in its company?

MR. FRIEDMAN: I would counter to the extent it's relevant to the operations of the company. I mean as an investor, well, in any--

HEARING CO-CHAIR FIEDLER: How do we know unless they tell us what they did?

MR. FRIEDMAN: Unless they tell you. You know that there's a chance. It's an Internet company in China. It's common knowledge the Internet is highly regulated in China. There's no access to certain information. Google was kicked out of China. I mean to disclose the affiliation with the Communist Party, we don't put in U.S. companies our political affiliation of directors and what party they're a part of.

HEARING CO-CHAIR FIEDLER: Wait, wait, wait. Stop. Let me just ask you a question. I just want to make sure that you're equating the Republican Party and the Democratic Party with the Communist Party?

MR. FRIEDMAN: I'm not equating. I'm not equating. I'm talking merely about political affiliations.

HEARING CO-CHAIR FIEDLER: No, it's not a spurious question I mean because what we're trying to get at is the differences between words used in the United States in disclosure documents regarding U.S. companies and words, the same words, used to describe something in China, which has different meanings and therefore perhaps different

thresholds of materiality.

So if the Communist Party, in the case of Mr. Shea's "red phone" that Mr. McGregor of Financial Times is writing about in his book, has a role, it is, to me, insufficient that the newspapers write that the Communist Party controls the country when I'm investing, not in the country, I'm investing in China Netcom. So I am much more interested in knowing what the role--does the Party have a role in China Netcom that is unique to it?

MR. FRIEDMAN: And I would draw the line as this. If the government owns a stake, and they are a shareholder and they own, let's say, 30 percent of the company, that should be disclosed. The ownership structure should be disclosed in your disclosure documents.

To say the government has a role, it's kind of, I mean that's a vague concept. The idea of a role--what is a role? And governments everywhere have a role in setting policies and rules and regulations that affect that company.

If the government actually has somebody sitting on the board, the Communist Party, the government--we have to separate the government from the Party, as well--that perhaps should be disclosed if it rises to the level of materiality. But, however, we know an Internet company in China, if it's owned by the government or the government owns the bandwidth or owns--that's disclosed, that the government controls the Internet. The Internet laws are--there are disclosure risk factors.

HEARING CO-CHAIR FIEDLER: Mr. Feinerman, what's your view of this?

MR. FEINERMAN: Well, I generally agree that there's perhaps a danger of making the obvious even more obvious, you know, that the Communist Party really does control everything in China, and presumably most sophisticated investors, even unsophisticated investors, probably know that.

I would say that given the model in some companies' prospectuses that they disclose parallel positions that people have in the government and the Communist Party, that it isn't a stretch too far to suggest that that would be the preferable kind of disclosure as a general matter.

And just to put this in another context, you know, I'm an academic. I've spent a lot of time, including administering an official exchange program between the United States and China for a couple of years, where it was important to know whether or not, for example, the president of a university was also the Party secretary of that university, and if it wasn't the same person, who was the Party secretary, to make sure that you were talking to the people who actually had control of the levers of power.

And in the same way, if a company reports, as Sinopec, as I mentioned, in their prospectus does, that so-and-so, who is the chairman

of the board, is also the president of the Communist Party leading group of that division of Sinopec, that seems to me to be something that an investor might want to know.

Now, the problem, related back to SEC disclosure rules and the question of materiality, is given the disclosure regime that we have and have had since the 1930s in the United States, we don't qualify prospectuses, you know, based on whether or not they have made adequate disclosure before the fact.

They make their disclosures, and then it remains for someone to bring an action saying that the disclosure failed to meet the standards of materiality, and, as a result, investors suffered a harm that's cognizable under the Securities Act of 1933, and then bring an action.

So there's a kind of chicken-and-egg problem here about how you would then go about encouraging this fuller disclosure unless some precipitating event occurs which says because of the failure to make this kind of full disclosure, which I would generally prefer, investors have actually been harmed.

HEARING CO-CHAIR FIEDLER: Thank you very much.

Commissioner Wortzel.

COMMISSIONER WORTZEL: I'm going to run the same path here. Whether you read the work of political scientists who are often discussed as somewhat sympathetic toward China, like--I hate to name names-- David Sham--but they have major books out--David Shambaugh and Susan Shirk, or political scientists, who are considered to be quite critical of China, and on the right, like June Dreyer--another major text on Chinese politics--they are all uniform that the Chinese Communist Party directs the government and directs the actions of state-owned and many provincial-owned enterprises and its members.

They do not distinguish between the Chinese Communist Party and the government, and if I'm not wrong, Shirk actually says that, one and the same thing.

Mr. Feinerman, on page three of your testimony, you list risk factors very nicely. And I guess do you believe that Communist Party membership and position of members of the board of directors and corporate officers of Chinese companies and their foreign registered subsidiaries should be disclosed?

I mean China is a one-Party state, and I guess, Mr. Friedman, I would ask you directly do you think that asking for that information on China or on Cuba is--

HEARING CO-CHAIR FIEDLER: We don't have any Cuban companies.

COMMISSIONER WORTZEL: We don't have any-- right-- politicizes disclosure?

MR. FRIEDMAN: I don't think it politicizes it. I just wonder if

it raises more questions than it answers. You put a sentence in, and this goes back to the issue of boilerplate disclosure, you say China is a one-Party--verbatim, what you said, Commissioner--put that in a disclosure statement or in a prospectus, and then you either have to write a treatise explaining it, and then the question becomes is the purpose of SEC disclosure documents to educate investors or merely to give them enough information to make an investment decision?

And you can put that one sentence in, but I don't. I guess the question I ask as an investor in a Chinese company, and this is the point that I tried to make, was that you know that. You know that the Communist Party is pervasive. You know that it's a one-Party state.

So you put that sentence--that's fine to put that in, but then where do you draw the line where you're providing valuable disclosure?

COMMISSIONER WORTZEL: Well, to do due diligence, some investors might be very happy that the corporate president is also the provincial Party secretary because they know what gets promised gets delivered.

MR. FRIEDMAN: Exactly.

COMMISSIONER WORTZEL: Let me go to Mr. Feinerman.

MR. FEINERMAN: Yes, just to pick up on that, and then I want to make three other comments. I think that clearly in Sinopec's case, they're almost crowing about the fact that, you know, these people have these positions in parallel, and that as most people would know if they're knowledgeable about the Chinese system, that it's maybe more important to have the Party position than it is to have the state position.

But backing out from that, first of all, with regard to disclosures, it seems to me that there's a stronger ground to argue for disclosure of Party positions if you're already making disclosures of government positions. That is to make them in parallel.

If you're going to say that I have these government positions, then you should also disclose whatever the parallel Party positions are, and if someone of a significant level is in a Party position but not in a government position, that should probably be disclosed as well.

There's also the possibility, though, that you might want to deal with this as the--I mentioned China funds that make more, somewhat brutally frank disclosures of country risks in China--do a general disclosure about the Communist Party that just says, you know, members of the board and other people who are chosen to be managers and operators of these companies may be chosen by Communist Party processes. The Communist Party, in fact, controls most of the major operations of China, including the Chinese economy, and investors should be on notice about that.

Now, it's obvious, I think, to me why Chinese companies registering in the United States don't want to make that disclosure

voluntarily. They would regard it as sort of telling tales out of school and maybe believe that it reflects or the foreigners would think it reflects badly on the way that China operates.

It's not a problem that foreign China funds have to worry about because they're operating outside of the Chinese economic environment.

And then, lastly, I would just say the question about, you know, how much disclosure can actually be required, I think it gets back to the point that Mr. Friedman was making, and it's an important one not to lose sight of, that it's very unlikely to me, and I realize that your mission here is to deal specifically with the China question, but that the SEC could justify making a kind of China-specific requirement that wasn't generally imposed on all other countries.

Now, there are other countries out there with Communist parties or dominant one-party political parties where you could make that a kind of blanket requirement, but I think that that would be important in fashioning a kind of general regulation.

MR. FRIEDMAN: Can I just say one more thing on that point?

COMMISSIONER WORTZEL: It's up to the chairman because I'm out of time.

HEARING CO-CHAIR CLEVELAND: Yes.

HEARING CO-CHAIR FIEDLER: Yes, please.

MR. FRIEDMAN: Just very quickly. The other thing about disclosure, if disclosure raises more questions than it answers, at least under case law, then you can require further disclosure, and there are certain prospectuses where you read it as an investor, and it says in the risk factors we don't comply with all the environmental laws; however, we don't pay any fines.

You know if you're an investor, you're thinking how does that work? I mean in America, at least if I don't follow the law, I get fined, and I pay a lot of money.

That would perhaps require further disclosure, and that may go to your point about, well, then, there probably is some connection or some tie either to the local government, provincial government, or higher up to the national government, and that would require disclosure because that raises a question and doesn't answer. It's not answered in a prospectus, and you wonder, well, how do you get away with breaking the law and not paying any fines?

And I think it goes to this idea of country-specific country risk disclosure, that it's important then the ties to the government, to the operation of the company, and just to go back to China Netcom, if it affects the operations or it's going to affect the returns that an investor gets, then, yes, you should have that disclosure in there if it's going to significantly or it has affected operations in the past.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: Can I just clarify one point, and then I'll defer to other colleagues who want to ask questions?

Mr. Feinerman, you said that China mutual funds do provide far more detailed disclosures. Why is that? Was it voluntary? I mean what was the history behind that?

MR. FEINERMAN: Well, there are several possibilities to explain why this may be the case. First of all, they're regulated under a separate set of SEC regulations, the 1940 Investment Company Act, and they may view the disclosure requirements of that act--they register, as well, with the '33 Act--as imposing higher standards on them.

Secondly, these are companies that are based in the United States that put together portfolios of securities that come from China but are usually American or sometimes non-U.S., but non-Chinese, companies that sell their funds to U.S. investors, and, as a result, they're not operating under the same political constraints that a Chinese company, even though it's registering in the United States, would feel it was under with regard to its own home government.

HEARING CO-CHAIR CLEVELAND: Is there room for us to consider a recommendation that levels the playing field between the--you said it was the '44 act, and--

MR. FEINERMAN: The '40 act.

HEARING CO-CHAIR CLEVELAND: --the '40 act and the '33 and '34 acts? I don't know the details of the former so I'm just wondering if it's worth, if we're trying to improve the quality of disclosure for Chinese companies, is there--

MR. FEINERMAN: I don't think there is as a matter of SEC or securities regulation jurisprudence because the laws were pretty much developed in tandem, and since the '40 act came after the '33 act, and most '40 act companies when they register their individual funds register them under the '33 act, as well, are subject to both levels of disclosure.

Now, if you're suggesting the '40 act kind of--

HEARING CO-CHAIR CLEVELAND: The other way around.

MR. FEINERMAN: --responsibilities should apply to '33 act companies, if you're not a mutual fund, if you're not a fund that's registered under the '40 act, there are a whole range of responsibilities you don't have because you don't present the same kind of risk profile that a managed or unmanaged fund of securities presents that justifies the '40 act regulations. So I'm not sure how to put that cart back before or behind the horse.

HEARING CO-CHAIR CLEVELAND: Okay. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thanks very much and thank you to both of our witnesses, and in the interest of full disclosure,

I should say that Professor Feinerman was one of my professors when I was at Georgetown Law School.

HEARING CO-CHAIR CLEVELAND: Did you get a good grade?

VICE CHAIRMAN BARTHOLOMEW: I think I got a good grade. It was a long time ago.

[Laughter.]

VICE CHAIRMAN BARTHOLOMEW: Mr. Friedman, one of the issues I want to go back to is a question that I raised also with the SEC, but you note in your testimony about--I think it's a very optimistic statement--about as more American companies, like investment banks and law firms, and you don't mention accounting firms in here, but as they get more interested and more engaged and more involved on Chinese issues, they're building up expertise.

But you also note that they've been actively building up their China expertise and courting U.S. listing opportunities from Chinese companies.

I wonder, given the fact that many American companies over the course of the past 20 years in the interest of doing business in China have made some accommodations to Chinese practices that are not standard business practice in the United States, if we have to worry that that's going to be a problem for law firms, accounting firms, and investment banking firms, so that they end up, that their participation ends up not raising the standard for everybody, but that their desire to get a foothold in the Chinese business world ends up lowering the standard?

MR. FRIEDMAN: Two parts to my answer, and first, just dealing with investment banks kind of separate from accounting firms and law firms because I think they're a bit of a different--bit of a different breed, and their risk profile is different than a law firm or an accounting firm. But just to say that for all of those professionals, they have to provide comfort letters and sign off on prospectuses.

So they are putting--that's the most--as a professional in one of those fields, it's kind of the--it's one of--I'm trying to get the right word to describe it. It's very big deal to put your firm or your company's name behind this offering, to sign off saying I on behalf of X investment bank or Y accounting firm are saying that these, this disclosure or these numbers, are accurate.

So that's kind of the blanket response. But the investment banks, I just go back to the point, is they all have different risk profiles, and as a former banker, and I remember my experience out there--internal compliance controls at banks vary, and we all, reading the news, know about that.

Different risk profiles, different risk appetites. It's hard to generalize, and I don't want to target any particular banks, but they do

vary, and there are some banks that would look at an IPO of a Chinese company and say, "I ain't touching that with a ten-foot pole." And there are others that would say, "I will go in and I will do that, and I'm willing to just kind of perhaps look the other way at certain things."

But I'd venture to say that no professional is going to rise to the level to put their firm name, to risk liability, and I think something Mr. Dudek pointed out is that under the Securities Act, there's Section 11 and Section 12. Section 11 applies to the issuers. Section 12 applies to underwriters but also other professionals, which could include lawyers, accountants, investment banks, and not just in the underwriting capacity.

So there is that potential for liability, that if you're defrauded by a professional, whether it's an accountant, investment bank or lawyer, there is recourse under U.S. securities laws to take them to task for not doing their job effectively.

So just to go back to this idea that there are different banks with different risk profiles. That's something to consider when looking at companies that are coming to the market.

But now to the second point is that as a lawyer, we're extremely risk averse, and I can say that working with law firms, seeing how lawyers respond to risk. But once again--you're right, it varies by the individual professional--what I'd like, you know, I think what we require with comfort letters when you're filing, that you have to have these entities, the professionals signing off on the disclosure documents, that that keeps the bar at a certain level.

But obviously we look--there was Enron, other examples, you know, in the past decade or so where professional firms did not, they cut corners. And there are other, you know, entities, government entities, that are responsible for regulating or looking into or investigating when those things happen.

However, I do think that what the SEC does in requiring this sign-off from these professionals, that keeps the bar for the most part at a certain level, ensuring that disclosure is adequate, and that we're getting full and fair disclosure for U.S. investors.

Now, as I said, there are exceptions and there are abnormalities and there are firms that are looking to cut corners. It depends. Unfortunately, I can't target either individual firms or individual professionals within a firm, that's a question for perhaps a recommendation to tighten up the standards of how banks go off signing off on deals internally and regulating internal compliance and their risk profiles.

And we do that kind of obliquely through capital requirements and other ways of ensuring that banks are doing things to protect not just their interests but also the interests of others who could be hurt by their

actions, but--

VICE CHAIRMAN BARTHOLOMEW: This would have been an easier conversation three years ago, I think, to make that case.

Mr. Feinerman, any thoughts on the question?

MR. FEINERMAN: Well, just two things. One, to supplement what Mr. Friedman has already said, I think certainly in the aftermath of Enron and WorldCom, because of Sarbanes-Oxley, there's a heightened awareness, at least on this side of the Pacific, with regard to anyone who might be construed as a gatekeeper, and that includes not just investment banks, but law firms, accountants, and other professionals who might be involved in the process of registering securities, that there's a heightened sense of liability, and I think that would extend to the risks that are involved with investments in China.

But, at the same time, and I mentioned this in my written testimony--I didn't get a chance to talk about it in my oral presentation--the due diligence problem in China is particularly daunting, and here the problem is a kind of cat and mouse game that the very people who in order to discharge their responsibilities under the law and also prevent themselves from being exposed to liability as professionals have to try and elicit from Chinese sources the kind of information that it's very difficult to pry out of the Chinese system.

Now, some of this is not intentionally so. It's just because of long-standing practices in the Chinese economy that are very slow to change and maybe will with the fullness of time, but some of them are less than passive resistance. They're active resistance to the requirements of our due diligence process which relates to our securities regulatory apparatus.

And that's a difficulty that I think remains and needs to be addressed, and I believe that the professionals on the U.S. side would be very happy to have further assistance with regard to that.

They don't enjoy being in this risky position. They are, as Mr. Friedman said, quite risk averse, and not just the lawyers, and as a result any ability that they have to go to their Chinese counterparts and say, you know, the regulators in Washington are making us do this, damn them, and, you know, we'd really like to help you out, but you've got to provide us this information, that, I think, would be quite helpful to them and also protective of foreign investors in Chinese companies.

VICE CHAIRMAN BARTHOLOMEW: Good. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Shea.

COMMISSIONER SHEA: Thank you both for being here.

As I understand both of your testimony, you both criticized this sort of boilerplate, precedent-based disclosure of country risk, and you recommend that the SEC should compel company-specific country risk disclosure and sort of abandon this one-size-fits-all approach, and I've

read some of the risk disclosures, and it was just all boilerplate. It's some 30-year-old associate just pumping it in and telling the partners it reflects the language in 20 other prospectuses, and that's how it works.

What you say, both of you say, makes eminent sense to me. I guess how do you operationalize it? Does Congress tell the SEC to do this? Does the SEC issue a regulation that is open to comment? Can the SEC just say when the lawyers bring the draft prospectus with the boilerplate, no, we're not accepting that anymore; you need to be more specific and more company specific? I mean can they--so there is no regulation needed or no new statutory authority needed?

How do you operationalize the idea both of you have suggested?

MR. FRIEDMAN: I'm going to start, and please feel free to interrupt. I think something that's been established here today, the interesting thing about securities laws is the courts have filled in a lot of the gaps. The laws are promulgated by Congress and the courts come and interpret.

Now what the SEC has done has issued regulations--Regulation S-K is probably one of the more significant, or Regulation FD, or more significant regulations in recent years, that have tried to clarify what goes into disclosure documents and various items in those regulations that lay out for professionals, as well as for companies that are looking to draft these documents, what to include.

That could be a start--write special regulations for foreign issuers and something specifically tailored to foreign issuers, and with the SEC, if you look in the history, there aren't a lot of--we have certain forms, like a 20-F, which is like an annual report, that the SEC has created for foreign filers where you can use your actual annual report that you issue and give that to investors in lieu of a 10-K in certain cases.

But we haven't, the SEC has not created a disclosure regime for foreign issuers, and that might be one solution, but, of course, keep in mind that this regime would then probably be subject to litigation and then further definition by courts, but it might get the dialogue rolling, and it might actually start the process of figuring out how to get at more company-specific country risk disclosure, as well as other disclosures that would be particularly tailored to foreign issuers.

COMMISSIONER SHEA: Professor?

MR. FEINERMAN: Yes, I would say a couple of additional things. One is that it's true that generally the courts have taken the lead in helping to define this, but that awaits a proper case, which, you know, constitutionally under Article III, has to arise in an actual case or controversy. So waiting for that right case to come along would allow the changes to be made and be in place going forward might take quite awhile.

I agree with Mr. Friedman that there is room for the SEC in its

rulemaking process to do something about this, either by making a separate rule that's foreign-issuer specific or by a possible expansion of existing rules.

FD might be a good one, the rules, the initials actually stand for "full disclosure." And it was a major advance that was made by the SEC a few years ago in sort of reversing the presumption that existed before about soft information not only not being necessary to disclose, but actually suggesting that companies had a free pass even if they were using shareholders' money to make projections about the future and keeping that information from the shareholders.

FD could be amended possibly to say that more specific country risk as well as more company-specific risk with respect to the situation in any individual country needed to be disclosed.

I would just note that going back to comments I made earlier, which may get me in further trouble talking about the 40 act as well as the 33 act, that the Investment Management Division in the SEC frequently does go back, particularly about risk factors in regard to particular portfolios of securities, and require before making a registration effective that fuller disclosure be provided, and this is something that exists as a possibility under the '33 act as well.

They can look at a so-called "red herring" prospectus and say that, you know, we're troubled by the lack of effective or full enough disclosure in the risk factor sector, and require that as a condition of effectiveness.

COMMISSIONER SHEA: So, for example, if I could just finish up this thought, I asked Mr. Dudek, has any lawyer for a Chinese state-owned enterprise seeking to register in the United States ever failed to disclose information by citing the "state secrets" law or the trade secrets law put out by regulations of SASAC, and he said no.

Professor, you say that the tight control, the media landscape, and the broad reach of the state secret law in China adds more uncertainty to the adequacy of the disclosure of information by the Chinese SOEs.

So, as I understand what you're saying, is that potentially the SEC could just demand that, for example, the risk posed by the state secret law and its impact, potentially adverse impact, on disclosure, full disclosure, should be disclosed as a matter of course if you're a Chinese SOE?

MR. FEINERMAN: That's a possibility although, given what I know of SEC practice, and here I'm on shaky ground--I'd rather have Mr. Dudek answer this question. I don't know if they would do that unless there was a particular risk in a specific company and its registration with regard to that. I don't know as a general policy matter if they would say any Chinese company that comes before us with a registration--

COMMISSIONER SHEA: Or SOE.

MR. FEINERMAN: Any SOE from China that comes to us with a registration that doesn't disclose this, we won't make them effective unless they make a fuller disclosure about this. I think they'd be much more likely to say we believe in respect to this particular SOE that the failure to disclose this problem is a grounds for not making them effective unless there is fuller disclosure.

COMMISSIONER SHEA: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Thank you both for being here and also for your very helpful prepared testimony.

This is an area of the law I don't know an awful lot about. I want to understand a little better. Professor, you mentioned there are 213 PRC-based companies that are publicly traded in the U.S. Would they have to disclose whether they're a government-owned company or not when they register to get publicly traded in the United States?

MR. FEINERMAN: I believe that they would although that's still subject to the overall materiality standard, but I believe that by almost any reading of that, yes, that would be material information that they would have to disclose.

COMMISSIONER MULLOY: Do you agree with that, Mr. Friedman?

MR. FRIEDMAN: I do.

COMMISSIONER MULLOY: Okay. Now if they're a government-owned company, are they, Mr. Feinerman, the government-owned companies, are they the ones with the red phones that are subject--I mean the Party has a lot of control over these government-owned companies?

MR. FEINERMAN: I'd say, as a general matter, the Party certainly has more control over them. I don't know in every case of an SOE, a state-owned enterprise, whether or not there is the "red phone," but I would suspect that there's a high degree of Party and government control over those compared to a private enterprise.

COMMISSIONER MULLOY: Do you agree with that, Mr. Friedman?

MR. FRIEDMAN: I do agree with that.

COMMISSIONER MULLOY: Now, are there companies from China that registered here that may not be subject to Party control? I mean are there private companies in China that are good-sized companies, are there private, and that may not be subject to Party control?

MR. FEINERMAN: Well, I think the answer to that is yes, but it depends what you mean by "subject to Party control." Obviously,

everything in China is subject to Party control.

COMMISSIONER MULLOY: Everything.

MR. FEINERMAN: As the Soviet humorist Yakov Smirnoff once said of the Soviet Union, you know, "In the United States, you can always find the party, but in the Soviet Union, the Party always finds you." In China today, the Party always finds you even if you're a wholly private enterprise with no previous government involvement, newly established as a private entity with no previous history of state ownership.

But it's a much more limited control and involvement than with a state-owned enterprise or a government company.

COMMISSIONER MULLOY: Do you know whether Huawei is a state-owned company or a state government owned company or not?

MR. FEINERMAN: I don't know the exact answer to that. I believe that it may have evolved from companies that were previously state-owned enterprises, but as to its current status, I don't have enough information to give you--

COMMISSIONER MULLOY: Do you know, Mr. Friedman?

MR. FRIEDMAN: To my knowledge, I recall, I think it was cobbled together. I think there were ties, not so much to the government but to the PLA, which is another, the Army, the military side of the government. But this is, to my knowledge, public. The ownership structure is rather opaque in terms of where it originated from and who actually owns it.

COMMISSIONER MULLOY: Do you think that Huawei would be subject to the Party control? The Party can find Huawei?

MR. FEINERMAN: Yes.

COMMISSIONER MULLOY: Yes. Okay. Now, help me understand this. The CFIUS process, when there's a purchase by a foreign company of an American company, it could undergo a CFIUS review. If it's a government-controlled company, it undergoes a more searching CFIUS review.

If Huawei is not a government-owned company, but when Chinese companies, they're not government owned, but they are subject to the "Party can find them," do you think they should all undergo the more searching review in the United States under the CFIUS process?

MR. FEINERMAN: It's hard for me to give a blanket answer, but I would say, in general, given the knowledge that we have about the Party involvement, in most cases, I would side on a more searching review than a less so.

COMMISSIONER MULLOY: What about you, Mr. Friedman? Do you have a--

MR. FRIEDMAN: We're talking, just to be clear, the context of securities now or are we talking about the M&A--

COMMISSIONER MULLOY: Yes, this is--no, CFIUS is looking at--

MR. FRIEDMAN: For an acquisition?

MR. FEINERMAN: Acquisition.

COMMISSIONER MULLOY: Yes.

MR. FRIEDMAN: For an acquisition, yes. I think, yes, state-owned enterprises from anywhere, from any country, should be subject to a more searching review.

COMMISSIONER MULLOY: No, we're not--but we're talking about a non-Chinese-state-owned company because--but it may not be government-owned or controlled, but you all both acceded that it could be controlled by the Party because the Party can always find a company in China.

So the question is, under CFIUS, do you think a non-government-owned company should undergo the more searching CFIUS review just because of the nature of the system they have in China?

MR. FRIEDMAN: I think you should, I think under the more searching review, you should try to understand the ownership structure of that company.

COMMISSIONER MULLOY: Okay.

MR. FRIEDMAN: And that should be one of the cornerstones of the more searching review.

COMMISSIONER MULLOY: Good. Finally, Chairman Slane earlier asked our witness from the SEC if there were specific recommendations that they wanted to make to this Commission that we could consider then making to the Congress related to the issues that we've discussed.

He gave me permission to ask you two if you have ideas like that, specific recommendations that we should make, we would welcome those for our consideration. And you don't have to do it now. If you want to do it later if some things come to your mind, we would be happy to have those.

Thank you both very much.

HEARING CO-CHAIR FIEDLER: Commissioner Slane.

CHAIRMAN SLANE: Thank you very much for taking the time to come here today.

My question is does the American investor realize that he may not be able to enforce a violation of the securities law against a PRC-based company? Is that in the disclosure?

MR. FRIEDMAN: Yes. There is, yes, there's elements because what's listing, as I said in my testimony, it's an offshore entity usually. So that's the actual entity that's listed in the U.S. is the holding company, and there is disclosure that you may not be able to get at the PRC assets or the PRC management. I've seen that.

MR. FEINERMAN: Even, I would just add with respect to the PRC, the disclosure is usually that the legal system is evolving, there's very poor legal infrastructure, that you may not be able to access the courts as you would in the United States, and things like that, that, again, although they become fairly rote statements over the years, at least provide that level of disclosure.

CHAIRMAN SLANE: It doesn't seem to give people real pause here.

MR. FEINERMAN: Well, as an experienced securities lawyer told me when I was a young associate on Wall Street, in fact, there's a kind of perversity with regard to disclosures of risk, and anyone who knows sort of basic corporate finance knows the risk/return curve, that the riskier you make an investment seemed to be the likelier at least that some investors are going to want to glom onto it because they perceive the upside of high risk as high return.

And so at some point, you have to worry about almost a self-defeating aspect of a fuller disclosure of risk, which makes some investors believe that this is really a hot property that they should want to acquire rather than having the salutary discouraging effect that you hope a fuller disclosure of risk might have.

MR. FRIEDMAN: I was told a similar thing by a very senior lawyer when I first started out, that give them enough information to make fools of themselves so, yes, investors like risk. That's kind of--

MR. FEINERMAN: Well, and more importantly, in the China context, I think that almost nobody is an innocent. I mean there may be a few investors who are sold a bill of goods by securities brokers or something like that who are really neophytes.

But I think that most of the investors who buy these are fully aware of the circumstances, but they're willing to accept the tradeoff, either because they believe that with the growth of the Chinese economy and the size of the Chinese market, they really need to have those investments in their portfolio, or that this particular stock or this particular company, despite the fallibilities of all the others, including all the other PRC companies that have registered in the United States, is different, and that they'll be able to make a buck with this one.

CHAIRMAN SLANE: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: Professor Feinerman, you talked in your statement about "the extent of related Party transactions as well as their full disclosure may prove problematic; in the PRC, such transactions are numerous, complex and inadequately disclosed."

Could you talk a little bit more about that as a problem?

MR. FEINERMAN: Well, this is a problem both with regard to the interrelationship of PRC companies generally in different lines of

business, but I think it's particularly problematic with regard to structures that are created in order for these companies to offer their securities in the United States and elsewhere abroad.

As Mr. Friedman has mentioned, what's offered for sale in the U.S. and Hong Kong or London or other international securities markets are shares of a holding company created outside of the PRC, and as we know in the United States, with our experience with offshore holding companies in relation to American and other foreign firms, there are often difficulties, complicated difficulties of regulation, corporate relationships, and also taxation that relate to these structures that are created between the holding company and its various subsidiaries.

And although often these are necessary, and they are in the Chinese case, to make it possible for these companies to even qualify to register securities on the international markets, at the same time they may serve to insulate them from the reach of regulatory authorities in those markets and elsewhere outside of China where the securities are sold.

And they only know what's been fully disclosed at the holding company and the next level down. They don't know about the interrelationships of companies at lower levels, if there's, for example, a Chinese domestic holding company which in turn has other subsidiaries which has relationships and inter-party transactions with other Chinese corporations not fully disclosed in the financial information that is provided about this particular company.

HEARING CO-CHAIR CLEVELAND: Why is it necessary to list offshore? You said that it was an ingredient that made it possible.

MR. FEINERMAN: Well, this is something I think Mr. Friedman may want to chime in on as well, but basically it's virtually impossible in the current state of Chinese corporate law to create an entity that would qualify for listing under the SEC or British, European or Hong Kong securities and corporate regulations.

HEARING CO-CHAIR CLEVELAND: Because of Chinese law?

MR. FEINERMAN: Because of Chinese law, but also just the extent of development and sophistication of the Chinese corporate form. Corporations are pretty new to China. The first company law that created the corporate vehicle was just passed in 1994, and it was recently amended, along with the securities regulations, in 2005-2006, but there isn't the history of development of corporations that we have in the West or even in Japan, Hong Kong or Taiwan.

And as a result, the typical way of doing this, and this is done, by the way, by other foreign issuers, not just in China, is to create one of these offshore holding companies in the Cayman Islands or some other jurisdiction that makes it relatively quick and convenient, as well as reasonably cheap, to do this, and then offer the shares of that, which in

turn gets all of its revenues from the underlying corporate entity in China.

HEARING CO-CHAIR CLEVELAND: Mr. Friedman?

MR. FRIEDMAN: Without getting into the technicality of it, it's kind of a two-sided thing. It's domestic Chinese law that putting--with assets and transferring assets overseas, but also it's what, what not just Chinese companies do, but most foreign companies, where the corporate law regime in that particular country doesn't jive with sort of the corporate law regime whether it's the U.S., Hong Kong, London or any other exchange where companies are listing.

As Professor Feinerman said, it's much easier to go to the Cayman Islands where you can probably get incorporated in three hours. That's maybe a bit glib, but it's a relatively easy process, in that that's the holding entity, and then it's the underlying assets that are onshore that provide sort of the, is what the investor is indirectly buying into.

But it's a combination of both just domestic law and the development of the market, as well as, you know, the requirements just of listing your company on an exchange in a different jurisdiction.

MR. FEINERMAN: And I don't know if either of us made this clear in our testimony. It's sort of something that everybody knows in this field, but what the investors actually hold are not the shares of the Chinese companies, but they're known as either ADRs, American Depository Receipts, or ADSs, American Depository Shares, and that designation specifically indicates to the purchaser that you don't own the underlying company, you own this sort of derivative, and I know that's a dangerous word to use the past couple of years here in Washington.

HEARING CO-CHAIR CLEVELAND: Facsimile.

MR. FEINERMAN: But it's a derivative security that relies on the underlying corporation and its securities. You are not actually a shareholder of the Chinese company.

MR. FRIEDMAN: And that's disclosed. There's actually a specific section of risk factor disclosure related to the ADSs or the ADRs so that is made clear to the investor.

HEARING CO-CHAIR CLEVELAND: Can we go on to a second round?

HEARING CO-CHAIR FIEDLER: Yes, go on.

HEARING CO-CHAIR CLEVELAND: Professor Feinerman, you talked a little bit about the fact that enforcement and compliance is an after-action issue, that there is no--I'm not going to misstate what you said, I think, but there's no compulsion to have full disclosure. There is this after-action process.

Could you talk a little bit about your assessment of the post-filing compliance and enforcement process? And then what might be the

elements of an SEC-PRC improved cooperative relationship?

MR. FEINERMAN: Well, I'll do that, but just a prologue before I do. One of the hallmarks of the U.S. system, which is actually what distinguishes us quite significantly from the Chinese system, is we have what's known as a disclosure regime rather than a qualification regime for registering securities.

That is we basically let everyone register. And we have these strict disclosure requirements, and we expect people who register securities to comply with them, and then we let the chips sort of fall where they may.

In China and many other countries, what they have is a qualification regime, which says unless you meet these certain standards, we won't even let you register securities, and it's a sort of fundamental reflection of our relative positions about open markets and economic freedom that these are the positions that we take.

The fallout of that in the United States is, of course, that we have this sort of post-hoc enforcement process. You have to wait until somebody who is adversely affected by a failure in the disclosure regime actually brings a lawsuit to see some amelioration of that, except that, as mentioned in previous discussion this morning, it is possible for the SEC in the registration process to require fuller disclosure, and specifically in the areas like risk factors, before making any registration effective for domestic or a foreign registrant.

And that's something where I think a fuller discussion between the SEC and counterparts in the CSRC could possibly make some headway in raising the bar and changing expectations about what's now going to be considered standard.

And the community of practitioners who do this in the law firms, investment banks and accounting firms is a relatively small one where the word could be transmitted.

I know that with open government and other things we don't necessarily like to do what's perceived as possibly non-public back door process, but the community I think would be pretty quickly made aware of what the changed expectations were, and with one or two denials of effectiveness of a registration, the SEC could establish that there's now a higher standard with regard to those things.

HEARING CO-CHAIR CLEVELAND: Do you think that that higher standard has yet to be established because there is no problem? Or because there is no staff? When you're talking about a higher standard, it begs the question of why there hasn't been movement towards that already?

MR. FEINERMAN: Well, I think just the history of regulatory change, not only in the SEC and securities regulation, but more generally in the American administrative state for the last hundred

years, is that change happens as a result of some sort of crisis or some sort of problem.

And the difficulty here may be that no Chinese registration has blown up, so to speak, in the U.S. market to such an extent that there's been a call for change here.

And even though other foreign registrants have had serious problems, and some have defaulted on their obligations, there seems to be a sort of general, at least there was up until 2008, laissez-faire mentality that, you know, these things happen in markets and, you know, unless there's a larger crisis that seems to be precipitated, that isn't reason enough because of one or two failings to make significant changes in the regulatory process that we have. If there are more, then, obviously, there will be a groundswell for change.

HEARING CO-CHAIR CLEVELAND: So you don't see the reforms that have been carried out or about to be passed by the Congress in terms of domestic issues having a knock-on effect in terms of foreign filings?

MR. FEINERMAN: Well, not in general, and certainly I think not with respect to China, because, again, the sense, which may be misguided or mistaken, is that China's been relatively immune to the problems and, you know, hasn't suffered in the same way. It's kind of a safe haven almost in an era of global economic crisis, and so why kill the goose that seems to still be laying golden eggs?

HEARING CO-CHAIR CLEVELAND: Is it fair to say that some of the issues that precipitated the financial market collapse had to do with transparency and accountability?

MR. FEINERMAN: Yes.

HEARING CO-CHAIR CLEVELAND: So it would be fair to assume or leap to the judgment that issues of transparency, accountability and governance in China, while not yet a problem, could travel the same path that we've experienced here?

MR. FEINERMAN: I think that would be a reasonable supposition, but again my caution is just that we tend not to do these things prophylactically. We unfortunately seem to learn our lessons after the crisis.

HEARING CO-CHAIR CLEVELAND: I agree, and I think the function of this Commission is often to try to anticipate problems and preempt them, and we may not be heard on this, but I'm just interested in whether there's a consensus on the need.

Mr. Friedman, do you have any additional thought?

MR. FRIEDMAN: I think the other problem, you asked the question why there isn't a higher standard, I think it's a question of what is that higher standard. And what are we, and this has been the crux I think of a lot of the testimony I've heard thus far, is that what are we

trying to get at and what do we want? And before the--the SEC is not going to on its own put forth a higher standard unless there's, as Professor Feinerman pointed out, a perceived problem or a crisis of some sort that addressed--that the higher standard would specifically address.

But if we don't know what--before we can get to a higher standard, we need to decide what we want from Chinese companies and other foreign issuers in terms of disclosure and what a higher standard would mean.

HEARING CO-CHAIR CLEVELAND: So if the higher standard flows from a desire to prevent, and with regard to Chinese listings in the U.S., what has happened here, how, what would that standard look like to you?

MR. FRIEDMAN: I have a hard time with that question because it seems like an apples to oranges comparison to me, in that we're trying to prevent in China--our U.S. regulators through disclosure are trying to prevent what happened in America in China or making it clear to investors that could happen.

HEARING CO-CHAIR CLEVELAND: That's more the issue. The SEC's fundamental charter being to reduce risk for U.S. investors, what would you seek to encourage in terms of that higher standard to reduce that risk?

MR. FRIEDMAN: I think it once again depends on the company; right.

HEARING CO-CHAIR CLEVELAND: Okay.

MR. FRIEDMAN: Let's say, for example, a Chinese bank were to list on a U.S. stock exchange, on the New York Stock Exchange, it would be very important to know about their loan portfolio, what type of, you know, capital adequacy requirements they have.

HEARING CO-CHAIR CLEVELAND: The interrelated--

MR. FRIEDMAN: But, if you're talking about--and one of the prospectuses I looked at recently was a lodging company called China Lodging Company, and they--we know in China that the government can bulldoze buildings without giving any notice. If they want to put up a train line or freeway or do, eminent domain is very strong there.

HEARING CO-CHAIR CLEVELAND: Eminent domain.

MR. FRIEDMAN: And the disclosure and the risk factor is, yes, our buildings could be knocked down without any notice, and they cite examples that have happened in the past couple of years.

Now--

HEARING CO-CHAIR CLEVELAND: Investors are not falling all over themselves is what you're saying?

MR. FRIEDMAN: Yes, they're still buying. They're like, okay, well, so a couple of hotels could be knocked down. We're still

purchasing the stock in these companies, but, to prevent what happened or to make that clear to investors, it depends on the company.

And if we're talking about a financial services company, then those things become very important, and lack of transparency in the loans that are made--you know, if you're a private company, perhaps it might be important to say that there is, it's historically known there has been trouble of getting access to bank loans as a private company in China. And that's a lot of the reason why a lot of these private companies are now trying to seek to raise capital probably overseas, in overseas markets.

It's just, it's easier than going through the process of getting a bank loan from one of the Big Four in China.

HEARING CO-CHAIR CLEVELAND: Particularly right now.

MR. FRIEDMAN: So I would say that I think to the extent it's company specific, and this goes back to what I put in my written testimony, as well as what I've said here today, is that I think it's important. You have to analyze the specific company, and part of that might be that there isn't the man--you know, the SEC might not have the manpower or the ability to do this for all countries and all companies from all countries, and I don't know if we advocate for an increase in the budget of the Office of International Corporate Finance or the Office of International Affairs or through some other way to ensure that the disclosure is tailored to give U.S. investors full and fair disclosure under U.S. securities law.

HEARING CO-CHAIR CLEVELAND: Protection. Thank you.

MR. FEINERMAN: Can I just add one other thing with regard to that?

HEARING CO-CHAIR CLEVELAND: Of course.

MR. FEINERMAN: And that is it's a combination not only of country-specific issues but also sometimes industry-specific issues in the Chinese context that's important.

Mr. Friedman mentioned Chinese banks, for example, which have notorious problem of nonperforming loans, and that's something you want to know about a Chinese bank registering.

But, for example, a recent prospectus that I looked at was of a Chinese company, one of the rarer private start-up companies, that's dealing with solar technology, and here there seemed to me a lot of questions about whether or not the disclosure was adequate, and it was quite extensive about related risks, given how much I knew or any investor might know about the nature of this technology, about how advanced the technological process was in China.

I mean, obviously, this could be a very hot selling security because of the current interest in alternative sources of energy, but as an investor, I want to know a lot more about how far along this is on a

global basis, how far along it is in China, what kind of technological capabilities they're able to marshal?

Also, can they use the research institutions that are still controlled by the Chinese state and the Communist Party and Chinese universities and scientific think tanks to do the kind of basic research they're going to need to be successful in creating and marketing their product? And that's not just a China-specific capability. It's something else that probably requires asking the SEC to hire even more people.

HEARING CO-CHAIR CLEVELAND: Oh, dear. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Wortzel for a second round.

COMMISSIONER WORTZEL: Gentlemen, thank you for your patience and bearing with us on this.

This question will follow up on Commissioner Mulloy's discussion about Huawei, and in my mind, I think about a company like Northern Industrial Group, a major conglomerate, kind of the opposite of a chaebol or zaibatsu, but if you could establish that the officers and directors of a Chinese company were originally seconded there from the People's Liberation Army, by the leaders of a department of the People's Liberation Army, and subsequently discharged from the Army to run that company, would you consider that material for SEC disclosure or for CFIUS review?

MR. FEINERMAN: I certainly would. And I guess the question is without some voluntary disclosure, how would that information come out and how would it be uncovered? This goes back to the question of, you know, what the SEC can do proactively before the fact as part of the registration process to surface these issues?

COMMISSIONER WORTZEL: Well, I thank you for raising that because that information probably would not come out unless it came, some of it is actually available in print by people that have written on China. And there are people that have covered these relationships in academia, but when a CFIUS review kicks in, they get the chance to get access to the intelligence community and that information.

To my knowledge, no such parallel process exists that would allow the SEC to go into the intelligence community and say who are these people; does it?

MR. FEINERMAN: But I guess that raises the question of whether or not you want to have a kind of CFIUS style review of every Chinese registration that comes to the SEC, not to make the kind of acquisition that CFIUS tries to regulate, but just to sell as a passive investment for American portfolio investors?

COMMISSIONER WORTZEL: Do you think it would be unreasonable to ask that the people that do the review at the SEC are

familiar with standard books on the Chinese military industrial complex by people like Evan Feigenbaum, Tai Ming Cheung, and James Mulvenon, which would bring that out?

MR. FRIEDMAN: Just as a side point to that, I think this idea of materiality, if it's relevant, you know, when you're reviewing a prospectus, you look at, let's say for a company that had ties to the Army, and there are former Army officers who are now on the board of the company, let's say you do a sales breakdown, and 30 percent of their sales are made to the military or 30 percent of their revenue comes from the military or profit or whatever, that is disclosed in SEC disclosure documents, and you know you could say, well, what do you have, what are your relationships with the Army, or do you have any material contracts with the Army, or what are your ties, and what if this revenue goes away?

Because the question has to be analyzed from the U.S. investor perspective, and, you know, for a U.S. investor, 30 percent of the revenue comes from the Army and that revenue disappears for some reason, I want to know how you have that revenue and what's the stability of that revenue of coming in?

And that might be a way of sort of SEC review of asking what happens if this revenue goes away or is there disclosure about this revenue might not be stable because it depends on the composition of our board of directors or our officers and their ties or their former relationships with members of the military.

And that might be one way, and that's relevant to the U.S. investor standpoint, as opposed to just kind of throwing a dart and saying we want, we want this kind of disclosure, but you have to tie it back to the U.S. investor perspective.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Shea.

COMMISSIONER SHEA: Thank you.

This may be beyond your expertise, but I've been reading about these reverse mergers of Chinese firms or micro caps or smaller than state-owned enterprises, I guess largely mostly private, that are merging into U.S.-based holding companies or shell companies and then getting listed on American exchanges without going through the formal listing process. Are you familiar with this trend or?

MR. FEINERMAN: No.

MR. FRIEDMAN: No. Reverse?

COMMISSIONER SHEA: Reverse mortgages.

MR. FEINERMAN: Back door listings is what we call them.

MR. FRIEDMAN: I've heard of reverse mergers as a corporate structure, as a corporate concept. I didn't know Chinese companies were engaging in putting their assets in the offshore holding companies.

COMMISSIONER SHEA: Yes, I'm just reading actually a CNBC story from June 22 about Chinese firms using the back door to U.S. exchanges. Anyway, something to take a look at.

MR. FEINERMAN: I'd be happy to look into it and try and submit something separate in writing if I can find out anything about it.

COMMISSIONER SHEA: Thank you very much. That would be great.

MR. FEINERMAN: It seems to me to be a relatively recent development.

COMMISSIONER SHEA: Yes. That would be very helpful. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you. It's a treat to have people with your expertise before us, and we really appreciate it.

This is for Professor Feinerman. On page seven of your testimony, you talk about financial assistance being given to the SOEs, and you say:

"Another type of financial assistance is given to SOEs to help them privatize or restructure. For instance, repackaging SOEs for foreign direct investment or listing on stock exchanges."

So there are two things going on. One, if they want to list here or, two, if they're enticing foreign investment in China. You say:

"The SOEs chosen for this purpose have typically been restructured in advance so that they possess the most productive assets of the enterprises and are rid of redundant workers and other social welfare responsibilities."

Now help me understand this because I think the--I've always thought the underpriced currency, you know, makes it more difficult to export and gives their exports an export subsidy, which is also discussed. But I've always thought it also acted as an incentive for American companies and other companies to invest in China because I've always thought part of what China wanted to do was to move up the technology chain and get our investment and know-how and other things.

Are most of the American investments in China, are they through joint ventures?

MR. FEINERMAN: No, I don't believe that's been the case for quite some time.

COMMISSIONER MULLOY: Is it mostly now non-joint ventures?

MR. FEINERMAN: Yes.

COMMISSIONER MULLOY: Would they, if there was a particular industry that they wanted to accelerate the development of in China, would this be a way that they would do it, they would get a

state-owned enterprise and strip off the bad assets and then entice foreign investment into that?

MR. FEINERMAN: Well, I think that's been done since the very beginning of joint venture enterprises in China. I mean the disincentive for foreign investors, including U.S. investors, to go into joint ventures once they were allowed in 1979 was that the Chinese companies that would be their joint venture partners had these various unattractive features that require the repackaging that I was talking about.

So, in many cases, and this is true as early as the early 1980s, they required the Chinese venture partner to strip down or to set up a separate entity which contained just the attractive partner and then hive off all these other responsibilities that were typical of all state-owned enterprises, in fact, of all, virtually all enterprises in China at the time, so that that wouldn't bog down the profitability of the joint venture enterprise.

COMMISSIONER MULLOY: Was the Shanghai Automotive Industrial--was this the partner for GM; wasn't it?

MR. FEINERMAN: Yes.

COMMISSIONER MULLOY: Was that the way they did that?

MR. FEINERMAN: I don't know the particular details of how that was accomplished, but I would suspect that they followed this path because it's been a fairly typical one.

COMMISSIONER MULLOY: Okay. But it's less, it's less the practice now?

MR. FEINERMAN: It's less the practice to do a joint venture, yes.

COMMISSIONER MULLOY: When you talk about they would do this repackaging for foreign direct investment, how does the foreign direct investment take place in an SOE? Is it a joint?

MR. FEINERMAN: Well, it can happen either through a joint venture, through some sort of--there are both equity joint ventures and contractual joint ventures. It can happen through asset purchases or other sorts of deals, and it can also happen through portfolio investments, you know, buying a certain share of the securities but holding them as a passive investor, not as an operating partner.

COMMISSIONER MULLOY: In China?

MR. FEINERMAN: Yes.

COMMISSIONER MULLOY: I see. Okay. So this would be a practice that they could do right now?

MR. FEINERMAN: Yes.

COMMISSIONER MULLOY: And are using?

MR. FEINERMAN: Yes. What I was talking about in my testimony here is specifically the companies that were going to then list abroad undergoing this repackaging process so that they would be more

attractive candidates for an overseas listing and more attractive to foreign investors who were seeking to make a portfolio investment in China from outside of China.

COMMISSIONER MULLOY: Yes.

MR. FEINERMAN: Who wouldn't want to invest in a traditional Chinese state-owned enterprise because, despite whatever profitable business they might be in, they had all these other economic responsibilities. Those could be eliminated through this process of repackaging.

COMMISSIONER MULLOY: Thank you both very much. Did you want to say anything, Mr. Friedman? I'm sorry.

MR. FRIEDMAN: No. No.

COMMISSIONER MULLOY: Thank you both very much.

HEARING CO-CHAIR FIEDLER: Thank you very much, gentlemen. It's been enlightening. I just want to get to one thing before we leave, and that is this precedent-setting boilerplate. Another word for that is "plagiarism." Right? I mean in another context.

MR. FEINERMAN: This is a good kind of plagiarism.

HEARING CO-CHAIR FIEDLER: Right. Right. Well, it's--

MR. FRIEDMAN: It's sanctioned.

HEARING CO-CHAIR FIEDLER: It's, I mean that question is whether it's sanctioned explicitly or tacitly; right?

So, in other words, both of you are criticizing it, and that it's sort of insufficient, so it's not unreasonable to say to the SEC or to say, generally, you know, it's--maybe it's time you looked at the boilerplate and see if it was appropriate, number one.

Number two, the country-specific stuff, because it is country-specific, it should be looking at the uniquenesses of that country, and those uniquenesses in concert with materiality make up the decision-making process on what should be disclosed and what should not be disclosed.

And I don't, I get the impression that people have gotten--at the SEC--and I don't mean this in a really pejorative way because they have so many companies to look at--is this sort of like laziness of saying, oh, well, they've been doing this, they've been doing that, okay, nobody said anything, nobody has crashed, so we'll let it go on? Yet, the underlying inaccuracy of it when there is a crash is disturbing.

So thank you very much for getting to the heart of the question for us.

MR. FRIEDMAN: Thank you.

HEARING CO-CHAIR FIEDLER: We will reconvene at 1:30 with the panel on state secrets.

[Whereupon, at 12:30 p.m., the hearing recessed, to reconvene at 1:33 p.m., this same day.]

A F T E R N O O N S E S S I O N

PANEL IV: CHINA'S "STATE SECRET" LAWS

HEARING CO-CHAIR FIEDLER: Welcome back. The first panel of the afternoon will address the implications of China's state secrets laws. To help us understand these issues, we'll hear testimony from Mr. Gordon Chang and Mr. Mitchell Silk.

Mr. Chang is a columnist at Forbes and the author of two books. He lived and worked in China and Hong Kong for almost two decades, most recently in Shanghai, as Counsel to the American law firm Paul Weiss.

Previously, he worked in Hong Kong as a partner in the international law firm of Baker & McKenzie.

Mr. Silk is a partner in the projects and banking department of the New York office of the global legal practice of Allen & Overy.

He lived for years in China and is head of the firm's U.S. China group. He has published widely on legal matters related to greater China and is fluent in Mandarin and Cantonese.

We request again that each of you keep your oral remarks to seven minutes so that we can have sufficient time for Commissioners to go into greater depth with you.

We will start with Mr. Chang.

STATEMENT OF MR. GORDON G. CHANG, AUTHOR and FORBES.com COLUMNIST, BEDMINSTER, NEW JERSEY

MR. CHANG: Chairwoman Cleveland, Chairman Fiedler, and distinguished members of the Commission, it is an honor for me to be here today, and I thank you very much.

China amended its State Secrets Law effective October 1. The amendments were adopted at about the same time as provisional regulations that related to the protection of state secrets in the possession of state enterprises and also at the same time as the central government's white paper on the control of the Internet.

As such, I think that the new State Secrets Law is part of the state's broad-based effort to tighten control of information.

The amendments to the State Secrets Law do a number of things:

First, they centralize the authority to classify information as a state secret by providing that classification decisions will be made at

higher levels of government. They also declassify information as state secrets after the passage of time, ten, 20, and 30 years. And they also require Internet service providers to stop the leak of state secrets.

Now, this last provision has been presented as something new, but nonetheless, there is an obligation in existing law for all parties to stop the disclosure of state secrets.

There is in the provisions almost no change in the definition of what is a state secret, and in broad outline, the new law when it comes into effect on October 1 will look very much like the old one.

As we have seen in recent trials of dissidents and others, the Chinese party-state has not respected its own laws in the prosecutions of individuals for leaking state secrets. And so the question is, well, if they don't respect their own law, then what's going on here? Why did they need to amend their law?

I think that there are three reasons for them to do so. First of all, the regime recognized that the Chinese people are increasingly starting to take their own law seriously, and this is, indeed, one of the most positive aspects that we have seen in modern day China, and therefore, I think the government also saw a need that it must appear to take the State Secrets Law seriously.

Second, and this is somewhat related, Beijing amended its law because it realized it must be seen to be responding to public opinion. If anything, Chinese people want to know more about the way their government works, and in various ways they have been pushing, they've been pushing their government for more open ways of doing things.

So Chinese society is dynamic, probably changing faster than any other on earth today, and Beijing's leaders are acutely aware of these societal trends. So even as they go about the process of tightening the management and control of information, they have to pretend that they're liberalizing the law instead.

Third, officials wanted to communicate to society the importance of protecting information. As I mentioned, the new law really is not that much different from the old one, and I think what the regime is doing by amending the law, it's trying to signal its concern about the Internet, and also about the need to keep secrets secret.

The State Secrets Law, and this is important for us as Americans, affects American business by potentially criminalizing the gathering of ordinary business information.

Beijing in its prosecutions of the four employees of Rio Tinto last year appeared to be willing to use this statute to gain an important advantage in its commercial dealings with the Anglo-Australian miner.

The lesson to the foreign business community is clear: the price for upsetting the central government means jail time for senior executives. So the State Secrets Law has recently become an even

worse weapon.

This unjustifiable use of the law is especially significant at a time when Beijing's leaders are developing a new economic model to replace Deng Xiaoping's well-known policy of reform and opening up.

Hu Jintao, the current President and General Secretary of the Party, is in many ways closing the country down. He is doing that by undermining foreign business to reserve the domestic market for Chinese enterprises and especially the so-called "national champions."

What happens in China does not stay in China, unfortunately. The State Secrets Law also undermines American securities laws. Chinese enterprises--there's about 210 of them--have listed securities in U.S. markets, and it's very possible that they may decide not to disclose information because they do not want to be prosecuted at home for the violation of state secrets.

When I practiced law in Asia, it was very clear. You just noticed a trend--that, of course, there are many times when you have conflicting requirements on a company; there will be requirements to do one thing under one country's law and not to do that same thing under another law.

But the one thing that I noticed in practicing law there was that companies generally tended to comply with the law of their home jurisdiction and to violate the laws of others. Now this is not to say that every Chinese company is going to violate American securities law because of China's State Secrets Law, but I think the one thing that is clear is that the manager of the larger state enterprises, the ones that actually list in American markets, the managers are appointed by the Communist Party.

So it's very unlikely that they are going to anger their superiors at home by disclosing what they must under U.S. securities law and thereby at the same time violate their own State Secrets Law.

But there is something even more fundamental than the American securities law. I think that the State Secrets Law is part of an effort that poses a fundamental challenge to the United States. And to understand why, we need a little background, and we need to talk about something that we often forget in this age, which most people call "China's century."

We should not lose sight of the notion that the State Secrets Law, like all other Chinese laws, lacks legitimacy. It was "enacted," quote-unquote, by the National People's Congress, which was itself chosen undemocratically, and it's a tool of a state which itself lacks legitimacy.

The new law can be seen as an attempt to legitimize the Chinese party-state's management and suppression of information, and as it goes about legitimatizing itself, the state seeks to de-legitimize others, especially the United States.

China may or may not want its authoritarianism to become a global model, but its model, and we got to be clear about this, conflicts with values that we hold dear. So China's securities law is not just about China; it's also about us.

Thank you.

[The statement follows:][3]

HEARING CO-CHAIR FIEDLER: Thank you.

Mr. Silk.

STATEMENT OF MR. MITCHELL SILK
PARTNER, ALLEN & OVERY LLP, NEW YORK, NY

MR. SILK: Good afternoon, distinguished members of the Commission. I'd like to start out by saying how much of a great honor it is for me personally and also for my firm to be here today and to participate in these proceedings.

I'd like to clarify that the comments that I'll be giving and contained in my written materials are my own personally; they don't necessarily represent the views of my firm.

I'd also like to give public thanks to a few of my colleagues that are here today that have assisted in the preparation of my written materials--Jillian Ashley, Nicolette Ward, and Emily Huang. They worked very hard in assisting me in doing some very helpful research. Also, they are joined by my daughter Bella Silk, who I may well call on to assist with some of the "easy" questions of the Commission. The hard ones being, of course, those that I'm able to answer. I thank you very much for your questions that you've sent down kindly. I've tried to dutifully answer them in my written remarks. I've prepared a set of slides that have been distributed to all of you that I hope will assist us in cantering through my very lengthy written remarks in what may be somewhat this cruel and unusual seven minute deadline that I've been given.

I'm going to take things at a slightly more micro level than my colleague Mr. Chang and try to take you through some of the details of the laws themselves and talk about the State Secrets Laws as they exist and as they developed, some of the other relevant laws and regulations, and how they are applied, how they have been applied, and then, most importantly, to talk a little bit about the practical implications for U.S.

[3] Click here to read the prepared statement of Mr. Gordon G. Chang

business, both here and in China, and probably the area that I think interests me the most, the implication of these laws on the expanding Chinese enterprises that are going abroad.

The laws themselves are not so numerous. The legislation began in the very early '50s, shortly after the establishment of the People's Republic of China, with two sets of regulations, one in 1950 and one in 1951. Those regulations were replaced by a State Secrets Law in 1988, and, as Mr. Chang just mentioned, that law was amended just recently in 2010. It will become effective in October.

There are some other relevant laws such as the Constitution, the Criminal Law, Criminal Procedure Law, and the State Secrets Law.

Just to run you quickly through some of the critical legal provisions, starting out with the 1951 Regulations, I think that the point that I'd like to make on all of the legislation is that it has pretty much reflected the prevailing policy and the state of development at the state at the time that they were promulgated.

So the '51 Regulations were very much reflective of the attempts of the early Communist regime to deal with the consolidation of its power after it had been through some number of decades of revolution.

Time won't permit reading through the very interesting preamble of the '50 and '51 Regulations. I have taken note of it here, and I'm happy to share it with all of you, but I would commend it for your reading as it does make some very interesting reading for those interested in rhetoric.

I think that the main point of substance is to really look at the definition of state secrets, as it appears in the regulations, which was meant to cover very highly sensitive matters in the area of national defense, foreign relations, infrastructure, state financial monetary matters and foreign relations, and then also some other less sensitive matters, such as education, hygiene, culture, and things like meteorology even.

But the interesting provision of the regulations that has carried through all of the legislation are the catch-all provisions that capture all state affairs not yet decided upon and all other affairs that must be kept secret within the context and the boundaries of what is regulated as a state secret under the law.

We then move on to the 1988 law. This law was very much reflective of the post-Mao open door policies, particularly. It was promulgated at a point when those policies really started to gain some real traction. Noticeably, the preamble was very much depoliticized and talks more about the regulations ensuring the smooth progress of reform, and also accommodating opening to the outside world, which I find very interesting.

Nonetheless, the State Secrets definition didn't change much. The

definition in the '88 law is more precise, but it still does include the catch-all ambiguity of its predecessor.

The 1988 law did include some very helpful procedural safeguards that relate to state secrets that Mr. Chang referred to, but, nonetheless, those are not so helpful, as it were, in the context of regulation when viewed against the ambiguity of the fundamental definition of state secrets.

Mr. Chang has already talked about some of the main parts of the 2010 Amendments, the main one of which is really the new provisions that relate to the Internet and how the Internet has impacted on the flow of information that could be controlled and regulated by this legislation.

When talking about the legal framework, we must talk about matters in the context of the penalties that come along with violations of the law. Those are contained in the criminal law and the state security law.

The penalties range from administrative sanctions, which could be monetary and otherwise, but the juicier ones are actually imprisonment, which could range in the light case of three years and all the way up to ten plus years. Very serious infractions of the State Secrets Law and the state security law do carry the potential imposition of the death penalty under the criminal law.

There are some other interesting relevant laws and regulations in the area of unfair competition and trade secrets that really relate to trade secrets and other confidential matters that relate to state-owned enterprises that time will not allow me to get into in my oral comments, and I would refer you to my written testimony.

The only other area of law that I think is worth referring to is that which relates to corruption and bribery that are included in various provisions of the criminal law, the simple point here being that it is quite, almost always the instance that there will be allegations of corruption and bribery in matters that relate to state secrets in the economic realm, and both do feed into each other and are used by the enforcement and regulatory authorities as essentially a two-pronged weapon, as it were.

There are numerous instances that we can refer to in respect of the application of the State Secrets Laws. I think that the simple point that I would like to make is that given the ambiguity of how the law is cast, there are instances of the government using and the judiciary using the State Secrets Laws as both a shield in instances where it may be in their interest. For example, when there is a public health epidemic where there might be information that they would wish to be guarded, or a pollution accident of which there are many cases that we could talk about.

On the other hand, it could and is frequently used as a sword in

instances where there is sensitive information that the government or other instrumentalities may feel, and charged with the enforcement of the law, may feel have stepped beyond the boundaries of policy or national interests.

And this, the fact that the same definition and the same piece of legislation can be used as both a shield and a sword really stems from the point that I've been making about the ambiguity of this definition.

The practical implications for U.S. business that is going into China, particularly given the high degree of technical and economic information that must flow into the system in order to get a foreign direct investment project approved, means that the foreign investor must really be very robust in adopting compliance policies that take into account the most sensitive of situations and really must be on his or her or its guard at all times--at the planning stage of every project, when the project is winding its way through the FDI approval process, and also once the project has entered into commercial operation.

As to the extraterritorial reach of the State Secrets Laws, there are many instances where they can and actually have been applied to impose criminal responsibility for persons that are in China for acts that occurred outside of China.

But the interesting point that I would like to bring to the attention of the Commission is that the State Secrets Laws will not and cannot act as a defense to compliance with U.S. law as to matters in the U.S.

I brought two specific examples in my written testimony that I'd just like to touch on very briefly, one of them being we've seen, for example, a recent uptick in the number of very large PRC banks that have come into the United States.

In order for these banks to be licensed, they must pass through a process that is imposed by, if it's a state licensed, state regulators, and in all instances, the federal regulators, under the Foreign Bank Supervision Enhancement Act of 1991.

The requirements of that act make it very clear that the home country laws may not stand in the way of the Fed doing its job and other regulators doing their job in respect of that bank's operations if it were to be granted a license and enter into operations in the United States.

There are similar limitations that have arisen in the context of litigation that I would be happy to expand upon in the course of questions and answers.

To conclude, the control of sensitive information has been a focus of Chinese law since really the establishment of the PRC. The focus and the manner of the control has really shifted with changes in government policy and developmental goals.

Over time, the legal concept of state secrets has become more

refined, with more procedural safeguards, but at the end of the day, its definition under the law is a broad one and it's an ambiguous one, and it has the potential and has been used as both a shield and a sword depending on prevailing government interests.

Thank you very much.

[The statement follows][4]

Panel IV: Discussion, Questions and Answers

HEARING CO-CHAIR FIEDLER: Thank you very much. We let you go a little more, and we'll let Gordon catch up in the question and answer period.

Commissioner Slane first.

CHAIRMAN SLANE: Mr. Chang, I wanted to pick up on a theme that you mentioned in your opening statement.

When I look at some of the laws that have been recently introduced in China, in addition to the State Secrets Law, the antitrust law, the labor laws, the patent laws, the indigenous product laws, it seems to me that they're laying the groundwork to expel gradually over time foreign companies and keep their domestic market for their own businesses.

Can you comment on that, and maybe Mr. Silk can follow up?

MR. CHANG: Well, that is a tough question. Unfortunately, I did not bring my daughter to answer it.

I think that it's been pretty clear since basically the middle of 2006 that there has been a new attitude on the part of the Chinese central government and the Party towards foreign business, and clearly what we have seen over the last maybe nine months or so is that this perception has indeed filtered through the foreign business community itself in China and, of course, us here as well.

I think that it's clear that what we are witnessing is an attempt to reserve their domestic market for their own enterprises, and part of it is they think that they don't need foreign business as much as they did before because they have all the money that they need.

They probably think that with regard to technology, yes, they don't have it, but they can also coerce it out of foreign businesses or they can just steal it, which is the old-fashioned Chinese way of handling these things.

What I think is different now, it's, of course, a question of

[4] Click here to read the prepared statement of Mr. Mitchell Silk

conscious policy on the part of the central government, but there's something else working here, and that is as power has been sort of diffused through the Chinese system, the managers of state enterprises have gotten more ability to influence the decision-making process in the People's Republic.

And so what you have got are players in the economy now have the ability to try to get their way and to certainly make their case and sometimes prevail, and that's why we're seeing, you know, large state companies saying, look, why do we need the foreigners? We can do this ourselves; we're Chinese.

I think that clearly there has been a very new attitude from what you've talked about, especially the indigenous innovation rules. So, yes, that's certainly been true. I date it, as I said earlier, to the middle of 2006, but, nonetheless, that trend is clear now.

CHAIRMAN SLANE: Thank you.

HEARING CO-CHAIR FIEDLER: Mr. Silk.

MR. SILK: Sorry. Was the question, is the new law reflective of protectionism or?

CHAIRMAN SLANE: No, it just seems like it's one of a number of laws that have been passed in the last few years only directed at foreign companies, antitrust, patent, labor, indigenous product, et cetera.

It just seems to be a shift away from welcoming foreign direct investment and trying to, as these Chinese companies mature and are able to dominate the market, that they want to protect their own domestic market.

MR. SILK: Yes.

CHAIRMAN SLANE: I don't know whether you're seeing that trend or not.

MR. SILK: I don't think that that's the case actually. I think that the legislation reflects an attempt of the legislators to deal with far more complex society and the economy that's grown up over the past five odd, seven odd years.

I think that the two points that I take out of this are that, number one, with the increased regulation, it's not only making it difficult and more challenging for the foreigners to operate, but the same, the same regulations apply to domestic enterprises as well.

So that to the extent that new legislation is bringing on harder labor requirements and harder environmental requirements with all of the compliance costs, those will apply equally to any enterprise whether it's foreign or domestically owned in China.

But as to whether legislation is welcoming or not welcoming foreign investment and is a reflection of whether the Chinese welcome foreigners or not, I think that some of the recent regulation does reflect

the fact that the Chinese acknowledge that they actually need foreigners and particularly foreign know-how to develop to the next level--services, asset management, certain aspects of banking.

I would say that the law is not necessarily targeted at assisting Chinese and keeping foreigners out.

HEARING CO-CHAIR FIEDLER: Mr. Chang.

MR. CHANG: I certainly agree with that with regard to the State Secrets Law, but we got to remember that this is not just a question of laws. For instance, when you look at the indigenous innovation rules, those are clearly directed only against foreigners.

But when you look at the other laws that you talk about, yes, you could say they're also relevant or applicable to domestic enterprises, but the whole issue is enforcement.

For instance, in the one clear example, you've got environmental rules in China, and no one is going to argue that China should not have those rules. Of course they should have those rules. They got the worst degraded environment in the world.

The problem is that the environmental rules are enforced generally only against the foreigners, or maybe I should say that when they are enforced, they are enforced generally against foreigners and more severely and more restrictedly against the foreigners.

So, yes, you can have a state-owned enterprise. Yes, there might be environmental rules that are applicable, but they don't get enforced. But if you have a foreign invested enterprise, yeah, they're going to be enforced very severely.

And you look through all of these rules, the ones that are neutral, they are almost always enforced against the foreigners and not against the domestic enterprises because the domestic enterprises have power in the Chinese political system and are able to use that power to prevent enforcement from slowing down their operations.

CHAIRMAN SLANE: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: If I was a foreign firm in China, where would I go to find out the content of these laws? I mean how, how do companies protect themselves with full knowledge of both the letter and the intent, given what happened to Google, just as one example?

MR. CHANG: Well, they go to Mr. Silk's firm, of course.

MR. SILK: Thank you very much.

MR. CHANG: I couldn't resist.

MR. SILK: The laws and regulations themselves are readily available in a number of sources both written and on the Internet. It doesn't take more than a Google search, and there's a very nifty compendium of them called the State Secrets Laws--"State Secrets:

China's Legal Labyrinth," that was put out fairly recently.

But I think that the reality is that the laws are relatively short, very terse, and what is relevant is how they're applied. When Mr. Chang was practicing and when I practice now, what we would typically do when we'd have a question on the application of the law would be to call up the regulator and try to get some guidance.

The folks that apply the state secrets laws are not typically the type of folks that you would tend to call up, and if you would call them, you probably wouldn't get anything close to the type of guidance that would be required.

HEARING CO-CHAIR CLEVELAND: Regulators being?

MR. SILK: There is one central agency that is charged by the State Council to apply the State Secrets Laws. Alternatively, one could call a judicial organ or possibly the public security authorities.

There is also an agency that deals with state security. I think even if one were inclined to pick up the phone, I'm guessing because of the classification of the phone numbers, that one might have difficulty in getting the phone number to begin with.

HEARING CO-CHAIR FIEDLER: Yes, but maybe you wouldn't have to dial it, just pick up the phone.

MR. SILK: And just start talking into it.

HEARING CO-CHAIR CLEVELAND: Simplicity. You've anticipated my next question, which is, when you said an element of the judiciary, how consistent and transparent is the court process in enforcing the secret laws?

MR. CHANG: Well, I don't know. When I was practicing law, and my last four years in Shanghai basically was involved in litigation, and this was in the period in the late 1990s. I never had a State Secrets Law case, but I did have a case which was somewhat similar, and, you know, in a sense, the judiciary is very difficult to deal with. There are all sorts of rules. There's a lawyer's law, there's a judge's law, and none of that gets respected in the actual practice of law, in the prosecution of cases.

I'll just give you an example, that there's a rule in China that you can't talk to a judge during the proceeding. But my client, which was a multinational bank doing business in Shanghai, was specifically told by its bank regulator to get in touch with the judge in connection with this case because of certain matters that the bank regulator felt were important that needed to be discussed and needed to be decided correctly.

So, basically, what happened for a period of three years was that we ended up talking to the judges all the time. The other side did the same thing. Everybody violated the judge's law. Everybody violated the lawyer's law. You know it was a free for all, and that's just the way

the system is. This was in Shanghai, which everyone says, oh, you know, is the best, the most transparent, the most Western city in China. Well, it was just as corrupt and dirty and non-transparent, and a few other adjectives that I shouldn't use, as any other city in China, maybe even worse.

MR. SILK: I think that the reality in state secrets cases is that there's a very significant shroud around them because they're criminal proceedings, and they would tend not to be in open court.

And so it's very difficult to monitor the checks on whether criminal defendant rights and procedural rights are being honored. There has been a lot written on it. There's quite a bit in the reference volume that I just referred to.

I'm personally not involved in the area, but the common theme does tend to be that all of the procedural safeguards of the criminal procedure law are not followed to the tee in the context of proceedings.

HEARING CO-CHAIR CLEVELAND: Do I understand in your answer that there is a separate state secrets court?

MR. SILK: No, I think what Mr. Chang was referring to was a civil proceeding, and I think all of the state secrets proceedings would be in a criminal court.

HEARING CO-CHAIR CLEVELAND: Okay. Sorry.

MR. SILK: So it would be subject to the Criminal Procedure Law and not the Civil Procedure Law.

HEARING CO-CHAIR CLEVELAND: My time has expired, but I'll have some more questions.

HEARING CO-CHAIR FIEDLER: Okay. We'll have another round.

Let me bring you back to the criminalization of the gathering of business information and the disclosure of information in the United States for state-owned enterprises with the SEC. It's a two-part question.

It seems to me in reading the business press about the Rio Tinto case that the Rio Tinto case presents all kinds of other problems, which may or may not have been created to mask the original, but that the old "kill the chicken to scare the monkey" routine is working pretty well here, and the ambiguity question also works well in the Chinese government's favor in inhibiting the gathering of information by U.S. companies doing business in China because they're worried about crossing over a line which they don't know its location.

In the case of securities laws, how do we know what they don't disclose if the SEC is not conversant enough with the dynamics of that situation? And therefore how do we enforce the nondisclosure? Okay. I mean it's a real problem.

Could somebody answer the first question and somebody else

comment on the problems that the SEC has in dealing with the State Secrets Law and commonly accepted information?

MR. SILK: On the first question of, how do we know; I think the answer quite simply is that we don't know, and the question, although my mother always taught me never to answer a question with a question, but I think the question is that does it really matter in the context of a securities offering?

You had my very old friend and colleague Jim Feinerman up here, and another of our colleagues who are at least far more schooled in securities laws than I, but I personally don't think it really matters much.

If there was an issue with nondisclosure, then there are remedies under the securities laws for the investors, and investors bring suits every day in court, and it keeps the securities bar and class action bar in business.

HEARING CO-CHAIR FIEDLER: Except there's a different problem with ADRs than there is with a normal U.S.-based company in terms of going after nonexistent assets in the United States, and the after IPO, after registration documents, you can't go after the professionals in the same way as you can in an IPO. So I'm not sure who there is to go after in a U.S. legal context.

MR. SILK: I think that the non-ADR where you have the straight issuer that's coming to the U.S. market probably presents, could present similar risks in that many of those issues are conducted by an issuing company that really has nothing at all in the U.S. and is supported economically and financially by operations that are all in China, management of which is all in China.

It is a problem. I don't deny that, but I don't know that the issue of State Secrets Laws preventing disclosure or just having a bad egg not making disclosure is necessarily it.

HEARING CO-CHAIR FIEDLER: Okay. Yes, Gordon.

MR. CHANG: I think that this is a really interesting question because you're right, we don't know what we don't know. And I think Mr. Silk is absolutely correct that in a certain sense it doesn't matter because U.S. securities laws say you have to comply with our law. We don't care what your law is back at your home jurisdiction.

But the real problem, of course, is that that's not the way the real world works, and when you have, for instance, these enormous offering documents that come from Chinese issuers, you can just sort of scan them if you have any sense of what's going on in China and see that there are real problems.

So, for instance, when International and Commercial Bank of China, the world's largest bank by capitalization, certainly China's largest bank by assets, when they had their offering about four years

ago, I just went through it, and I could see a number of things that just were like red flags that really begged asking more questions, but obviously this document was okay, you know, and clearly, you had Goldman Sachs, I think it was, as the underwriter.

These are things that should have been caught but probably weren't so, at the end of the day, I do think that the SEC does need to have people who are very familiar with what's going on in China, perhaps Mr. Silk's associates or something like that.

But the point is that what we are seeing are larger and larger offerings. Agricultural Bank of China, which has just gone to market, is the world's largest IPO in all probability when it finishes up. So, clearly, this is something that is important because these issuers are trying to access the American markets, and there are some very obvious problems that really do cry out for some answers right away to protect American investors.

HEARING CO-CHAIR FIEDLER: Thank you very much.

Mr. Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Thank you, both, for being here. Mr. Chang, you've been a friend of this Commission and testified more than once. We're delighted to see you again.

Mr. Silk, does your firm have offices in China?

MR. SILK: Yes, we have offices in Beijing and Shanghai.

COMMISSIONER MULLOY: Can American lawyers be licensed to practice law in China?

MR. SILK: No.

COMMISSIONER MULLOY: So you have to rely on Chinese?

MR. SILK: In the context of giving a formal opinion on PRC law, yes, we'd have to arrange for that to be issued by a PRC lawyer, and that's the reason for that very healthy health warning that I put at the end of my--somewhere--in one of these papers.

COMMISSIONER MULLOY: How many lawyers would your firm have in China?

MR. SILK: We have about 70 professionals on the ground.

COMMISSIONER MULLOY: And how many of them would be American?

MR. SILK: A small number, maybe ten to 15 percent.

COMMISSIONER MULLOY: You mentioned the Foreign Bank Supervision Enhancement Act of 1991. My recollection is that law said that the Fed--it made the Fed the gatekeeper of foreign banks coming into this country and said that you could not come into the country unless you had comprehensive supervision on a consolidated basis.

I think that was the test. I remember when I was in the Clinton administration, the Chinese were always coming in and asking that they

be granted licenses for branches in the United States, and the Fed could not make that finding, and therefore none were given.

When did that change?

MR. SILK: About a year ago. And I would add, Mr. Mulloy, that I lived painfully under that because I represented the first two PRC banks to apply after FBSEA, ICBC and ABOC, and we had applications pending before the Fed for two years until the Fed invited our clients to downgrade their applications to rep office, which meant that they could not engage in any form of banking business but could gather information and kind of act as a marketing liaison.

COMMISSIONER MULLOY: Are they branches now? Are they branches?

MR. SILK: The ABOC is in the process of applying. ICBC was granted its license last year, as was China Merchants Bank and China Construction Bank.

COMMISSIONER MULLOY: Okay. So the Fed, has the Fed written how they made that finding?

MR. SILK: Yes, they've issued orders on those three applicants, and they've also issued an order in respect one other Chinese bank, I think it is Minsheng Bank, that acquired a minority interest in a San Francisco community bank.

COMMISSIONER MULLOY: Okay.

MR. SILK: Which also required the CCS finding.

COMMISSIONER MULLOY: The State Secrets Law, extraterritorial application. I know when Americans apply their laws abroad, if you're a branch, it applies. There's a little more question if you're incorporated in the other country.

Do the Chinese make that distinction that if a Chinese company is incorporated in the United States, that the State Secrets Law would still apply even though if you're incorporated here, it means you're an American company; right?

MR. SILK: I think that the test is that if there is an act in violation of the State Secrets Laws that occurs outside of China that has an impact in China, then the Chinese law will take the view that the State Secrets Laws apply, and then it's just a question of getting jurisdiction over the person or people that government which is to prosecute.

COMMISSIONER MULLOY: Okay.

MR. SILK: In China.

COMMISSIONER MULLOY: So they would apply it to either a branch or an incorporated company?

MR. SILK: Yes.

COMMISSIONER MULLOY: If it has an impact in China?

MR. SILK: Yes.

COMMISSIONER MULLOY: Okay.

MR. SILK: In respect to state secrets or other criminal matters for that matter.

COMMISSIONER MULLOY: Okay. That's helpful.

Mr. Chang, on page eight of your testimony, you talk about this question that Chairman Slane asked about, that the Chinese, "Beijing is not hesitant to undermine the multinationals" operating in China, "and the State Secrets Law is apparently one of its main tools to help domestic enterprises at home," and this idea that they're squeezing the foreign companies more.

And as I saw it, Mr. Silk, you don't think that's the case in China.

MR. SILK: Yes.

COMMISSIONER MULLOY: I have a sense, just listening to some of the multinationals in Washington and their trade associations, that there is more of a fear of the American multinationals now operating in China that something has happened over there that makes them more uncomfortable than they were two or three years ago.

Do you sense any of that, Mr. Silk?

MR. SILK: As to state secrets?

COMMISSIONER MULLOY: As to their operations in China, whether it's--something has happened in China, whether it was the Rio Tinto prosecution, whether it was the innovation, something is going on that is making them more uncomfortable. Do you sense that?

MR. SILK: I personally don't see it in my practice.

COMMISSIONER MULLOY: Okay. And your practice is mainly the financial guys, banks and--

MR. SILK: No, I do work, quite a bit of work, in the energy sector, infrastructure, kind of larger investments as well, some manufacturing.

COMMISSIONER MULLOY: My time is up. Maybe if we have another round, I'll come back.

MR. SILK: Sure.

COMMISSIONER MULLOY: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Shea.

COMMISSIONER SHEA: Thank you both for being here. I just want to clarify. When someone, there was a discussion we had about if someone needed an interpretation of the State Secrets Law, they make a phone call. Who in China administers the State Secrets Law? Is that the Ministry of State Security or who is the body, the government body, in charge of administering that law?

MR. SILK: It's the roughly translated as the National Administration for Keeping or Guarding State Secrets.

COMMISSIONER SHEA: Okay. That's a new one for me.

MR. SILK: We can maybe ask for a nod of confirmation?

COMMISSIONER SHEA: Bella, do you agree?

[Laughter.]

MR. SILK: Yes. I'm getting a nod.

COMMISSIONER SHEA: Okay.

MR. SILK: I'm getting the nod.

COMMISSIONER SHEA: Okay. Now, I understand that the State Assets Supervision and Administration Commission, an agency I'm familiar with to some degree, SASAC, issued new guidelines or regulations regarding trade secrets, which seem to cover a lot of what state secrets are, and I'm just sort of speculating.

I think for most Westerners, they don't understand the state secret concept, but maybe they'd be more, they would have a greater ability to understand what a trade secret or proprietary information might be.

What is the genesis? Are you familiar with what the genesis of the SASAC regs are, and is my speculation correct, that that might be an effort to make these laws a little bit more palatable for Western understanding because we can understand what confidential proprietary business information is?

MR. SILK: Do you want to go?

MR. CHANG: I think what we have is those interim regulations which were issued March 25 were really almost contemporaneous with the enactment of the State Secrets Amendments, which was, I think, April 29, so they're very close in time, and those interim regulations that you referred to say very specifically that trade secrets can be state secrets.

COMMISSIONER SHEA: Right.

MR. CHANG: So it looks like part of a coordinated campaign to tighten the control of information, which is the reason why I mentioned them in my written testimony.

COMMISSIONER SHEA: But it seems like if they want to go after the Rio Tinto employees, they could have gone after them under a trade secret concept or theory as opposed to a state secret theory. Is this an effort to carve out, create something where they can use in the future in similar situations?

MR. CHANG: I think what they were trying to do, if you look at Rio Tinto, it occurred after a series of very unfortunate incidents for the Chinese steel mills. They had just fared very poorly in iron ore negotiations, and, as well, Rio Tinto itself rebuffed an attempt by a Chinese state enterprise to invest in Rio Tinto.

There were all sorts of frictions between Australia and China, which weren't major, but certainly did not help. So I think what happened here is that it didn't really--it's not like in the United States where you might have a court trying to push a law in a direction because a law really isn't that important in China. When the state wants to do

something, it will go out and do it, and we've seen this in so many instances.

So I think what they were trying to do in Rio Tinto is to send a message to the foreign business community that we are going to use every tool of this state to punish this company, and going back to Chairman Fiedler's remarks, this is "monkey scaring" time.

COMMISSIONER SHEA: Uh-huh.

MR. CHANG: So, in a sense, I don't see the evolution of Chinese law as being this sort of procedural careful process. Really what we have got is a state that is determined to accomplish certain goals, and in this case, they saw Rio Tinto as offending China, and certainly prejudicing the steel mills which were involved in those very contentious discussions over iron ore price. So this really was payback time.

COMMISSIONER SHEA: Are you aware of any Western enterprise being prosecuted under the new trade secret regulations?

MR. SILK: I don't even think they're new enough.

MR. CHANG: No, I don't think so, I mean that they're too new for that.

COMMISSIONER SHEA: Too new. Okay. Thank you.

Bella, do you have anything to add?

[Laughter.]

COMMISSIONER SHEA: Okay..

HEARING CO-CHAIR CLEVELAND: A very clever staff put in our briefing book a memo called "Significant Revisions to PRC State Secrets Laws Passed" which Greenberg Traurig--it's a memo that they wrote.

And I'm interested in your view of this final observation:

The question continues to loom large as to whether State Secrets Laws may be used improperly to hide negative developments from investors in SOEs that have a significant public float to help keep their share prices high and cost of capital unfairly low.

It's a question, I guess, that Greenberg was posing, not a view.

MR. CHANG: I'm dying to answer this one, but since I answered the last one, you should do it.

MR. SILK: Please, please, please.

[Laughter.]

HEARING CO-CHAIR FIEDLER: It's Mr. Silk's turn.

MR. CHANG: Yes, it's Mr. Silk's turn.

MR. SILK: But Mr. Chang has made so many kind comments

HEARING CO-CHAIR CLEVELAND: Mr. Chang, go right ahead.

MR. CHANG: Oh, thank you very much, Commissioner Cleveland.

Clearly this is something that's going to be a problem because we

saw it, we referred to the floatation of Agricultural Bank of China, the last of the Big Four. And what's interesting about this whole process is that AgBank was supposed to go to the market a couple years ago, and then it was supposed to go to the market a year ago, and there have been real problems in floating its shares, and we really don't know, of course, why there have been all of these delays, but clearly you can see that they are very concerned about certain pieces of information about AgBank's nonperforming loans being certainly higher than have been disclosed to the regulator.

When we have seen the Chinese Banking Regulatory Commission talk about AgBank's NPL ratio, they just do not seem to correspond with other information that is available in the market, and I think that there was a long process on the part of AgBank and the underwriters to try to come to some sort of consensus as to what could be sold to the public regarding the NPL nonperforming loan posture of AgBank.

So it doesn't take much imagination after Rio Tinto, after some of the other prosecutions that we have seen, that the State Secrets Law could be used in the future when AgBank does not perform as well as people expected and as well as one might expect if one looked at the offering documents. So, clearly, this is something that should be on everybody's radar at this point.

MR. SILK: If I could just add a bit, and maybe start by saying if we could first place a period, and then move on, only because our firm is acting as underwriter's counsel in the ABOC offering although I myself am not acting on it. So I want to comment, but not necessarily in the context of anything that relates to ABOC.

The observation that I'd make on the sentence that the Commissioner read is that, you know, at the end of the day, one doesn't need the State Secrets Laws to support a bad egg doing something that is manipulative in the markets, and it may be that there's been a lot of past practice, and it may be that there hasn't been.

But if it's going to happen, I don't think that anybody in a position to make such a decision to do something with such profound impact on the market and on investors is going to make the calculation of, oh, well, we have this wonderful shield to stand behind because there are plenty of other bases under Chinese law that I'm sure--or practice or regulatory administrative practice--that would give grounds for a person, a manager in that position, or a senior official to take such a view.

I wouldn't condone it if it were my client, but I don't rule out that it does happen in the market.

HEARING CO-CHAIR CLEVELAND: Okay. Shifting subjects a little bit, Mr. Silk, in your prepared statement, you described the struggle over information control and Internet, and you said:

"To date, companies have tended to take two contrasting approaches--one involving conflict with Chinese authorities and market withdrawal, and the other involving cooperation with Chinese government and resulting in client alienation and potential human rights litigation. Neither route bodes well for business."

So what's the third way?

MR. SILK: One could choose not to enter the market, but that's not a great alternative either. I myself, as you may have gathered from the way that I've taken questions, tend to be a very middle of the road person. And what experience has told me over the past nearly 30 years in China is that going to one extreme or the other doesn't make for, is not a great recipe for success.

And it is those folks that tend to go to one extreme or another that will find themselves either having to deal with the tough decision of getting into a brawl with government or having to make a disclosure that would be sensitive to a client or group of clients or other participants in the trade.

So if I could pinpoint anything at all, it would be a middle of the road approach. I don't know, since I don't really do that much in information and communications and Internet, how that would necessarily play out. It may not be an alternative at all, but it seems to me to be at least the sensible approach.

HEARING CO-CHAIR CLEVELAND: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Wortzel.

COMMISSIONER WORTZEL: I want to thank both of you for your oral testimony and your written submissions.

I wonder if either or both of you could discuss parallels between the trade secrets law in China and the way the United States and United States law treats corporate proprietary secrets? Corporate proprietary information and its disclosure?

I have to admit, I have dealt personally many times with the National State Secrets Bureau of the People's Republic of China in the course of my government jobs, and they're pretty close to the U.S. General Services Administration Oversight Office for Classified Information. They function about the same way. They have about the same position in the bureaucracy. They do not have an investigative function. They do not have enforcement function. It's purely administration and cataloging.

But it strikes me that our real problem isn't so much with the fact that they may have trade secrets, that it may be illegal to give out corporate proprietary information, but it's almost the hidden and arbitrary application of these things. So I'd just draw both of you out on that.

MR. CHANG: I think there are really two differences between the

United States and China with regard to this, and, of course, you know, and I think they are fundamental, but nonetheless they need to be stated.

One of them is that at least up until a year or so ago, the United States government was really not involved in the ownership/in the operation of business in the United States, and of course that's just a temporary reaction to the global downturn, which eventually the United States will sell off its holdings in companies such as General Motors.

But in China, it's very different where you have large businesses that are not only owned by the government but also controlled by the government and the Party, and I mentioned in my written and in my oral testimony about how managers of state enterprises are owned and are selected by the Party.

And that's just from my practice in China in the middle of a very important deal, which was an issuance of shares of a Shanghai company, we suddenly found out that the general manager, in fact, the chief executive officer was out because a new replacement had been put in by the Party for political reasons.

So it's a very different thing, and so in China, because you have this pervasive state ownership of the large players in the economy, then you're going to have much more of a problem when it comes to protection of trade secrets.

The other thing, and this is I think even more general, but even more important, and that is that whatever problems might be in terms of the U.S. government's dealing with proprietary information and the attempt to keep information quiet, you know, in this country, we've got courts. We've got a free press. We've got independent prosecutors.

And although you can say maybe some of the same problems that we see in China also exist in the United States, it's very different because of the nature of the government.

I know that this sounds like I'm grandstanding, but it's absolutely important because we often forget about this important distinction when we talk about the differences and the similarities between our two countries.

MR. SILK: I think just to take Mr. Chang's points at a slightly different level, all of which I agree with, it's interesting that these new regs have come out, and that the legislation is geared to regulate on trade secrets for the benefit of SOEs.

I guess what I'm trying to get at is, taking one of Mr. Chang's points, is that the legislation in China has dual purposes. One of them is completely at item with our legislation and common law, which is it's a pure commercial matter. You have trade secrets laws in order to protect the proprietary owners of those trade secrets, and if there's a problem, then you go to the courts.

Similar result and impact by the legislation, but in addition to

that, because of the fact of the prevalence of government ownership of these large enterprises, it becomes a regulatory matter as well.

HEARING CO-CHAIR FIEDLER: Let me make a slight transition. Mr. Silk, in your presentation, State Secret Laws, 2010 Amendments, is the bulleted point affirmative obligation for Internet network operators and service providers to cooperate with security authorities in state secrets cases.

To me, non-lawyer that I am, an affirmative obligation means to me that you have to report it as opposed to provide, just simply provide, requested information. Am I wrong?

MR. SILK: I don't know the answer to that. It's a very good question, and it is an honest reading, but the issue has not yet been tested. We certainly haven't been asked to advise on the issue, but it is a very good issue, and I expect that many ISPs will be putting the issue.

HEARING CO-CHAIR FIEDLER: So let's review this a second a little bit and maybe, since you're lawyers--in the next panel are Internet experts--go back to the Yahoo case, I guess, where it blew up publicly for the first time where Yahoo cooperated and provided information on Shi Tao and others, and there was an outcry that--in the United States--that U.S. companies, to be sure, shouldn't do that. And their response was, well, we have obligations when we're operating in China to follow Chinese law, and Yahoo withdraws, sells its shares or transferred shares to Alibaba, and it kind of gets out from under control issues that way.

Google puts its servers in Hong Kong, ostensibly outside the reach of the Chinese government.

This, if my reading is anywhere near correct, there will be no wiggle room for anybody, and not only is there no wiggle room, it is put up into the state secrets classifications, which makes it extremely serious.

MR. SILK: It's an issue. I would agree with what you've said. I did take some counsel with a couple of my partners in the litigation department, all of whom are former U.S. Attorneys from the Southern District, who tell me that a similar obligation and respective cooperation of ISPs exists in the U.S.

But I don't believe that there is, I don't know that it is an affirmative obligation. In other words, the context that I was asking the question was if there was an investigation--

HEARING CO-CHAIR FIEDLER: And a subpoena.

MR. SILK: Yes, and that investigation implicated an issue that required information, then the ISP would then be required to comply with the subpoena.

And I have not put the question to my colleague of whether requirements under the U.S. law required actual affirmative disclosure even in the absence of an inquiry? And I just don't, I'm afraid I don't

know the answer to the question.

HEARING CO-CHAIR FIEDLER: Okay. Thank you.

Mr. Chang, Anything?

MR. CHANG: Clearly, there is a requirement under the wording of the amendment to report a disclosure of state secret. This mirrors language in the existing law while also imposing an obligation to stop the disclosure of state secrets.

What is happening here is that, you know, Internet service providers have, as you mentioned, been tightly controlled by the Chinese government anyway, and so, in a sense, this is sort of like a signaling, as I mentioned, of the government's priorities and its beliefs and what it wants to do.

In a sense, what they are doing is they are saying, and again going back to your point about killing chickens to scare monkeys, they are really putting the onus on Internet service providers to not do anything, to be especially cautious, that when any sort of information appears on a Web site, to scrub it immediately and to report to officials.

So it's signaling an intention. Perry Link when he was at Princeton talked about the "snake in the chandelier" as sort of the intimidation factor, as sort of the intimidation factor that pervades all of Chinese society, and what we have just seen is the National People's Congress, in reality the Communist Party, putting this into the law.

We tend to think of law as being something you've got to respect. We argue about what it means and all sorts of things, and that's what people do in criminal prosecutions in the United States, but that's not what happens in China.

As we've seen in the trial of Shi Tao, who you just mentioned, it's just like you're guilty. You know you want to present witnesses, don't even think about it. You can't cross-examine. You can't even have your own lawyer. So, you know, God, what can I say?

HEARING CO-CHAIR FIEDLER: Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you, gentlemen. Thanks very much for appearing today, and I'm sorry that a prior commitment meant that I missed your testimony so I hope that I'm not asking a question about ground you've already covered.

In China, is there a distinction drawn between trade secrets and state secrets?

MR. CHANG: Not any more.

VICE CHAIRMAN BARTHOLOMEW: This issue that arose in December about indigenous innovation is, if I understand it correctly, essentially Chinese government coercion of the opening of U.S. and other companies' trade secrets; is that correct? Do I get that correctly? That essentially if you wanted to participate in certain parts of the Chinese market, you would have to turn over some of what really is

your own trade secrets; am I accurate?

MR. CHANG: It's turning over intellectual property basically, yes, which could easily be a trade secret.

VICE CHAIRMAN BARTHOLOMEW: Right.

MR. CHANG: But it's framed in the context of the intellectual property of foreign enterprises have to be shared with, have to be licensed to domestic providers. Those rules are in flux because of all the criticism from the United States government, from all of the European and the American Chambers of Commerce. We don't know where it's going to end up, but right now, it's certainly very ugly.

VICE CHAIRMAN BARTHOLOMEW: Right, and I recognize they're influx, but what I'm trying to understand is at the same time that the Chinese government draws perhaps arbitrary or capricious lines around what it defines as state secrets, it is trying to capture what would be corporate proprietary information? Intellectual property. For a lot of businesses, those are their trade secrets.

MR. CHANG: Yes.

VICE CHAIRMAN BARTHOLOMEW: So there's an effort to manipulate openness as well as closed?

HEARING CO-CHAIR CLEVELAND: I think it's called "have your cake and eat it, too."

VICE CHAIRMAN BARTHOLOMEW: Yes. Actually, as my colleague here says, it's called "have your cake and eat it, too."

Okay.

MR. CHANG: A recognized legal term.

VICE CHAIRMAN BARTHOLOMEW: Mr. Silk, any comment?

MR. SILK: Well, just a couple things. First of all, there is a distinction I think between strictly under the law between trade secret and state secret, and I think that that's probably quite obvious to all the Commissioners, but the trade secrets regulations were mainly established to protect the commercial and other technical secrets of state-owned enterprises.

Not all of that information would be considered a state secret necessarily but does have the potential based on the ambiguity and the drafting of the regulations to be a state secret.

The other point, coming back to a point that I made on a different question earlier, is that, going back to the beginning of time, 1979, when the first foreign direct investment laws came out, until now, there have been many other bases for the Chinese regulators and legislation to capture benefits of foreign assets in the form of intellectual property for the benefit of Chinese participants in the economy, mostly up until recently state-owned enterprises.

VICE CHAIRMAN BARTHOLOMEW: Right.

MR. SILK: Wholly through the operation of laws that did not

relate to those that we're talking about today.

VICE CHAIRMAN BARTHOLOMEW: Okay.

MR. SILK: So it's not a new thing.

VICE CHAIRMAN BARTHOLOMEW: Right.

One of the things I always find troubling that I struggle with on all of these kinds of issues are that in order for business to really take place, people need access to information, to accurate information, in real time, and when the Chinese government includes among state secrets basic economic information, what kind of confidence can any American business have with the interactions it's having, doing business in China, or an American investor have in any investment that it might want to be doing in a Chinese business?

MR. CHANG: None.

VICE CHAIRMAN BARTHOLOMEW: Mr. Silk?

MR. SILK: I think it really depends at what level of the economy that the foreign investor is operating at. My level of concern and risk for my clients is certainly greater when dealing at lower level localities with smaller enterprises or individuals.

I've not had those concerns or may have had different concerns about information when dealing with large multi-hundred million dollar or multi-billion dollar projects.

I haven't been as concerned on--the concerns that I've had about information when dealing with the larger projects is they all tend to be very politically sensitive, and if one thing were to go wrong, the passage of information, one way or the other, could lead to a problem for my client coming to him, as we saw in Rio Tinto, or going over and then being applied or used inappropriately.

VICE CHAIRMAN BARTHOLOMEW: Go ahead.

MR. CHANG: If I could just mention one thing. There is an unpredictability in the way the system works. I can agree with everything that Mr. Silk said, and that was more or less my experience in China dealing with larger projects, but, nonetheless, there is this unpredictability in the way that the government and the Party make decisions, and so there are times when I thought that something would go one way which goes entirely a different way because--I don't know--there is some decision-maker who had for his or her own reasons decided to move in a different direction.

So even in what you would think to be a predictable environment in a commercial transaction, things can go ways which are just completely unforeseen, and this, I think, in general pervades decision-making in the People's
Republic anyway.

Part of this is because there is a goal, I think, to keep even China's friends off balance, and so we have seen that in terms of, for

instance, Rio Tinto, which was at one time, in July 4, 2009, was considered to be safe, and then July 5, the announcements of the detentions were made.

So I think that while we can sort of take some comfort in the way that things work, oftentimes we cannot say that we can rely, as we could rely in other countries.

VICE CHAIRMAN BARTHOLOMEW: Can I change gear? I have actually two other gears I'd like to change to.

HEARING CO-CHAIR FIEDLER: As long as we have enough time for Mr. Mulloy.

VICE CHAIRMAN BARTHOLOMEW: One is we had a discussion this morning with the SEC about materiality, and given, Mr. Chang, what you've said, and Mr. Silk, what you've been very careful about saying or not saying, at least while I've been sitting here, do you think that Chinese Communist Party participation in senior management or their ties to board members on companies that are being listed here should be considered material?

MR. CHANG: I'll be less than careful as I have been throughout this.

[Laughter.]

MR. CHANG: Clearly, it needs to be mentioned because the Party dominates the Chinese business landscape as it does the political system, and the Party does give directions to senior officials, and in the one example I mentioned, where a Shanghai company was about to go to market, the manager gets pulled because of some political consideration that we're not fully informed of.

So, it is certainly material in a society where you've got a one-party state. I don't see how it could not be material.

MR. SILK: I probably don't share the same view as my learned colleague, and the reason is that I don't know, similar to answers that I've given in the same vein a little bit earlier, I don't know that it really makes a difference these days.

I work with a lot of PRC companies, some of which are state-owned and some of which are not. I haven't found the decision-making, particularly recently, and I'm talking about the last three to five years, to be any different between either of the two companies, and in fact, I can say much to my sometimes shock, I find the decision-making to be at some of the large, very large state-owned companies, some of which we've spoken about today, to be in a manner and at a speed that I would not have thought could or would have been the case.

So in the context of an SEC discussion, is it material that a board member is appointed by the Communist Party? Well, I don't know. There are a number of questions that would come up in my mind. Does being a member of the Communist Party necessarily mean that that

board member is going to take a decision that is very different than any other board member or that is not necessarily in line with what a commercially appointed board member would do?

Similarly, if that person makes a decision that is guided by the Party, let's say, it doesn't necessarily mean that it's commercially wrong and not in the best interests of the company.

Even if we were to assume that one would give a negative answer, the investors that are investing in these securities are either sophisticated or have had sufficient enough disclosure or should have enough knowledge to know that there may be potential issues to make a sound investment decision, I would have thought.

So I'm just coming at it from a purely kind of practical and commercial standpoint as opposed to, you know, what the legal guidelines are.

VICE CHAIRMAN BARTHOLOMEW: And caveat emptor, of course. Do you think that that holds for institutional investors, too, though? You know, pension funds, people who's--

MR. SILK: All the more the case. All the more so for the institutional investor because they are treated under the law as a sophisticated investor, and if they can't figure out the potential risks or the potential benefits, as the Commissioner pointed out in the morning's session, of having a Communist, having Communist Party influence, then they shouldn't be considered a sophisticated investor.

VICE CHAIRMAN BARTHOLOMEW: Okay. Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Mulloy, second round.

COMMISSIONER MULLOY: Thank you, Mr. Chairman.

I have a question. When you gentlemen refer to state-owned enterprises, does that mean nationally owned or can they be provincially owned enterprises that are also--what's the distinction or is there any distinction?

MR. CHANG: When people talk about state-owned enterprises, it is indeed a broad term. There are some that are directly controlled by the central government. There are some that are controlled by provincial governments, some even by localities, though those would not be considered state-owned enterprises, I suppose.

But, the real problem here is that we're coming at this from an American perspective of a federal system where you have divided sovereigns. There are no divided sovereigns in China. It is one government.

So your local township committee is the same government as the central government, and so, the state is the state. Now, in terms of general parlance, you wouldn't talk about a township enterprise being a state-owned enterprise, but in reality, it is, but when people talk about

that, they generally refer to the 150 or so very large state-owned enterprises controlled directly by the central government.

COMMISSIONER MULLOY: By the central government. What is the Shanghai Automotive, SAIC? Is that a provincial company or enterprise; do you know? They're the ones I think that were partners with GM.

MR. CHANG: Right, they are the partners with GM, and they're controlled by the municipality.

COMMISSIONER MULLOY: But would they be a state-owned?

MR. CHANG: Well, yes, they would be considered, I suppose, a state-owned enterprise, but the Shanghai municipality, just to make this clear, is, although it's a municipality is considered a provincial level government. But it is controlled by the Shanghai municipality.

COMMISSIONER MULLOY: Do you have any distinction you want to make on that, Mr. Silk?

MR. SILK: No, I agree.

COMMISSIONER MULLOY: Okay. I think in an earlier panel we were told that these state-owned enterprises can be big political players in China and influence the government?

MR. CHANG: Definitely.

COMMISSIONER MULLOY: Yes. If GE has major plants in China or GM or other American companies, can they be political players and influence players in China and influence government decisions?

MR. SILK: I've seen instances where they have. In the larger-scale investments, yes, which, wouldn't be any different from a large investor coming into a smallish place and bringing in plenty of benefits for the local economy and local society.

COMMISSIONER MULLOY: Okay

MR. CHANG: I agree.

MR. SILK: The best example I can think of is--this goes back quite a number of years, and it will begin to show my age despite youthful appearances--is it used to be that--I worked on what was then the world's largest open pit coal mine which was in Shaanxi Province in China. It was originally invested by Occidental Petroleum, and--

MR. CHANG: You do go back.

MR. SILK: Yes, I do go back.

[Laughter.]

MR. SILK: And, it used to be that Armand Hammer would come in, if an issue needed to be dealt with, and he would deal with it at the highest level of government, namely, at the level of the premier.

And he was able through that investment to exercise a fair degree of influence not only at the central level but also at local and provincial levels of government.

COMMISSIONER MULLOY: Uh-huh.

MR. SILK: By virtue of that investment.

COMMISSIONER MULLOY: I don't know whether you've heard of this, but there is a lobbying community in Washington that some people think have a lot of influence.

Is there such a community in China that foreigners can hire lobbyists that can influence decision-making in the Chinese government?

MR. CHANG: They just generally bribe officials.

MR. SILK: There are folks that make a business of that, you know, basically fulfilling the government relations function, and in the old days, it used to be that the good number of them were foreign consultants who would have, you know, very good contact, some of whom might have been overseas Chinese, but there are a number of Chinese, some of whom are retired officials or sons and daughters of high-ranking officials or other relatives that have set up their own consulting firms to deal with facilitation of government matters.

COMMISSIONER MULLOY: Okay.

MR. CHANG: If I might, what really happens is you sit down with your regulator, for instance, who will then say you really need to speak to Mr. Chen, and Mr. Chen is not technically maybe part of the government. Maybe it does work. And it works through an informal network that can go all the way up to the secretaries or the members of the Politburo Standing Committee or even the Secretary of--the General Secretary himself, and that is really the way political lobbying does work.

It's not so formalized here as you walk down to K Street or something, but, nonetheless, that industry does exist.

MR. SILK: And I think the simple point is that no project gets done unless some of that type of interaction happens.

COMMISSIONER MULLOY: But that could be dangerous because then you place yourself outside the law in some ways if bribery is being made, and so therefore it would seem that the government could get a lot of control over people because they're all subject then to criminal prosecution of one sort or another.

MR. CHANG: Exactly. And also in a sense, you have a system where you don't really need to do anything wrong to actually be prosecuted and put into jail. So it's just the nature of the system.

Obviously, if you do the types of things that you're talking about that are more sensitive, then, yes, you increase your risk of prosecution, but, nonetheless, we got to state for the record, that you don't need to do anything wrong to find yourself on the inside of a Chinese prison.

MR. SILK: Well, there are certainly risks. In the projects that I tend to deal with, which, most of which tend to be very high profile, with companies that have very, very strong and solid sets of internal procedures that relate to how they interact with government officials, I

myself have not seen instances where folks on our side of the table have stepped across a line.

That line is blurry, I would tend to agree very much with what Mr. Chang has said, which is what makes that particular job very challenging and exciting and maybe even a little bit risky or a lot bit risky.

But, the interactions, whether one calls it conditioning or lobbying or otherwise, does need to happen, you know, for the basic reason that every project, unlike the U.S., every foreign direct investment project in China must be approved.

In order for it to be approved, the applicant has to establish a number of different standards, technical standards, economic standards, compliance with state macroeconomic policies, and so on and so forth, and has to provide a ton of information to support that application and really needs to know at all levels of the application process where it stands, and the only way to get a read on that is to meet with the person that has ultimate authority to make the decision on the approval, very much unlike the position in the U.S.

There may be other approvals that will stand in the way of getting a large petrochemical facility up and running in a wetland, but those are going to be, you know, environmental in nature and not necessarily, you know, whether the project satisfies, you know, government economic development plans.

COMMISSIONER MULLOY: Thank you very much, very helpful.

HEARING CO-CHAIR FIEDLER: Commissioner Shea had a question.

COMMISSIONER SHEA: I'll be real quick. Mr. Chang, you write in your testimony about the potential chilling effect of the State Secrets Law on Chinese enterprises fully disclosing information as required by American law.

Should the SEC, when a Chinese SOE wants to list its securities on a U.S. exchange, should the SEC require that the prospectus or whatever disclosure document indicate that the state secrets law may have a chilling effect on the registrant or issuer in fully disclosing information that may be material? Is that what you're suggesting?

MR. CHANG: I think that the disclosure should be more in the nature of what is the Chinese system, the economic system, the political system, and there could, I think, be general language. I don't know if it necessarily needs to key into the State Secrets Law. Maybe it does, but clearly a statement about the nature of the economic system, as we've talked about in our various comments, would be appropriate for investors.

I agree with Mr. Silk. He's absolutely right that when you deal with an institutional investor, they are sophisticated. They don't need

the same level of hand-holding, but in terms of shares that, you know, retail investors can have, I actually think that there should be more disclosure about the nature of the Chinese system because not everybody has that same level of awareness as we have in this room or in terms of what Wall Street has. But I think that it is important because people just don't know.

COMMISSIONER SHEA: Mr. Silk.

MR. SILK: No, I'd agree completely with what Mr. Chang has said. To be specific in the response to your question, I don't know that it would be so prudent for an issuer to use the words "chilling effect" in respect to the state secrets in a disclosure.

I don't draft disclosures so often. I do sometimes for large funds that tend to be marketed to institutional investors, and we would think of a way to put it that would get to the appreciation of the risk without necessarily using--

COMMISSIONER SHEA: Mr. Chang in his testimony makes a pretty strong statement. He says, "The State Secrets Law can undermine American securities laws." So that's a very strong statement. So it seems to me that with that type of statement, there should be some sort of disclosure. I'm not suggesting what the language would be.

MR. SILK: Yes.

COMMISSIONER SHEA: But some sort of disclosure that there is this law that impacts how companies in China may disclose information or may not disclose information.

COMMISSIONER SHEA: The appropriate wording is something--

MR. CHANG: I think that the disclosure should mention the nature of a one-party state. It may sound sort of outdated to talk that way, but that's the way the Party works, and in terms of directions that come from the Party to managers of state-owned enterprises that issue on American markets, I think that's important for people to know.

COMMISSIONER SHEA: Thank you.

HEARING CO-CHAIR FIEDLER: We'd like to wrap up with a question from Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: Two. Reading again from the Greenberg memo, they indicate that in the interim provisions on trade secrets, that the scope of trade secrets is extremely broad and includes operational information such as: strategic plans, management methods, business models, ownership restructuring and IPO, merger acquisition, restructuring property transactions, financial information, investment and financing decisions, manufacturing, purchasing and sales strategy, resource storage, customer information, and tender and bid, as well as technical information, such as design procedures, product formula, processing technology, manufacture, method and know-how.

What's left? What's not a trade secret?

MR. SILK: I think perhaps not much would be the answer, but I'm not sure what the point of the--well, perhaps to be fair to the writer of this, there is something in that bulletin on the particular issue, but the real question is, you know, how does one deal with this?

HEARING CO-CHAIR CLEVELAND: Right.

MR. SILK: As either an SOE that is subject to regulation and may need to make disclosures in the ordinary course of its operation, some of which may require or entail dealing with a foreign investor, or at the same time being a foreign investor that's participating with an SOE, that may be the recipient of information that may be subject either to trade secret or to state secret regulation.

I guess my question is we all can read what the definition is, and I'm just wondering if our colleagues at Greenberg have provided us any good guidance with how actually to manage because it is a great question?

It's a question that we, in our firm and many other firms are grappling with everyday. And these new regulations have added an additional layer of challenge of being not only concerned with clients being tagged with criminal responsibility under the State Secrets Laws, but then also potentially being tagged with administrative issues under the trade secrets regulations.

HEARING CO-CHAIR CLEVELAND: I guess my concern is that it's sort of cautionary in nature in terms of we don't really know what is inside or outside.

MR. SILK: But the reality is that even absent the trade secret, new trade secret regulations, the risk existed since 1950--

HEARING CO-CHAIR CLEVELAND: Okay.

MR. SILK: --with the State Secrets Laws because they contained the same ambiguity with even harsher potential penalties for violations, and so this is not as much of a concern when looking at it from the standpoint of risk.

MR. CHANG: I think that's certainly true that the legal risk has really remained the same. What's changed is the attitude of the government to apply the law.

VICE CHAIRMAN BARTHOLOMEW: May I ask a question of Mr. Silk, which is that it also seems to me that one of the things that is potentially different between now and 1950 is that people's sophistication about how to potentially use state secrets for competitive advantage--sorry, state secrets--state secrets. In other words, Rio Tinto, again.

MR. SILK: Yes.

VICE CHAIRMAN BARTHOLOMEW: It's kind of a black box still, how that all unfolded. But if there is more of a willingness to use

state secret leverage in a negotiation within an industry then it seems to me that's probably pretty different than 1950.

MR. SILK: Well, I would agree with you 100 percent in two respects. Number one, the issue of the foreign investor having to be much more guarded in respect of this risk is much greater now because there are many more people in China that really want to and are becoming quite adept at capitalizing on a good opportunity, in most instances, opportunities that are not in the best interest of their company.

VICE CHAIRMAN BARTHOLOMEW: Right.

MR. SILK: The second distinction is that even if there were people that might have been looking to take advantage in the '50s, according to the regulations, one had to be a counterrevolutionary in order to have a problem, and you don't have many of those these days.

[Laughter.]

MR. SILK: And it's actually been written out of the law.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR CLEVELAND: One final question. In an effort to balance all that we've asked, is it possible that given the fact that the State Secrets Laws now have bounds to them in terms of time, and I guess top secret classified information is declassified after 30 years, and I think there's a time table associated with each category, is it possible that the new law actually may allow human rights organizations or other groups access to information that heretofore was unavailable publicly?

MR. CHANG: In my written testimony, I talk about the Open Government Initiative and how one could see human rights activists, ordinary citizens, trying to say, well, look, you know, you apply the two together, 30 years is over, I'd like to know more about, for instance, how Lin Biao died in that mysterious plane crash in Mongolia.

But, don't believe for a second that any of that information is going to be declassified, and the real problem is that this provision is unenforceable in terms of declassification because an official can always say, yes, we extended beyond the ten year limit, the 20 or the 30-year limit. So I think that it's very interesting. I'm sure that citizens in China are going to try to use this, and I think it's a terrific thing that they do.

But, again, I think that the Party is going to push back, and that this is really just sort of a gloss to try to convince the Chinese citizens that the system is indeed more transparent when, in many ways, it's becoming less transparent.

HEARING CO-CHAIR CLEVELAND: Mr. Silk?

MR. SILK: I would agree. There are, to take one of the points in a little bit more detail, there are bases for citizens to bring actions

against government agencies where they feel that there's irregularity or some impropriety in the application of law.

And so that would be the legal basis for bringing a suit in respect of declassification. On the other hand, there is the ability, as Mr. Chang pointed out, of regulators to extend a period or otherwise classify the information as a state secret and therefore deny.

So I think even with the legal basis for bringing suit, I don't, I don't believe that it would necessarily provide much traction.

HEARING CO-CHAIR CLEVELAND: Okay. Well, thank you all, both, for being here, actually all, Bella, we appreciate your coming too. You've been extremely helpful in advising us on trade and state secrets.

MR. SILK: Thank you. Thank you very much.

HEARING CO-CHAIR FIEDLER: Thank you.

We will continue without a break on to our next panel so as not to penalize them for time.

[Pause.]

PANEL V: THE INTERNET AND BAIDU

HEARING CO-CHAIR CLEVELAND: Our final panel today in this long march will consider the Internet in China with particular emphasis on the firm Baidu.

We're pleased to have two experts on the subject--Rebecca MacKinnon and Rebecca Fannin--to help explain the relevant issues.

Ms. MacKinnon is a journalist, free speech activist, and expert on Chinese Internet censorship. She's presently writing a book about the future of freedom on the Internet age. In September, she will join the New America Foundation as a Bernard Schwartz Senior Fellow, focusing on the intersection of the Internet, human rights, and foreign policy.

We also have Ms. Fannin, an expert on entrepreneurship, innovation and venture capital in emerging markets. Her book Silicon Dragon was favorably reviewed by the Wall Street Journal and Financial Times and translated into several languages.

She is currently a columnist and contributing writer at Forbes.

Thank you both for joining us. We'll hear seven minutes of testimony from each of you and then follow up with our Commissioners asking questions. Please go ahead, Ms. MacKinnon.

STAEMENT OF MS. REBECCA MacKINNON
SCHWARTZ SENIOR FELLOW, NEW AMERICAN FOUNDATION
WASHINGTON, DC

MS. MacKINNON: Thank you, Commissioners, for the opportunity to testify today. My written testimony goes in much greater

detail, of course, on the role of Baidu, which is China's leading search engine, in implementing and legitimizing Chinese Internet censorship.

I will conclude with some thoughts about American investor support and complicity, to a certain extent, in this system. China, as I explain in more detail in my written testimony is, I believe, pioneering a new model for how authoritarian regimes can survive in the Internet age.

I call this political innovation "networked authoritarianism," and it's really a new form of authoritarianism that enables a great deal more discourse, a great deal more give and take between government and public without actually having to cede control when it comes to the judiciary system or actually move away from having a one-party state, and enables the government to manipulate conversations amongst the public in a much more subtle way than was ever possible in the pre-Internet age.

The Chinese government made it clear also in its recent Internet white paper that the rapid nationwide expansion of Internet and mobile devices is a strategic priority. The development of a vibrant indigenous Internet and telecommunications sector is deemed critical for China's long-term global economic competitiveness.

At the same time, Chinese companies are, of course, fully expected to support and reinforce domestic political stability and to ensure that Internet and communications technologies will not be used in a manner that threatens Communist Party rule.

Globally, two trends are working in the Chinese government's favor. First, the Internet is evolving away from personal computers and on to mobile devices, appliances and vehicles.

Second, the most rapid rate of growth in Internet and mobile use is, of course, happening in Africa and the Middle East where Chinese technology companies have a strong presence and where authoritarian regimes are also quite prevalent.

The Chinese government strategy is for Chinese companies to be global leaders in mobile Internet innovation, particularly in the developing world, and it goes without saying that innovations by Chinese companies are expected to be compatible with the needs and requirements of an authoritarian state.

As one of China's leading Internet companies, Baidu is, of course, expected to be a leader in what one might call "harmonious innovation." And while China's system for blocking overseas Web sites, which is popularly known in the press as the "Great Firewall of China," receives a great deal of the attention in the media, that's really only the first layer of Internet censorship in China.

And when it comes to any content that appears on Web sites that are hosted inside China that are on computers or operated by people and

companies inside China, you don't have to just block the Web site, you can compel the offending content to be deleted from the Internet completely, which means that VPN's circumvention tools, or proxy servers aren't going to be of much use if the content is gone.

All Internet companies operating within Chinese jurisdiction, domestic or foreign, are held liable for anything appearing on their Web sites, blogging platforms, social networking services, et cetera.

One might call that a form of intermediary liability, in fact, and in this way much of the censorship and surveillance work is actually delegated and outsourced to the private sector, who if they fail to censor and monitor their users to the government satisfaction will lose their business license and be forced to shut down.

So all Internet companies of any size have a special department whose sole job is to police users and censor the content being uploaded and transmitted by users around the clock. Last year, as I described in more detail in my written testimony, an internal set of documents detailing exactly what the rules and procedures were for policing and deleting content, were leaked by a Baidu staffer onto the Internet, and circulated, and kind of helped to lift the veil a little bit on these processes.

Of course, Baidu won't speak on the record publicly about these processes because that might be a violation of state secrets, which is again one of the problems. And in these documents, it showed that in addition to the expected censorship of anything mentioning Falun Gong or Tibet independence and so on, there is a very extensive list of anything related to petitions by people demanding their rights of various kinds, conversations about demobilized Army officers, clashes with police, discussions of AIDS, discussions of any names of jailed dissidents, names of cities where unrest had recently incurred, and so on.

Baidu censorship has been found in tests conducted by Human Rights Watch, OpenNet Initiative, and others to be consistently more extensive than the censorship that had been carried out by Google.cn before Google pulled that out of China, redirected to Hong Kong, and also by other foreign players in China.

Baidu's relationship with the Chinese government, it is fair to point out, is really the same as any company dealing with content of any kind in China, that they answer to a range of regulatory bodies, that regulate traditional media.

They also have to answer to a number of regulatory bodies that deal with technology, the Internet and telecommunications. And just like Google with its license being renewed just this week, they too have to have their license renewed on a regular basis, and if they're not scoring well enough in terms of how they're conducting themselves, they

can lose their license.

I've elaborated on all of this to a much greater extent in my written testimony, but just to conclude, the question is: with so much of the cost and the job of information control and censorship delegated to the private sector in China and with a great deal of American investment in Chinese Internet start-ups and also large Internet companies like Baidu, what kind of responsibility do American investors have, particularly when, to be fair, American investment dollars support a great deal of unethical and/or shall we say questionable behavior by many companies in many parts of the world?

But I do I think we've gone beyond the stage where a company can credibly argue or an investor can credibly argue, all we need is capitalism plus the Internet, and China is going to democratize eventually. I think we're learning that with China's political innovations, with the development of industry and the development of what some analysts call "state capitalism" in China, that just because you have capitalism, just because you have Internet penetration in China, doesn't mean automatically that you're going to have a democratic society over time.

Or at least we certainly have no data to support such an assumption, and so we need to be careful.

While it's hard to say exactly what kind of regulation would be appropriate, and I do not advocate total disengagement from China, by any means--I don't think that would help the situation in China either--I think there does need to be more honest acceptance by the U.S. investment community, in addition to American companies, of the role that they may be playing, and their responsibility to at least try and push things in a more positive direction.

I know I've gone over my time so thank you very much.

[The statement follows:][5]

MS. FANNIN: Thank you for the invitation to be here today. I want to put some of this, what I've been hearing today, into context of the whole entrepreneurial and venture capital environment that has been evolving in China for the past decade plus.

I've been able to have a very good observation point of this whole entrepreneurial spirit that has helped to encourage companies like Baidu to start up in China over the past decade as a journalist and as a book author. So most of my remarks are in that vein.

[5] Click here to read the prepared statement of Ms. Rebecca MacKinnon

I was given a number of questions to answer, and I've done my best to answer those and will go through some of this in my statement now.

Baidu, the Chinese search engine, owes its origins to Silicon Valley's culture of entrepreneurship and venture investment. This is a trend that I wrote about in my book Silicon Dragon, which really traced the evolution of a Silicon Valley culture developing in China with the Internet and with the mobile communications boom.

Baidu was founded by two Chinese citizens, both of whom got their education here in the U.S. or their graduate degrees here in the U.S., and also their beginning career experience before they went back to China, as China was opening up, and that's when they started Baidu.

Baidu is a very young company. It only began in 1999, in late 1999, so Robin and Eric, the two co-founders, were like many, many other young Chinese, very well educated and groomed entrepreneurs returning home at the same time to start up businesses. They were not unlike any other of the other entrepreneurs who we have profiled and have met and interviewed.

So they were attracted, as I said, by the new opportunities that were opening up in their homeland, and they sought to capitalize on it just as the Internet boom was taking off in China.

Today China has the world's largest number of Internet and mobile phone users. It also has the fastest-growing venture capital market and the fastest growing number of companies listing here in the U.S. as public companies.

So I have some figures to share on this venture capital investment trend that has taken off very steadily since 2002. The peak was in 2007 at 10 billion. Most of that capital actually came from the U.S. Many of these U.S. investors were from Silicon Valley. Many of the leaders were from Sand Hill Road who had seen what happened in Silicon Valley and wanted to help this develop in China as well.

So Baidu followed that structure. Most of its investment came from Sand Hill Road. It's been structured, as many of these other start-up companies have been in China, with the wholly foreign-owned subsidiary that was talked about earlier today through the Cayman Islands, and that was to allow for an IPO in the U.S. on NASDAQ, which Baidu did go public on NASDAQ in 2005.

It also was a means to get capital into the company and then exit from the company. Exit means getting an investment return when the company went public so both of these--this structure allows for this to happen.

One of the things that's not very well documented about Baidu's early history is that in reality Google actually made an investment in Baidu, and at one point there looked like there was going to be some

sort of deal between Baidu and Google, but Baidu went public instead on NASDAQ, and then a few months later then Google actually cashed out its shares in Baidu and made a huge profit on that. So that's one of the things that I talked about in my book that's not that well known, but it's, I think, relevant to today's discussion.

Now, on the issue of censorship, all Chinese companies, as has been mentioned today, operate in the same environment. Any company operating in China today is subject to censorship. These companies self-censor their sites. They have departments that are set up to do the self-censoring.

They filter out sensitive terms, and when searches are made for politically sensitive subjects or any other kind of offensive subjects, what will happen is users will see a blank screen or a message that the connection did not go through.

So in Google's case, Google had actually entered the market very early on, back in 2000, and they had long, Google had long faced censorship of its search results, and the decision to redirect searches to the market to Hong Kong earlier this year came after Google had already been operating in China for four years and had been competing with Baidu during that time.

With the retreat of Google.cn from China and the redirect to Hong Kong, the search market is now pretty much left open to Baidu, and Baidu already had a very large lead in the market, almost a two-thirds share in the market. That lead was built up steadily. In spite of Google trying to compete very aggressively with Baidu, Baidu continued to have the market dominance.

Now with Google's decision to retreat and redirect the searches, this is leaving, if what happens next is that Chinese users are left with only Baidu as the default search engine, it could mean that searches in China will suffer, that the quality of Internet searches will decline. So it does raise an issue in that regard.

What has happened since Google's decision to redirect its searches to the Hong Kong market is that Baidu's financial results have increased dramatically. The results are soaring. Stock price is up. Net profits more than doubled. Revenues jumped 60 percent.

So all of this, all of this is unfolding as we speak. It's a rapidly evolving scene. Anything today in China, particularly when it involves the Internet and mobile communications, this is happening in a supercharged energetic environment.

Finally, what I could say is having been to China many, many times and seeing some of this up close, I can say that Internet users are a very industrious bunch, and regardless of some of the censorship controls in China, many, many people do find ways to use VPNs or proxy servers to access the content.

So that's it. Thank you.

[The statement follows:]

Prepared Statement of Ms. Rebecca Fannin, Author "Silicon Dragon." New York, NY

Baidu is not a U.S. company, but it owes its origins to Silicon Valley's culture of entrepreneurship and venture investment. It was founded by two Chinese citizens—Robin Li and Eric Xu--who came to the U.S. for graduate degrees and career experience at some of America's finest organizations and then returned home as China was opening up to start a new business.

Robin and Eric were no different from dozens of other young entrepreneurial Chinese who were attracted by the new opportunities in their homeland and sought to capitalize on it. The Internet boom had started in China, and the mobile communications era was about to unfold. Today, China has the world's largest Internet and mobile communications markets, at 384 million online users and nearly 800 million cell phone users. Baidu's founders did what many of their peers did – they copied some of the most successful Internet business models such as paid search that had worked in the U.S. and tweaked them for China. Baidu was developed as a Chinese version of Google customized for local users.

The venture investment in China trend has steadily accelerated since 2002, with a peak in 2007 at $10.1 billion followed by nearly $10 billion in 2008, according to the Hong Kong-based Asian Venture Capital Journal. Most of this capital has come from U.S.-based venture investors, many of them from well-known firms in Silicon Valley.
Baidu follows the structure of most investments that have been made by venture capital firms from Asia, Europe and North America in Chinese startups over the past decade.

Like many others in China, Baidu got its start with venture capital funding from abroad and with board directors representing its investors. Two of Baidu's five current directors are American: Greg Penner, general partner of Madrone Capital Partners and William Decker, a retired partner of PriceWaterhouseCoopers.

Baidu was molded the typical way of most Chinese startups during these early days of China's entrepreneurial awakening with the rise of the Internet era. It was set up as a wholly owned foreign offshore holding company. Most of these so-called WOFIs were based in the Cayman Islands or the Virgin Islands. This structure is a way for venture investors to put capital (usually US dollars) into a Chinese company. It also provides an avenue for getting investment returns from the Chinese company as shares as sold, typically through an initial public offering in New York, London or Hong Kong.

Today, Baidu is one of dozens of Chinese Internet companies that now publicly trades in the U.S. Baidu went public on NASDAQ in August 2005, and its shares are held by Fidelity Management & Research Co.

The history of Baidu's investment is also fairly typical – except at one point Google was an investor in the Chinese search engine. The initial investors were Peninsula Capital and Integrity Partners, which put $1.2 million in the startup in 1999. Then, a year later in 2000, Baidu raised $10 million from DFJ ePlanet Ventures, a former affiliate of Draper Fisher Jurvetson, and from IDG Ventures China, an investment group that is part of the large Boston-based publishing and research group IDG. By 2004, Baidu began turning a profit and it soon raised another $15 million from DFJ ePlanet, which then owned a 28 percent investment stake. At the same time, Google invested $5 million for a 2.6 percent stake. In June 2006,

Google sold its shares in Baidu for more than $60 million and began competing directly with the Chinese search engine.

Like all companies—Chinese or not—operating in the People's Republic of China, Baidu is subject to censorship. Indeed, companies in China *self-censor* their web sites. Baidu's search results filter out sensitive terms or topics such as the 1989 student uprising in Tiananmen Square. When searches are made for such subjects, users typically see a blank screen show up on their personal computer or mobile phone, with the message that the connection did not through.

The same is true for any Internet company operating in China—from search sites to video sharing sites to social networking sites. If companies do not censor politically sensitive subjects, they risk being shut down by the Chinese government. For instance, some video sharing sites in China have suffered from periodic blocks after airing what was considered offensive material – in some cases, pornography.

As an American company operating in China for several years dating from 2000 until early this year, Google has long faced censorship of its search results. Now that Google has withdrawn from the Chinese market and is directing searches through Hong Kong-based servers, it is managing to skirt the issue of censorship in China while still providing a service to Chinese users.

Interestingly, Google—by agreeing to open shop in the country—had agreed to censorship when it first entered the market in 2000. When Google later revamped its Chinese-language search engine in 2006 for speedier service and more precise search results from servers in China, it built in some additional safeguards to protect the privacy of its users. For example, Google opted not to provide blogging or email services – to avoid having to turn over the identities of individual users in China and face the political issue that Yahoo did after releasing the names in 2003 of two bloggers who had criticized the Chinese government. But it still censored its search results in China. The company leadership argued that even a censored Google site in China was better than no Google in China.
With the departure of Google.cn from China, the search market is left open to Baidu. In early 2010, the Chinese search engine had a wide lead in the market with a 64 percent share – a lead built largely from a greater understanding of Chinese users. For instance, Baidu built in community-oriented searches to its site where peers could exchange answers. The large gap between the two rivals has remained in spite of Google going head to head with Baidu in China beginning in 2006 with the hire of former Microsoft executive Kai-Fu Lee as the head of Google China. Lee, however, was able to increase Google's portion of Chinese search revenues from 15% in mid-2006 to more than one-third by the end of 2009.

Now with Google's decision to withdraw its Chinese search engine from the country, leading Internet analysts such as Richard Ji of Morgan Stanley are predicting that Baidu will capture 20% to 30% of Google's market share in China. That leaves China with no viable competitor. Minus competing search engines, the quality of service may decline, leaving individuals in China with fewer options to seek out information. Certainly, Google's retreat puts Baidu on a more powerful footing.

As Google has retreated from the market and began routing searches through Hong Kong, Baidu's financial results have soared. For the first quarter of 2001, net profits more than doubled to $70 million while revenue jumped 60% to $187 million. Second quarter results are expected to climb at least 67%. Likewise, Baidu's stock price has been trading steadily upward since the beginning of the year, to a high of $82 as of May 13, 2010, more than double the price at the beginning of the year. See http://www.nasdaq.com/aspx/dynamic_charting.aspx?selected=BIDU&symbol=BIDU

No matter how the censorship issue unfolds in China, it's a reality that Internet users in China can still find ways to access content behind the "Great Firewall." For most expatriates in China, virtual private networks (or VPNs) are the most common way. Such VPNs are typically the ways that users access

Twitter and Facebook too, which are blocked in China. Proxy servers are another way.

The bottom line is that Internet users are an industrious bunch, and regardless of what controls are placed on content, have found ways to access content in China and readily shared these ways with their peers.

Panel V: Discussion, Questions and Answers

HEARING CO-CHAIR FIEDLER: Let me make a couple of comments first. We invited two American board members of Baidu, Gregory Penner and William Decker, to testify. We didn't hear back from Mr. Decker, but we did hear back from Patton Boggs, I believe representing Baidu. I don't know that they actually said they were representing Mr. Penner.

HEARING CO-CHAIR CLEVELAND: Declining to appear?

HEARING CO-CHAIR FIEDLER: Yes, they declined to appear. You mentioned Google had an initial investment. It is also little known that Madrone Capital that was one of the angel investors in Baidu in the first place, is Rob Walton, the chairman of Wal-Mart's personal investment vehicle, run by Gregory Penner, his son-in-law.

So we have not only American investment, we have some of the wealthiest American investment, and then what you've raised, Ms. MacKinnon, and you to a lesser extent, is the thing that troubles me most, and that is you have a lot of money, you can put it a lot of places. Okay. But you're putting your money, and it continues to pay off to major American investment, and we're talking 70 some odd percent institutionally held, largely by American institutions.

So there are all kinds of people profiting from the most aggressive censorship system going, and I don't know that I'm to believe that they had no other choices on where to put their money. Everybody always says, well, you got to follow the Chinese law. It smacks a little bit, and I don't want to overstate this, of, we're just following orders making our money; right?

That's what Baidu is saying, we're just following orders. Just following orders may not, I mean what it's resulting in is not necessarily death yet to somebody who is being prosecuted for violating state secrets or whatever, but it is certainly involving imprisonment, as in the case of Yahoo.

I don't know what you think about the reasonableness of anyone asking is it acceptable that Americans are underwriting this enterprise? And continually profiting from it? This is a public policy question of some consequence, I think.

MS. MacKINNON: If you don't mind my responding, I had a conversation with an American who invests in Chinese technology

companies, and I won't name who this person was, but--and I kind of confronted him with just this view, that aren't you concerned about what you're supporting, and are you doing anything to try and use your investment dollars to change practices at all, or are you just telling the people you invest in, do whatever you have to do in order to get the approvals you need to get, to make as much money as possible? You know, are you at all trying to move things the other way?

And he responded with a couple of fairly troubling statements. One is that he says, well, my Chinese friends whose companies I'm investing in, they all tell me that the Chinese people don't want democracy anyway. That's what Chinese people are telling m;, they don't want democracy anyway, so I guess it's okay because I'm just acting according to the wishes of my Chinese friends anyway.

And then the other even more troubling statement that came from this person was, well, it's not like American democracy is working so well these days anyway, you know. And you do hear these kinds of things being said by people in the investment community.

I think one of the problems, of course, as well, in China, is that you have a situation where the business elites very much profit from the stability of the current political system.

And when I speak to Chinese entrepreneurs who run Internet companies, they do say, well, yes, I don't like having a censor, but then on the other hand, if we lifted censorship tomorrow, the country would go into chaos, and it wouldn't do anybody any good anyway. So this is kind of what we have to do, and we have to be gradual, and so that's the argument that they give their investors.

So it's this kind of vicious cycle that goes on. And it's difficult to say what to do about it because, you know, from a regulatory standpoint, of course, there's all kinds of investments and companies listed in the United States that human rights groups and environmentalists feel are doing things that are not particularly good ordinary people.

But, you know, it's all being supported by our investment dollars and a certain small percentage of individuals are getting very rich off of it, and this China slice is one slice of a much bigger issue, I think, about the lack of ethics in investment in a whole range of sectors, and sort of lack of interest, and it does get down to, of course, corporate responsibility.

A hundred years ago, people might have argued and did argue, well, I have to employ 12-year-olds because it improves my bottom line, or I have to pollute the rivers because I have a responsibility to my shareholders to maximize profits, but society kind of worked out that there are certain bottom lines you have to have, and particularly when it comes to free expression, I think that that's been hashed out even to a

much lesser degree.

HEARING CO-CHAIR FIEDLER: Ms. Fannin.

MS. FANNIN: I don't really have much to add on that. Thanks.

HEARING CO-CHAIR FIEDLER: My time is up.

HEARING CO-CHAIR CLEVELAND: Ms. MacKinnon, in your written testimony, you talk about a study you did examining 15 different Chinese blog hosting services and their censorship.

Can you describe in a little more detail where Baidu fit into that in terms of where they ranked, and I'm also interested in the mechanics of how it happens? Is the censorship process, there is self-censorship obviously, but is the actual process administered by employees at Baidu? Is it therefore paid for by Baidu? What is the actual or what are the mechanics of the process of censorship?

MS. MacKINNON: In the paper I published on that study, I ended up deciding not to do a full ranking: this company censored most, this one was number two, three, four, all the way down because I was worried that the companies who censor the most would use information about the companies who censored least to kind of tattle on them, and use that to their competitive advantage, or the regulators might come across this information themselves and use it against those who censor less.

But I can say that Baidu ended up being number three, and basically in the study that I did I took a wide range of content that was of varying degrees of political sensitivity, you know, paragraphs from lots of different sources ranging from Tibet independence treatises to just critiques of local officials, to economic concerns, and so on, and I set up accounts on 15 different blog hosting services, and then posted the same content on each one, and then just watched to see what would happen, and then documented what happened.

In some cases, some of the blog hosting services were aggressively deleting much of what I posted, and some of them were only deleting some things, and they all did it a little bit differently, and Baidu, in the case of the most sensitive material, when you wrote your blog post into the box, and then, as anybody who has used any of these services would know, there's a little button that says "publish," and you click on "publish," and then I would get a message that would say we're sorry, but you cannot publish this because it contains sensitive terms.

So I wasn't even able to get this thing on to the Internet. So that was kind of the first degree. Another method for somewhat less sensitive content would be that it would go into a moderation queue, and then clearly some human would look at it and then decide whether or not they would actually allow it to appear.

In other cases, you would succeed in publishing it, but then it would disappear from the site after a random amount of time, sometimes

very quickly, sometimes less quickly, and so what this indicated was that Baidu internally had a system, kind of a number of levels.

One was that their software was geared to catch things that contain the most inflammatory keywords and not even allow people to publish it.

In cases of phrases and words that might require a human to look at it: are they talking about tourism in Tiananmen Square or are they talking about a massacre, or are they praising Hu Jintao or swearing about him, then it might go into a "moderation" queue so that a human can review the context of the thing before they allow it to go through.

And then there were other things that didn't get flagged at all, but perhaps somebody notices it afterwards and reports it, or it suddenly has a huge traffic spike, and then an administrator checks it out because they know that if you get a huge traffic spike, it's either political or it's porn usually, and in either case, they need to deal with it. Or it's a very popular person.

So, there is this mixture of automated software and human management that goes on internally. And yes, this is all, in all cases--and I've spoken to people who work in most of these companies--these are departments of employees of the company. So all of what I just described, the software is done by Baidu programmers, the mechanisms are built by Baidu staff, and it is Baidu staff who are doing this censorship work.

Now, certainly they are receiving regular instructions from a range of regulatory bodies about what content they need to keep an eye on, and there are also people in regulatory bodies and also in volunteer Party organizations, and what not, who are regularly scouring the Internet and flagging things and reporting it, and so on, some of who might be employed by the state and some of whom not.

But absolutely, it is private, the private sector is subsidizing this censorship.

HEARING CO-CHAIR CLEVELAND: During the break, Commissioner Shea and I were talking about what that would mean to an American investor, that their investment was, in effect, subsidizing censorship? And he posed the question, which I will pose to you, which is should listing documents which companies are required to submit to SEC identify whether a company engages in state directed/sponsored instructed censorship?

MS. MacKINNON: Again, I am not an authority on how listing documents tend to be structured and so on, but certainly if I was an investor, I would like to know how much of a company's overhead is going towards controlling the speech of the users, as opposed to innovation.

HEARING CO-CHAIR CLEVELAND: Okay. Thank you.

HEARING CO-CHAIR FIEDLER: Carolyn.

VICE CHAIRMAN BARTHOLOMEW: Thanks very much and thank you to both of you who bring, I think, quite different perspectives on this.

Ms. Fannin, you invoked Sand Hill Road, which to me having spent a lot of the years of my professional career working for the city of San Francisco, Sand Hill Road embodies sort of the promise of the Internet. And I always think of the early years of it as really being focused on access to information and the free flow of information, which is the promise of the Internet, which is I think one of the reasons that struggling with these issues is so difficult, which is here was a world and a universe that was being created that was supposed to facilitate the flow of information, and what it looks like is that a lot of people are really focused on facilitating the flow of profit.

I'm not going to be naive enough to say that the early pioneers in this were not also interested in profit, but there certainly was an attitude of wanting free flow of information.

But looking forward a little bit, I'm trying to understand moving into cloud computing, if that's what the future is, if information is held in these clouds, and I'm not sure that I still fully understand that, who is the holder of the clouds and what are the implications for information for all of us if a country with as much power in all of this as China decides that censorship is something that it doesn't want to apply just to its own population but--can you play that out for me a little?

MS. FANNIN: Yes. It's a good question you raise because a cloud assumes that it's open and--

VICE CHAIRMAN BARTHOLOMEW: Out there somewhere.

MS. FANNIN: --accessible to everyone to see, right, and to feel and touch, but it may not be if you're dealing with the Great Firewall. So it raises, I think, an interesting question issue.

VICE CHAIRMAN BARTHOLOMEW: Do you think, though, as these systems get integrated in one way or another, that will clouds exist within that Great Firewall or do they exist outside any of the constraints of any of this? And where are the operating rules coming from?

Ms. MacKinnon, I know I've heard you speak before also about concern about Chinese practices being adopted in other countries. Congressman Smith mentioned that, too, you know, that they're exporting some of these censorship techniques to other countries that have authoritarian governments or interested in having more authoritarian governments. What does that mean with the future of information?

Ms. MacKinnon, you want to give it a try?

MS. MacKINNON: Sure. I mean it's a really tough question, and

people are still grappling with it, but I think that in the Chinese Internet white paper that the government recently issued, they made a very strong statement about sovereignty, and what this means is that the bits that flow through PRC territory or bits that reside on computers inside China are subject to Chinese sovereign jurisdiction, with everything that that entails.

So we do have this problem, we like to think about the cloud as just this, kind of like the air. But the physical reality is that data actually goes through pipes. It goes through signals. It resides on servers even if it's kind of distributed across many different ones. And all of these pipes, servers, and signals are within physical national jurisdictions.

So it's not even just a problem limited to China. I actually spoke recently to somebody who works for a European service provider who was saying that some of their customers don't want their data going through Sweden because they don't like Sweden's laws about data retention and what the Swedish police might be able to access versus the Norwegian police.

And so depending on what you're up to in what country and which governments you trust more than others, different users are going to have different concerns about their rights and interests vis-à-vis different jurisdictions. So, of course, with China, the human rights implications are much closer to the forefront, and, yes, so most likely you'll see a lot of cloud computing that's geared towards the Chinese market being on a cloud that's within Chinese jurisdiction, and you're most likely to also see customers and services who are operating more global products and services not routing things through China or hosting things in China because of the implications.

So, yes, it certainly does have a lot of implications, and there have been situations just in terms of Internet address routing and with the domain name system. There have been some weird kinds of glitches that have gone on in the past year or so where accidentally because Pakistan blocked something, it suddenly got blocked on some other ISP's in other countries, just kind of accidentally, just because the way things were being routed around the world.

The same thing with something blocked in China, and then it ended up being blocked elsewhere kind of by mistake because of the routing path. So this is also a really big issue.

VICE CHAIRMAN BARTHOLOMEW: I'll have another question if there's a second round.

HEARING CO-CHAIR FIEDLER: Please. Go ahead.

VICE CHAIRMAN BARTHOLOMEW: I guess it's a simple question, which is we've seen Google and a lot of other companies that, of course, don't want to operate just in the United States. Is Baidu

currently operating anywhere except in China and does it have a business plan to move outside of China in the work that it's doing?

MS. FANNIN: It has moved into the Japanese market, and one of the reasons is that the Japanese and Chinese characters are similar enough that it was able to do that, and I think many Chinese companies do have global aspirations, but certainly the language is a major barrier.

VICE CHAIRMAN BARTHOLOMEW: And is Baidu in Japan complying with Chinese law or with Japanese law on things like access to information?

MS. FANNIN: I'm not sure.

MS. MacKINNON: It's been awhile since I've looked at that issue, but my impression is the latter, Japanese law, because I remember reading something, and again, I haven't looked at this recently, but sometime ago there was a story about how among Chinese Internet users, the word was getting around to go over to the Japan site. I'm not sure if that's still the case, if it's been made more unified or what's happened because one never really hears about Baidu Japan anymore.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Thank you both for being here and for your helpful testimony.

Ms. Fannin, in our briefing book, there's an article from Forbes, dated December 21, 2009, called "Google's China Blues," in which you wrote it, and I think you're predicting that Google may be wanting out of the China market.

And then you have another article, dated January 15, 2010--it's entitled "Why Google Is Quitting China." In that article you say:

"It's easy to give up if you've already lost the battle." That's what you say. "And Google is doing just that in China. Eric Schmidt's move to quit offering a censored Google search engine to the Chinese market has been read by idealists as the right thing to do. But it is first a business decision."

So as I get it, then you're saying Google's decision may have been painted as some kind of a movement for not being censored, but I think in this article you're contending they've really lost the battle for market share in China and were looking for a graceful way out. Is that your contention?

MS. FANNIN: I think if they were number one in the market with 80 percent market share, it would be a much tougher decision.

[Laughter.]

COMMISSIONER MULLOY: Okay. I can see that. Are you contending, then--I really am curious--that it wasn't idealism? It was a business decision?

MS. FANNIN: My opinion is that it was a, primarily a business

decision, and I know there are a lot of people who will disagree with me on that.

COMMISSIONER MULLOY: Ms. MacKinnon, do you agree that Google's decision was primarily a business decision, and then it was maybe coded or put in a more idealistic explanation?

MS. MacKINNON: I think it's more complicated than that. Google has made some commitments, as a member of the Global Network Initiative, on free expression and privacy.

I think they perceive their brand image as being associated with a free and open Internet so by having a censored search engine in China, if you're looking at their more global strategy, there was some conflict.

Google is in conflict with a lot of governments that are seeking to regulate them more heavily. David Drummond who has been at the forefront of Google's announcements has been convicted on criminal charges in Italy because of information appearing on YouTube. So Google is basically recognizing that a free and open Internet, and as little government interference as possible anywhere, is in their best business interest.

Having agreed to censor their search engine in China puts them in a much weaker position in their fights with all these other governments that are also trying to get Google to censor more for lots of different reasons, or to hold them more heavily liable for their content.

So I think if you take it broader than the U.S.-China Google frame, and you put it in the "what is Google's global strategy" frame, and look at their relationship with governments and regulators all over the world, you can see how actually the idealistic motivations of their founders, which are not non-existent--you know, Sergey Brin, he's from an émigré family from the Soviet Union, and he feels very strongly about these matters--that I think there certainly was principle involved, but I think it also helps that the principle was consistent with Google's long-term global interests.

COMMISSIONER MULLOY: Uh-huh.

MS. MacKINNON: And granted, they were not number one in the Chinese market, but 35 percent of 400 million Internet users is certainly a non-trivial amount of business, and so, again, would it have been harder to make this step had they been market leader? Perhaps so. I think that's absolutely a valid point, but I think they are looking more globally and more strategically as well.

COMMISSIONER MULLOY: Mr. Chairman, just a follow-up. Ms. Fannin, you just heard the same response I did. Do you think that's a pretty good assessment of what really happened?

MS. FANNIN: Well, I do think Sergey Brin was operating out of some idealistic agendas. But I also know that Google went into the market in 2006, and they censored their site for four years, so then to

all of a sudden when they had a management change in China to shift their strategy for China, and to say, okay, now after four years, now we will no longer self-censor, I think it does raise some issues.

COMMISSIONER MULLOY: Thank you both. Very helpful.

HEARING CO-CHAIR FIEDLER: Commissioner Wortzel.

COMMISSIONER WORTZEL: Let me try and see if I can understand part of your book chapters here, Ms. Fannin, and I take it that the business side of the Internet is really about "pay for click." Is that right?

MS. FANNIN: That can be a very important part of it, yes.

COMMISSIONER WORTZEL: Leave aside information flow, personal network, and so if I'm clicking for academic research and information, who pays for that?

MS. FANNIN: Who pays for that?

COMMISSIONER WORTZEL: Nobody, right? It's just out there.

MS. FANNIN: Yes, right.

COMMISSIONER WORTZEL: You have painted what seemed like an idealistic decision by Google and a principled one as a market decision, and I can also see that if you're paying for click, clicks on porn sites pay more than clicks on running shoe sites; would that be right?

MS. FANNIN: Probably, yes.

COMMISSIONER WORTZEL: There's more of them probably, you know.

MS. FANNIN: If they get through.

COMMISSIONER WORTZEL: There's more. Yes, if they get through.

MS. FANNIN: If those sites get through, yes.

COMMISSIONER WORTZEL: So, again, it becomes a business decision. So what that got me thinking about as I was reading and listened to both of you talking is, is it worth thinking about separating the communications e-mail and information aspects of the Internet from retail, commercial applications? You know have kind of a PBS Internet?

MS. FANNIN: Well, we do have dot.org, dot.edu.

COMMISSIONER WORTZEL: Right.

MS. FANNIN: We do have some separation.

COMMISSIONER WORTZEL: There would be less, aside from places like China, for the rest of us, there would be less, perhaps less problems with censorship, retail applications, domestic market content, things like that.

MS. FANNIN: Uh-huh. Well, yes, the Internet has developed its own naming system so that you do have, in effect, some of this separation already. Dot.net is different from dot.com, different from

dot.edu, is different from dot.org, et cetera. So--

COMMISSIONER WORTZEL: So nobody pays for a click on a dot.org? That's not true. I know that from my work at the Heritage Foundation.

MS. FANNIN: Uh-huh.

COMMISSIONER WORTZEL: We've put in a lot of money to get ourselves up there number one on clicks.

MS. FANNIN: Okay. Most of it is advertising supported so that's the--

COMMISSIONER WORTZEL: So you could begin to think, if you're taking this idealistic approach as opposed to a business approach, you want the free flow of information, you want communications and networking, you could begin to think about perhaps a PBS-like private or even government support for that intellectual aspect of the Internet and let those commercial guys do something else elsewhere? You could have two clouds?

MS. FANNIN: Maybe.

COMMISSIONER WORTZEL: Yes, well, I'm just thinking.

MS. FANNIN: Yes.

COMMISSIONER WORTZEL: Go ahead, Rebecca.

MS. MacKINNON: If I could just add a couple of cents, the PBS of the Internet, that's an interesting way of putting it. There is something called the "free culture movement" in the Internet community. There are Open Source software developers and other people who won't use a commercial blog hosting service, and who buy their own server space or run their own server from their bedroom on Open Source software and kind of go guerrilla, you know, run their own e-mail server, et cetera, et cetera.

It can be done completely or fairly noncommercially except you still have a commercial ISP you're going through. But there are some people who go fairly guerrilla. They have to be technically pretty savvy to do it, but one of the interesting things actually in a number of societies that tend to have authoritarian governments is that people who tend to be involved with the Open Source community, people who use Open Source blogging platforms and software platforms like WordPress and so on, tend to also overlap with the free speech activist communities pretty heavily, and that's not a total coincidence or fluke.

COMMISSIONER WORTZEL: Could I be permitted a minute more?

HEARING CO-CHAIR FIEDLER: Sure.

COMMISSIONER WORTZEL: You've kind of established people like Robin Williams and Sergey Brin weren't in this for idealistic reasons and for the free flow of ideas. Can either of you cite or find detailed anywhere the arrest or detention of people in China, of people that have

run Internet Web sites outside China? Because you cite that in your article.

MS. MacKINNON: Uh-huh. People who have run--

COMMISSIONER WORTZEL: Internet Web sites outside China.

MS. MacKINNON: --Web sites outside China who got detained inside China?

COMMISSIONER WORTZEL: Who got detained inside China.

MS. MacKINNON: Well, there are certainly people in jail who were involved with contributing to outside Web sites who are now on CPJs list of jailed bloggers and journalists and so on.

There are people who are in exile running Web sites that are clearly publishing a lot of information that the government doesn't like and they tend not to go back.

But a lot of times it's more subtle. It's just that people get blocked. Or they get shut down. I know somebody who ran a site that was partially in China and partially outside of China, and then it got blocked, and, they got told off, and then they stopped. So a lot of it is more about intimidation. And this is the thing about the system. Things get stopped or moderated long before anybody goes to jail a lot of the time.

So it's only the most determined people who are doing the most acute political things who actually end up going to jail because everybody else has other interests in moderating their behavior long before it gets to that point, and there are lots of warning signals along the way, you know, starting with when Baidu won't let you post your blog post, and ending with maybe, the Party secretary from your factory having a little chat with you about what you've been writing online and suggesting you not write it anymore. And going on from there.

So actually when you look at the number of people--I mean this is what's interesting--you've got so many people putting so much stuff on the Internet from China, but, as a relative percentage, not that many people in jail. And that's because there are a lot of other controls that are, one could say, much softer.

VICE CHAIRMAN BARTHOLOMEW: Ms. MacKinnon, you told an interesting story the other day at a forum that you and I were at about the people being invited in for tea, and then--can you say it in this forum--and the manual on how to deal with being invited in for tea?

MS. MacKINNON: The Commissioners are probably familiar with Charter 08, which is the pro-democracy treatise written by Liu Xiaobo and several other intellectuals-- and he is currently in jail. It circulated around the Internet, and quite a lot of people saw it, and initially didn't sign it, were maybe talking about it a little bit online, but then heard it had been censored, and then a lot of young people ended up signing it later on because they got angry because it got censored, more than

whether or not they fully supported it, which was interesting.

But then what happened was that quite a lot of people around the country got invited to "drink tea" in the local police station or have tea in the principal's office with the Party secretary of their school, or, you know, have tea with certain relevant authorities in the presence of law enforcement, and have a conversation about what it was they had done and whether or not they should do it again.

And this is a very intimidating thing that has been going on for a very long time, and when I lived in China and was working as a journalist, my news assistant got invited for tea from time to time. But what's interesting is that these young people who had never had this kind of experience before and hadn't really thought of themselves as being all that political started sharing their experiences online about, you know, the police asked me this, and this is how I responded, and, oh, my God, I can't believe what a dumb question this cop asked me about the Internet, et cetera, et cetera.

And so then a couple of people started circulating what were basically manuals for what to do when you get invited for tea. And the suggestions involved a lot of things like: invoke Chinese law and the Chinese Constitution right away, and, you know, be clear about your rights, and be clear in stating that everything you had done was actually guaranteed under the Chinese constitution as being part of your rights, and that therefore you didn't understand what the fuss was about, and giving people advice for tactics.

And so what this has done has helped to reduce the fear a little bit about these experiences. Of course, these blog posts will get deleted on these platforms, but then people e-mail them around or post them overseas, and some people access them. So you are getting this kind of conversation going on that helps people avoid feeling completely frightened and isolated by having spoken at all.

HEARING CO-CHAIR FIEDLER: Let me come back to the Americans profiting from censorship. So I smoke. Society in the embodiment of Commissioner Bartholomew doesn't like that, and therefore they levy a tax on me.

VICE CHAIRMAN BARTHOLOMEW: That's both T-A-X and A-T-T-A-C-K-S.

HEARING CO-CHAIR FIEDLER: Right.

[Laughter.]

HEARING CO-CHAIR FIEDLER: Both. That's correct. So they levy a tax on me to sort of attempt to mitigate my behavior, and it works for some people, and it doesn't work for the rest of us.

When you profit from censorship by investing in Baidu, you pay the same capital gains as you do if you invest in dairy milk. If society in the embodiment of the Congress believes that it is not in our interests

to further this censorship, but it also believes that it doesn't want to inhibit investment entirely or prevent investment into it, they could tax it; could they not? At a rate of 39 percent ordinary income instead of capital gains. That certainly would precipitate a lobbying campaign where we might get Patton Boggs talking as opposed to simply communicating that they wouldn't appear today.

But now we're getting to the economics of this. The corporate responsibility debate in a vacuum absent some economic factor inhibiting it, it seems to me, goes nowhere like it has for the last 30 years. Why do you need corporate responsibility if you've got laws?

So any comment on taxing? You think Greg Penner would put as much money in if he was taxed at a higher rate or would he look like most capitalists for a better place to put his money?

MS. FANNIN: I guess it depends on how high the tax was and how high the return was, but it would have to be a pretty high tax to discourage them from investing in China.

HEARING CO-CHAIR FIEDLER: I didn't say China.

MS. FANNIN: Okay.

HEARING CO-CHAIR FIEDLER: I said in censorship in China. The only choice is not investing in China and investing in censorship. They're two separate choices.

MS. FANNIN: So the tax would be on any investment?

HEARING CO-CHAIR FIEDLER: Only in censorship, not, a censorship tax, not a China tax.

MS. FANNIN: So other markets that practice censorship as well as China.

HEARING CO-CHAIR FIEDLER: Absolutely.

MS. FANNIN: Uh-huh.

HEARING CO-CHAIR FIEDLER: I mean you tax me for my cigarettes; why can't I tax you for your censorship?

MS. FANNIN: It's just all assuming that the censorship issue is just going to stay where it is or get worse.

HEARING CO-CHAIR FIEDLER: It just got worse. We just heard testimony that the State Secrets Law, now you have an affirmative obligation for Internet network operators and service providers to cooperate with security authorities in State Secrets cases. That's, and actually lawyers, even, couldn't tell me whether my common sense definition of "affirmative" meant that you actually had to report it. That's troublesome.

MS. FANNIN: I think when you're in China and you see so many young people with their cell phones and they're always online and they're texting one another and there's non-stop communication, the Internet and mobile communications boom has allowed this, this information exchange, to happen in China.

HEARING CO-CHAIR FIEDLER: Yes, but it also got Shi Tao ten years or more.

MS. FANNIN: Pardon me? Yes, right. Yes, well--

HEARING CO-CHAIR CLEVELAND: I think that raises an interesting point, and you may have mentioned this, Ms. MacKinnon, in the beginning. Do you think that the nature of the censorship presents the risk of shaping public opinion in China over the long term?

MS. MacKINNON: I think it has already started to do that. I think one of the problems is that while people are online and communicating and even talking to friends around the world, people don't know what they don't know. So I know very educated people who work for foreign companies who tell me they didn't realize how much censorship there was until something happened that affected them that was just slightly more political than usual, and they went searching for information related to it, and suddenly--

For example, I know one woman whose brother was detained for awhile, and so she suddenly started looking for information about what to do, and she was getting blocked, and she hadn't ever even thought about how do you get around blocks because she had never really been seeking out that kind of information.

And I think what we saw around the unrest in Tibet a couple of years ago in 2008 and then the unrest in Xinjiang was that domestic Chinese public opinion was very successfully manipulated in favor of the Chinese government and the Chinese government's policies in those regions, and people tended to believe what they were hearing and not be as aware of counter-arguments, or the counter-arguments were effectively discredited.

So again, it's not foolproof. It's not that everybody is an automaton and brainwashed. It's not that the government is controlling everything. But they're controlling it enough that they're preventing any serious challenge to the Communist Party's authority from arising.

And, yes, you can have a local disturbance, or a local strike, but the moment anybody tries to connect something up to a bigger movement, that's gone, and the conversations are managed to such a degree, and the censorship works well enough, again, not 100 percent perfectly, but it works well enough that the majority of people are not angry enough to do anything about it. Plus they feel that they have enough of a steam valve to talk about it, and so on, so that the pressure is actually less likely to build.

So, again, it's hard to predict what will happen. At the moment, you only have under 30 percent of the population online. Once it goes to 50, 60, 70, 80 percent, will the current system scale? We don't know. Nobody has ever tried any such a thing.

But at the moment, the government has been surprisingly

successful at, again, not controlling everything, and they're not trying to control everything, but managing things well enough to stay in power and prevent serious opposition movements from arising.

HEARING CO-CHAIR CLEVELAND: Interesting. Thank you.

HEARING CO-CHAIR FIEDLER: Okay. I think we're done. Any other questions? Thank you so much. We really appreciate it.

HEARING CO-CHAIR CLEVELAND: And thank Rob who supported us in this hearing.

HEARING CO-CHAIR FIEDLER: Yes.

HEARING CO-CHAIR CLEVELAND: I don't think we would have looked nearly so intelligent if we did indeed--

HEARING CO-CHAIR FIEDLER: We did look intelligent?

[Laughter.]

HEARING CO-CHAIR CLEVELAND: --but for his help. So thank you, Rob.

[Whereupon, at 4:16 p.m., the hearing was adjourned.]