Capital Markets Transparency and Security:
The Nexus Between U.S.-China Security Relations and America's Capital Markets

June 29, 2001

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Executive Summary

Background

This report on "capital markets transparency and security" was commissioned by the Congressional U.S.-China Commission. Capital markets security may be broadly defined as the nexus between foreign fundraising activities in the U.S. capital markets and traditional national security concerns. For the purposes of this report, this burgeoning issue area will be treated in the following manner: 1) reviewing the funding efforts of higher risk foreign companies and governments, or so-called global "bad actors," in the U.S. capital markets; 2) examining systemic shortcomings that enable, or could in the future enable, the wrong sorts of foreign entities to access U.S. capital; 3) recounting efforts to safeguard American investors; and 4) evaluating the use of capital markets leverage as a potential foreign policy tool. Due to China's extensive capital requirements and accelerated international fundraising initiatives, that country serves as an instructive case study in this rapidly emerging national security and human rights portfolio.

To assist the U.S.-China Commission in its efforts to assess the global funding patterns of the PRC -- and the impact of that external fundraising on the broader bilateral security relationship -- this study seeks to accomplish the following:

- Define "bad actors" in the markets
- Evaluate China's large-scale funding requirements and options for accessing capital
- Provide examples of dubious foreign entities in the markets and offer case studies in capital markets security
- Identify systemic shortcomings and efforts to strengthen U.S. transparency and disclosure requirements
- Assess the efficacy of capital markets leverage

Findings

Section I: Introduction

- The preponderance of the groundwork for this report was provided by the five-year "Capital Markets Transparency Initiative" of the William J. Casey Institute of the Center for Security Policy. The Institute has sought to ensure that American investors do not unwittingly help fund foreign companies or governments engaged in activities harmful to vital U.S. security interests and fundamental values.
- Global "bad actors" have been defined as companies or governments that could constitute a higher risk for investors due to their being suspected or known proliferators; firms partnering with terrorist-sponsoring regimes; intelligence or technology-theft front companies; companies owned or controlled by potentially hostile foreign militaries; governments that abuse human rights and/or deny religious freedoms; and funding vehicles for organized crime-affiliated firms or money launderers. "Bad actors" can also include

those companies -- or their subsidiaries, affiliates and/or parent companies -- that help underwrite entities under U.S. sanctions regimes.

Section II: China's Capital Requirements

- The government of China is currently coping with a prospective banking crisis of considerable dimension. The country's banking system remains largely state-owned and inefficient and its rural credit cooperatives are technically insolvent by some accounts. Non-performing debt is a substantial source of concern and efforts to recapitalize and stabilize the banking system would require, by some estimates, between $450-600 billion.
- China is likewise contending with increasing energy supply shortfalls and has committed the country to a costly overseas energy development strategy. It is conservatively estimated that China will earmark tens of billions of dollars to secure long-term sources of supply abroad as well as develop its domestic infrastructure. Moreover, energy imports are expected to increase sharply over the next decade.
- The PRC must also confront a faltering pension system, reported to be underfunded by as much as $600 billion.
- Some have estimated China's overall, near-term capital requirements to be over 100 percent of its GDP.

Section III: China's Recapitalization

- Although China can craft domestic and export policies designed to generate additional revenues and attract foreign direct investment, the country's most promising venue to secure large-scale funding in the coming years remains the international capital markets. Unlike the PRC's nascent domestic markets, the global -- and especially the U.S. -- capital markets can provide relatively inexpensive funds to help China meet its prodigious hard currency requirements.
- The "privatization" of hundreds of state-owned enterprises (SOE's) is a centerpiece of this international funding strategy. Not only can China list these entities directly on global exchanges to raise billions of dollars annually, but it can also utilize "red chips" (i.e., Hong Kong-based funding vehicles for mainland SOE's) to attract capital without encountering political problems or other obstacles that might accompany the funding of government-owned entities. China's forays in the global debt and equity markets have accelerated in recent years. It is expected that this trend will intensify markedly in the coming decade.

Section IV: "Bad Actors" in the Markets

- The international capital markets have replaced traditional commercial bank loan syndicates and Western government financing vehicles as the preferred funding venue for many sophisticated "bad actors." In addition to the governments of potential adversaries of the United States, a number of overseas companies, several of which are Chinese, have raised "yellow flags" with respect to their U.S. fundraising activities.
- Due to the complex relationship between China's People's Liberation Army and many of that country's SOE's, the precise connection between Chinese "red chips" and other listed firms and the PRC's military/intelligence services merits careful review to ensure that

Americans are not unwittingly underwriting China's robust military build-up or proliferation activities.

- Beginning in 1998, the issue of problematic foreign entities in the markets began to receive more serious attention in the U.S. policy-making community and media. Two bipartisan Congressional commissions affirmed the legitimacy of this concern and a number of recommendations were offered to manage this burgeoning security challenge.

Section V: Case Studies

- Three high-profile cases involving the collision of national security, human rights and/or religious freedom concerns and the U.S. capital markets underscore the existence of new material risk factors in the markets that can depress the value of certain foreign securities.
- Specifically, the cases of Gazprom, China National Petroleum Company/PetroChina and Talisman Energy Inc. of Canada highlight intensifying market activism in these issue areas as well as systemic shortcomings that facilitate the accessing of U.S. capital by the wrong types of foreign enterprises.

Section VI: Systemic Shortcomings

- The U.S. markets are ill-prepared to address the complex, new risk-related security issues resulting from an increase in foreign registrants. Moreover, the U.S. government has not undertaken a serious review of capital markets security or sought to determine the extent to which global "bad actors" have successfully tapped the U.S. capital markets.
- Due to offshore exemptions and other methods by which foreign entities can acquire American capital without adhering to stringent U.S. disclosure requirements, the challenge of protecting American investors and vital U.S. security interests is exacerbated. Similarly, the often symbiotic relationship between Wall Street underwriters and those entities that are contracted to purchase securities on behalf of this nation's public pension funds is cause for some concern (i.e., conflicting interests).
- Enhanced transparency and disclosure requirements can help those in the markets discern between sensible, benign foreign investments and dubious overseas enterprises.
- Recent SEC disclosure "process biases" have provided an important indicator to the markets that U.S. security-related issues require additional scrutiny. A sea change could occur by which foreign securities are purchased should public pension and other funds incorporate national security, human rights and religious freedom concerns into their "due diligence" risk assessments of foreign registrants and other overseas investment opportunities.

Section VII: Capital Markets Leverage

- Increasingly, policy practitioners and market activists are calling for the leveraging of America's capital markets to advance vital U.S. foreign policy objectives. Over the past year, legislative initiatives employing capital markets leverage have intensified in frequency and scope. As recently as June 14, 2001, the U.S. House of Representatives passed legislation (the Sudan Peace Act, H.R. 2052) that included the denial of U.S. market access to those foreign oil firms operating in Sudan's energy sector.

- The global dominance of the U.S. capital markets reinforces claims regarding the efficacy of this form of political leverage. Depending on the model applied, U.S. entities account for between 40 and 60 percent of global demand for securities. Similarly, the U.S. debt and equity markets account for as much as 50 percent of funds raised through securities offerings globally.
- In the case of companies already listed on U.S. exchanges, a suspension of trading in the U.S. could prove debilitating. The same could hold true with respect to the denial of market access for those foreign firms seeking large volumes of capital annually.
- When considering the egregious activities of certain foreign governments, there is also a case to be made that denial of U.S. market access could prove to be a potent policy instrument. For example, the following may be expected were U.S. entities prohibited from holding -- or trading in -- the securities of a foreign government and/or its companies: 1) an increase in perceived material risk; 2) the dampening of demand in foreign markets, thereby altering debt or equity values; 3) a higher cost of those funds raised; 4) the prospect that thinner volume markets could, over time, become "booked up" with risk exposure to that country; and 5) the slowing of the targeted nation's rate of market activity and likely reduction of its aggregate funds raised.

Recommendations

[*Recommendations have been provided to the Commission for its internal consideration*]

Introduction

Higher risk foreign companies and governments that have come to be known as global "bad actors" are increasingly seeking to fund activities inimical to the security interests and fundamental values of our nation in the U.S. debt and equity markets.[1] Traditionally, "bad actors" have often been viewed as those foreign governments that are known proliferators of weapons of mass destruction, sponsors of terrorism, human rights abusers or religious persecutors. With respect to companies, the list would likely include firms owned or managed by potentially hostile national militaries; intelligence or technology-theft front companies; and funding vehicles for organized crime-affiliated firms or money launderers.[2]

In the subtle, complex world of global finance, however, such lists or definitions do not adequately capture the nuances of this rapidly emerging 21st century national security challenge.

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1. The term "bad actors" is a colloquialism used by a number of observers that has come to represent those foreign governments whose policies – as well as those foreign companies whose international activities -- may conflict with U.S. national security, human rights and/or religious freedom concerns, thereby posing material risks to investors. The term should not be construed to indicate a value judgement or a determination of which foreign entities should or should not have access to the U.S. capital markets. It is rather a catch-all phrase designed to capture a diverse group of higher risk foreign governments and firms.

2. Testimony of Roger W. Robinson Jr., former Senior Director of International Economic Affairs at the National Security Council, before the Senate Banking Subcommittee on Financial Institutions, November 5, 1997.

Indeed, the ability of global "bad actors" -- on occasion with the assistance of their investment banks -- to establish affiliates, subsidiaries, off-shore funding mechanisms and other means to obfuscate unsavory business operations while simultaneously accessing the international debt and equity markets makes it considerably more difficult to identify wrong-doers and develop appropriate policy responses. In an age of "globalization," when the activities of -- and financial markets available to -- multinational firms are not limited by national boundaries, this challenge is further exacerbated.

An expanded definition of "bad actors," therefore, that identifies global companies that aid and abet rogue nations, human rights abusers and other potential adversaries is urgently required. In addition to those cited above, "bad actors" should also include those companies -- or their subsidiaries, affiliates and/or parent company -- that help underwrite egregious offenses of terrorist-sponsoring nations, countries that abuse human rights or religious freedoms and proliferators of weapons of mass destruction. For example, as long as Iran continues to be designated by the U.S. Department of State as a terrorist-sponsoring nation, a foreign energy company doing business with Tehran should warrant concern (and disclose this material risk) under this expanded definition due to the revenue-generating nature of its activities.[3] Similarly, were the government of Iran -- or its state-owned firms or military-connected companies -- to seek access to the global debt and equity markets, a more exacting review would be merited.

Historically, the United States has sought to distance its epicenter of political power in Washington from its financial center in New York. It is not difficult, however, to find occasions when financial considerations have been subordinated to U.S. foreign policy objectives. For example, the former Soviet Union was not able to offer securities in the U.S. capital markets at any point in its history.[4] Similarly, no one on Wall Street would have considered underwriting a German or Japanese sovereign bond during World War II. More recently, those companies that have been identified as playing a role in the Holocaust have been subjected to severe public criticism and some have been made to pay compensation for their activities.[5]

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3. Testimony of former Undersecretary of State for Policy, Peter Tarnoff, before the Senate Banking Committee, October 11, 1995:
Former Undersecretary of State for Policy, Peter Tarnoff, underscored the nexus between seemingly benign business activities and U.S. national security interests in testimony before the Senate Banking Committee in 1995. He testified: "A straight line links Iran's oil income and its ability to sponsor terrorism, build weapons of mass destruction and acquire sophisticated armaments. Any government or private company that helps Iran expand its oil must accept that it is contributing to this menace."

4. The former Soviet Union was, however, able to access other international debt markets -- but not until about 1987. From 1987 through 1991, the Soviet government raised a total of only $1.8 billion through bond offerings in currencies including the yen, lira, Swiss franc, Austrian schilling, deutschmark, British pound and French franc. It is interesting to note that it was primarily the institutional investors from each of these countries that underwrote these offerings. While it is difficult to determine if any of this debt was ultimately purchased by U.S. investors, it is historically significant that the United States, for all intents and purposes, denied access to our capital markets as a source of funding for the Soviet Union.

5. Roger W. Robinson Jr., "Financial Sanctions: How Might They Be Used Against Proliferators?" (Prepared for the Nonproliferation Policy Education Center, 1997):
In a December 1996 letter to William McDonough, President of the New York Federal Reserve, attorneys for a group of Holocaust survivors stated, "No [foreign] banking institution should be permitted the privilege of conducting

These precedents point to a guiding principle relevant to an evaluation of U.S. capital markets security.[6] Specifically, Americans have, in the past, been loathe to help finance foreign governments or companies that seek to contravene this nation's vital security interests or fundamental values. Taken one step further, this argument may also apply to those companies whose operations -- and associated revenue streams -- help enable the malevolent behavior of potential adversaries of the United States.[7]

China represents an important case study for the burgeoning field of capital markets security. A U.S. policy of engagement has presented Beijing with an unprecedented opportunity to help underwrite its global activities and prop-up its faltering domestic economy by recruiting Western investors to finance both its government -- via sovereign debt offerings -- and its state-owned enterprises. Regrettably, several of the "bad actors" that have been identified in the U.S. capital markets to date are Chinese entities.

There are two primary reasons for this phenomenon. First, China and its companies are actively seeking to engage those countries that the U.S. has deemed to be national security or human rights abusers. Indeed, China has extensive business and political ties to countries under U.S. sanctions regimes including Iran, Iraq, Sudan, Cuba, Pakistan and North Korea. Second, China is one of the world's leading "emerging market" economies. Put simply, rogue nations (and their companies) such as North Korea and Sudan cannot access the global debt and equity markets. It should therefore come as no surprise that a number of the examples cited in this report involve Chinese, or Chinese-affiliated, entities.

Three areas of study have emerged from the intersection of the U.S. capital markets and national security, human rights and religious freedom: 1) a broader examination of "bad actors" in the markets; 2) operational processes related to the global debt and equity markets; and 3) the potential use of capital markets leverage as a future U.S. policy instrument. Before proceeding with these areas of consideration, however, a brief review of China's current financial requirements may illuminate why the PRC is so active in the global capital markets as well as help demonstrate the potential effectiveness of exercising financial leverage vis a vis that country, should the need ever arise.

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business in this country which has committed and participated in the commission of violations of international law."

6. Capital markets security may be broadly defined as the nexus between foreign fundraising activities in the U.S. capital markets and traditional national security concerns.

7. Senator Sam Brownback, "Investing in Terror," *Washington Times*, November 3, 1997:
In a *Washington Times* editorial linking the revenue-generating activities of those foreign energy firms doing business with Iran to that country's nuclear and ballistic missile programs, Senator Sam Brownback stated, "American investors should not fund Iranian ballistic and nuclear missile development. And yet, that is essentially the deal that the Russian company Gazprom will be offering to unsuspecting American investors when it launches a new convertible bond this month...We should not stand by and watch U.S. retirement dollars bankroll an enterprise that subsidizes barbarism in the Middle East and is a threat to world peace. Trading peace for profit is a lousy investment."

China's Capital Requirements

As *Business Week* noted in March of this year, "The Communist regime's legitimacy rests largely on its ability to keep the dragon economy roaring."[8] While Chinese official reporting highlights the country's impressive foreign currency reserves (roughly $165 billion) and somewhat inflated economic growth, Beijing likely understands that a bullish medium-term outlook may not be warranted.[9] Three burgeoning financial concerns that will likely claim significant state resources in the coming years are: 1) a prospective banking crisis that could undermine projected development and potentially disrupt social stability; 2) looming energy shortfalls and infrastructure demands; and 3) an underfunded pension program.

Banking System

Depending on the source of statistics, the percentage of non-performing loans in China's "big four" banks (i.e., Bank of China, Industrial and Commercial Bank of China, Construction Bank of China and Agriculture Bank of China) is between 25 and 40 percent. Merrill Lynch, for example, has offered that 40 percent of all bank debt in China is bad -- only 15 percent of which is recoverable.[10] According to the *Financial Times*, the bad loans equal a troubling 25 percent of the banks' assets.[11]

Nicholas Lardy of Brookings Institution, considered to be one of this country's foremost experts on China's economy, has offered that three of these four banks are technically insolvent by international standards.[12] In total, the country's non-performing debt may be anywhere from $450 million to over $1 trillion when the extensive rural cooperative banking network is factored. It has been estimated that any attempt by the government to recapitalize its "big four" banks alone could raise China's debt-to-GDP ratio to an alarming 48 percent by 2002.[13]

Perhaps one of the best sources for examining China's banking system is that country's National Bureau of Risks. According to that government agency, "The risk of accumulated non-performing assets has become a major factor affecting the stable operation of the banking system."[14] The Bureau goes on to warn that risks attendant to the stability of China's banks have

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8. "China's Money Mess," *Business Week,* March 12, 2001.

9. "China's Capital Flight Reaches U.S. $20B a Year," *China Online News*, January 22, 2001.

10. Lester J. Gesteland, "No Turning Back: China's Privatization Trend Irreversible, Report States," *China Online News,* January 1, 2001.

11. James Kynge, "China's Fraught Fiscal Future," *Financial Times*, January 11, 2000.

12. "China's Economy: Red Alert," *Economist,* October 24, 1998.

13. James Kynge, "China's Fraught Fiscal Future," *Financial Times*, January 11, 2000.

14. "Risky Business: New Study Spots Financial Danger on China's Business Horizon," *China Online News,*

increased some 47 percent since 1991.[15] It also cited growing non-performing debts as a central factor in increasing risk. The *South China Morning Post* further validated stability concerns in November of 2000, paraphrasing China's State Statistics Administration: "The escalating non-performing loans by the big four state-owned commercial banks have dramatically cut their capital-adequacy ratio to 5.51 percent in 1999, well below the international accepted critical level of 8 percent."[16]

To date, attempts by Beijing to address its potential banking crisis have been primarily cosmetic. Over the past few years, China has launched four asset firms to manage roughly $1.4 trillion Yuan in bad debt accumulated by the "big four" banks.[17] Nevertheless, the structural flaws underlying the problem remain largely intact. For example, despite attempts to correct inefficiencies and production concerns in China's roughly 300,000 state-owned enterprises (SOE's), these firms continue to claim some two-thirds of the available capital of China's "big four" banks while only accounting for roughly one-third of national output.[18] Due to the prospective social backlash that would likely accompany the restructuring, or closing down, of SOE's (i.e., massive lay-offs with inadequate severance packages, etc.), the Chinese government has chosen to allocate billions of dollars to recapitalize its primary banks, thereby compounding the non-performing debt problem. For example, rather than using these capital infusions to stabilize existing bad debt portfolios and lend to productive, revenue-generating firms, the banks divert these resources to prop-up underperforming SOE's.[19] Baring systemic change, China will likely continue to "throw good money after bad."

The PRC's banking crisis, however, is not limited to its "big four" banks. According to Stratfor Global Intelligence Update, the most daunting short-term banking concern in China is the insolvency of the country's roughly 40,000 rural credit cooperatives.[20] With over 800 million rural inhabitants, these banks represent the principal means of funneling capital to agricultural and other development projects in the countryside. These cooperatives are also the primary savings institutions for rural Chinese. The People's Bank of China reported last year that these banks

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November 10, 2000.

15. Ibid.

16. Raymond Li, "Rising Financial Risk Raises Concern," *South China Morning Post*, November 14, 2000.

17. Ibid.

18. Dilip K. Das, "Reforming the Financial Sector in China," *Journal of Commerce*, October 13, 1999; "The Longer March," *Economist*, September 30, 2000; and "China's State-Owned Enterprises. Beijing Rules," *Economist*, May 3, 1997.

19. "China's Economy: Red Alert," *Economist*, October 24, 1998:
This lending pattern to SOE's compounds other capital deficiencies in China. At this writing, China's "big four" banks are responsible for providing some 80% of the development capital in China. By continuing to lend to inefficient, loss-generating SOE's, the banks reduce the pool of available capital for entrepreneurial and other profit-generating ventures.

20. "China's Other Potential Banking Crisis," *Stratfor Global Intelligence Update*, September 28, 2000.

have a combined negative net worth, due primarily to bad loans.[21] Stratfor put a fine point on the problem: "[I]t's not clear where the money is going, who has been receiving the loans or how prudent the cooperatives have been in extending them."[22]

Over the past few years, China has diverted some $7.6 billion to the cooperative banks in an effort to staunch this burgeoning financial crisis.[23] Rather than using the funds to close insolvent banks, guarantee depositor accounts and train employees to be more proficient lending officers, these capital infusions have primarily gone to finance new development projects.[24] In addition to the long-term, troubling financial impact of continuing this indiscriminate lending pattern, a prolonged economic downturn -- or short-term loss of depositor confidence -- in China could precipitate a run on cooperatives akin to the type witnessed in Beihai in 1997. Again, according to Stratfor, "a run on credit cooperatives in Beihai eventually led to the collapse of all fourteen cooperatives in the city."[25]

While the long-term economic repercussions of China's non-performing debt problem are unclear, it is difficult to foresee the resolution of this banking crisis barring large-scale capital injections. In addition to the estimated $450-600 billion required to restructure or write-off non-performing debt, China must also dedicate billions to capitalize the "big four" as well as local banks and cooperatives. These estimates do not factor in the cost of structural adjustments and training programs required to ensure the long-term viability of the PRC's banks and other financial institutions.

Energy Shortfalls and Pension Requirements

A second major claimant on capital resources in the coming years will be China's intensifying energy import requirements. Although roughly 20 percent of the world's population resides in the PRC, the country only possesses some two and one-half percent of known oil reserves.[26] In 1993, China became a net importer of oil. Last year, the PRC imported some 1.3 million barrels of oil per day.[27] The International Energy Agency estimates that figure will climb as high as eight million barrels of oil per day by 2020.[28] Although Beijing recognizes its impending energy shortages and has taken steps to increase domestic production and develop offshore and overseas supplies, the International Energy Agency has also predicted that "China's long-term oil

21. Ibid.

22. Ibid.

23. Ibid.

24. Ibid.

25. Ibid.

26. David Holley, "China's Thirst for Oil Fuels Competition," *Los Angeles Times*, July 28, 1997.

27. "China Imports Up Remarkably," *Asiainfo Daily China News*, January 23, 2001.

28. "Huge Increase in China Oil Imports Predicted," *Houston Chronicle*, March 21, 2000.

imports will outstrip by three times the country's own forecasts."[29]

In order to meet future demand, China has dedicated enormous financial resources to domestic and foreign energy projects. Over the next five years, it plans to invest some $120 billion Yuan (roughly $14 billion) to explore and develop several offshore oil and gas fields.[30] Billions more will be dedicated to the development of reserves in Western China and a projected 16,000 kilometers of oil and gas pipelines to be laid by 2020.[31] Morever, this past year, reports indicated that the country has also taken steps to create a sizable reserve.[32] Stratfor Global Intelligence Reports has estimated the cost of a ninety-day reserve for China at some $10 billion.[33]

Beijing's "prize" energy strategy, however, may well be the completion of six major foreign oil and gas projects over the next decade. Indeed, "source diversification" is apparently the central pillar of the government's strategy to ensure access to these energy requirements. According to a 1999 profile of China's energy industry by *Asian Pulse*, "China plans to develop 50 million tons of oil and 50 billion cubic meters of natural gas from abroad by 2010 by giving priority to developing oil markets in the Middle East, Africa, Russia, South America and Central Asia."[34]

In fact, China's strategy for developing international energy sources may be more expansive than indicated in many Western reports. Over the past several years, China's flagship energy firm, China National Petroleum Company (CNPC), and the country's second largest oil concern, China Petroleum and Chemical Company (Sinopec), have assumed prominent positions in the international energy market. As the *National Security Forum* recently reported,

> "To compensate for heavy reliance on the Gulf, large Asian energy consumers are moving aggressively to build wider energy networks. China is building energy relationships worldwide, in Central Asia, Russia, Africa, the Middle East, and even in Latin America. In less than four years, Beijing has established an energy presence in twenty different countries. Since 1997, China's state-owned energy companies have signed 47 contracts with 44 overseas oil companies and 130 exploration contracts with 70 foreign oil companies in eighteen different countries."[35]

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29. Ibid.

30. Jamila Zhou, "Mainland to Spend 120B Yuan on Oilfields Development," *South China Morning Post*, November 27, 2000.

31. "A Profile of China's Oil Industry," *Asia Pulse*, August 12, 1999.

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. S. Enders Wimbush, "Energy and Strategy: 2001," *National Security Forum Review*, Spring 2001: According to Mr. Wimbush, "China is creating a strategic petroleum reserve and is building a fleet of super-tankers for Iran that will transport energy to China."

33. "China's Congress Calls for National Oil Reserve," *Stratfor Global Intelligence Update*, March 10, 2000.

34. "A Profile of China's Oil Industry," *Asia Pulse*, August 12, 1999.

35. S. Enders Wimbush, "Energy and Strategy: 2001," *National Security Forum Review*, Spring 2001.

Not surprisingly, Chinese energy companies -- which often cannot compete with Western firms -- have focused the bulk of their attention on countries currently under U.S. or international sanction regimes. CNPC, for example, currently has ties to Iraq, Sudan and Venezuela.[36] Similarly, Sinopec inked contracts with Iran in January 2001 reportedly valued in excess of $160 million and as recently as last summer was active in Sudan.[37]

Irrespective of China's internal strategy for meeting energy requirements in the 21st century, the bottom line remains clear: China will earmark tens of billions of dollars to finance adequate energy supplies in the coming decade. Another pressing claimant on capital facing the government will likely be the country's expanding, near-term pension requirements. By 2003, China will have some 90 million people over the age of 65.[38] As was recently noted by *China Online's* coverage of a detailed Merrill Lynch report on the PRC economy,

> "As alarming as [bad debt concerns] may sound, the government's social security obligations are more onerous still. Unemployment compensation, medical coverage and pensions -- benefits that have historically been supplied by SOE's -- are currently 'grossly underfunded'...to the tune of US $600 billion, or 60 percent of GDP."[39]

Additional Economic Indicators

A review of China's current macroeconomic outlook indicates that the PRC will have difficulty generating internally the revenues required to restructure the banking and state sectors, finance energy imports and capitalize its pension system.

While capital requirements mount, state borrowing has intensified. For example, the ratio

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36. David Holley, "China's Thirst for Oil Fuels Competition," *Los Angeles Times*, July 28, 1997:
Although Venezuela is currently not under U.S. sanctions, the country has nevertheless taken steps to curtail political freedoms since the election of Hugo Chavez in 1998. China has extensive energy-related and political ties to that country. According to the *Los Angeles Times*, "CNPC made an unusual foray into Latin American oil production, bidding a total of $359 million for rights in two marginal Venezuelan fields that are producing only small quantities of oil but could yield more by the use of advanced technology."

37. A primary impetus for this international energy development activity may be China's reluctance to rely upon the oil spot market. Such a policy could be due to Beijing's concern that any future conflict with Western countries could lead to energy-related retaliation. Rather than assume this political risk, China prefers to have a physical "flag in the ground" in major oil producing nations often shunned by the West (e.g., Iran, Iraq, Sudan, etc.). Not surprisingly, several of these countries have been reported to be major recipients of Chinese arms-related exports and technologies.

38. James Kynge, "China's Fraught Fiscal Future," *Financial Times*, January 11, 2000.

39. Lester J. Gesteland, "No Turning Back: China's Privatization Trend Irreversible, Report States," January 1, 2001:
In addition to raising concerns with respect to Beijing's financial stability, this report underscores the government's need to keep faltering SOE's afloat. The current pension shortfalls would be significantly increased in the event that millions of SOE employees were to be laid off in the course of "restructuring."

of treasury bonds issued by China nearly doubled between 1991 and 1999.[40] State debt, which stood at some 5 percent of GDP in 1993, rose sharply to an estimated 20 percent of GDP in 1998.[41] While such a debt-to-GDP ratio would be of little concern in Western economies due to strong revenue streams, China's consolidated fiscal revenues were only 12.4 percent of GDP in 1998.[42] According to the *Financial Times*, China's budget deficit is likewise expanding and reached $13 billion (or roughly 2 percent of GDP) in 2000.[43] This figure will likely rise in the coming years as Beijing seeks to jump-start its economy and maintain at least 7 percent growth figures through fiscal stimulus packages and infrastructure development projects.

The business climate in China is also worrisome to some analysts. According to the recent PriceWaterhouseCoopers "Opacity Index," China is the world's most difficult place to do business due to the "lack of clear, accurate, formal and widely accepted practices in the broad areas where business, finance and government meet."[44] This might explain recent drop-offs in foreign direct investment in China -- which *The Economist* described as the best single indicator of business confidence.[45] Moreover, capital flight continues to pose a serious problem for Beijing and the country's production capacity lags well behind that of the West.[46]

Finally, and most troubling from the standpoint of the Chinese government, economic growth continues to be driven by exports due largely to structural and other economic inefficiencies. Put simply, any global economic downturn would impede China's capacity to export. Given the PRC's overall economic fragility and substantial capital requirements, the net effect of slower growth could prove debilitating.

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40. Raymond Li, "Rising Financial Risk Raises Concern," *South China Morning Post*, November 14, 2000.

41. James Kynge, "China's Fraught Fiscal Future," *Financial Times*, January 11, 2000.

42. Ibid:
According to Dong Tao of Credit Suisse First Boston, "China has one of the weakest revenue streams in the world. It is in a similar state to Russia."

43. Ibid.

44. Al Santoli, *China Reform Monitor*, February 16, 2001.

45. "Money In, Money Our," *Economist*, October 23, 1999; and "China's Private Surprise," *Economist*, June 19, 1999:
While, officially, the numbers only suggest a year-on-year drop-off in foreign direct investment (FDI) in China of 10% in 1999, this figure ignores accounting anomalies. Specifically, much of the FDI in 1999 represented funds that had already been committed. Similarly, a significant percentage of "new" FDI is actually accounted for by Western firms taking over projects initiated by multinational counterparts as more and more firms downscale -- or cease altogether -- operations in China. In this sense, "updated" FDI figures are actually counting for a second time investments that have already been factored into statistical analyses. Moreover, FDI also includes monies recycled from China through Hong Kong and back to the mainland.

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. "China's Capital Flight Reaches U.S. $20B a Year," *China Online News*, January 22, 2001; and Peter Zhang, "Why China is Still an Economic Pygmy," *The New Australian*, December 12, 2000.

Conclusion

The true condition of the Chinese economy is a matter of animated debate among policy analysts and economists. The objective of this review is a narrow one: to highlight China's pressing -- and large-scale -- capital requirements. There is likewise abundant evidence to suggest that China's domestic economy will not generate sufficient revenue and other capital flows in the coming years to meet the government's extensive demands. Indeed, combined with fiscal spending obligations, some have estimated China's overall, near-term capital requirements to be over 100 percent of its GDP.[47]

While China may not be "going broke," as characterized in one recent report on China's macroeconomic outlook, barring massive, near-term infusions of foreign capital, the chances of economic dislocation for the Chinese government expand considerably.[48] The impact of China's three principal financial concerns (e.g., non-performing debt and energy- and pension-related capital claimants) has not been lost on the government. Beijing recognizes these and other requirements and has made the development of alternative sources of capital a high priority.

47. Lester J. Gesteland, "No Turning Back: China's Privatization Trend Irreversible, Report States," January 1, 2001.

48. Ibid.

China's Recapitalization

There exist a number of ways China might attempt to "recapitalize" its economy. Domestically, the government can seek to expand its revenue stream by strengthening tax collection and eliminating corruption and graft at the provincial level. It can similarly stimulate domestic demand to reduce the country's reliance on export-generated revenues as well as encourage investment in -- and lending to -- capital-producing projects. Moreover, China could strengthen its rule of law and improve its business environment to attract more foreign direct investment.[49] While worthy objectives, the effects of these measurers, if successful, would likely have little impact on Beijing's more immediate hard currency requirements.[50]

Two more promising funding venues, however, could yield the sustained, multi-billion-dollar capital streams China requires annually: 1) the PRC's domestic capital markets; and 2) the international capital markets.

Domestic Chinese Markets

China dedicated significant resources in the 1990's to developing its nascent capital markets. Although it has advanced the process -- and could become the third largest financial center in Asia by the end of this decade -- its domestic markets remain inefficient, thin and, compared to those in the West, relatively underdeveloped. Even when viewed optimistically by international analysts and market players, it is difficult to envision China's markets as a decisive source of capital for the government in the coming years.

China's most pressing domestic capital market concern is its underdeveloped bond market. This limitation makes it difficult for the government to issue sovereign debt in order to help fund stimulus measures and the above-referenced capital requirements. According to a 1998 *Financial Times* article, "Perhaps the most important reform for the government is the creation of a liquid bond market that would facilitate the issuance of government debt."[51] Central government policies, however, continue to hamper progress. Specifically, China's central bank controls interest rates, thereby disrupting the fluidity of the market and undermining its vitality.[52]

49. Peter Zhang, "Why China is Still an Economic Pygmy," *The New Australian*, December 12, 2000:
As of now, China is the recipient of roughly 10 percent of global foreign direct investment.

50. WTO, it can be argued, will likely be an effective instrument in helping to "recapitalize" China. The political and market legitimacy WTO membership provides as well as the stringent requirements for systemic change within China should stimulate increased Western foreign direct investment and make available venture and other infusions of capital. Moreover, the WTO process provides defacto legitimacy for China's hybrid economy. This new status should also translate into greater access to the global capital markets for Chinese state-owned and other firms. Recent reports indicate, however, that China could possibly renege on some of its key WTO commitments.

51. James Kynge, "China's Fraught Fiscal Future," *Financial Times*, January 11, 2000.

52. Ibid:
The importance of this market -- and the extent to which it remains underdeveloped -- was also noted by Song Fengming of China's Tsinghau University: "We don't have a proper Treasury market. We don't have a Treasury Bills auction system. We must build up a modern capital market system as soon as possible."

China's equity markets have faired little better. Irrespective of impressive figures regarding the market's capitalization, rate of listings and active trading, its domestic stock market fails to inspire confidence. Of principal concern are artificially high prices, insider trading, market manipulation and a dearth of transparency and disclosure.[53] In addition to these challenges, Nicholas Lardy of Brookings Institution raises doubt with respect to the empirical strength of China's equity markets, pointing out that "the market's huge capitalization wildly overstates their importance because it reflects the total value of listed companies, not the tiny number of shares traded."[54]

Far from serving as a primary recapitalizing vehicle for the central government, China's burgeoning markets could potentially become a net financial drain. Currently, some 34 million Chinese -- many of whom are unemployed -- actively trade in China's equity markets.[55] China's own National Bureau of Statistics emphasized recently that "immense risk could be lurking in the markets," likely due to what *China Online News* terms "an under-regulated stock market, low-quality public companies and investor irrationality."[56]

Three prominent Chinese economists came to a more dramatic conclusion in a recent letter to China's National People's Congress. According to *China Reform Monitor*, the correspondence stated, "Rampant market speculation and a massive drain of capital from floundering state-owned enterprises, combined with a lack of regulation in China's mushrooming securities markets, could lead to a 1929-style stock market crash."[57] While Beijing's control over its domestic markets makes such a scenario improbable, any financial implosion of this type could cripple the government financially and possibly result in significant social backlash.

International Financial Markets

China's most realistic -- and near-term -- venue for meeting its large-scale capital requirements is the international debt and equity markets. Statistics reflecting the country's increasing presence in these markets attest to the efficacy of this strategy. Between 1980, which marked China's return to the global debt markets, and 1999, China issued some 195 global debt

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53. "China's Money Mess," *Business Week*, March 12, 2000:
The judgement handed down by a recent *Business Week* report was less forgiving. "The government is simultaneously trying to improve the quality of publicly listed companies and tame China's stock markets, which are less a productive channel...than a vent for the pent-up national passion for gambling and a prop for state companies."

54. "China's Money Mess," *Business Week*, March 12, 2001.

55. "Risky Business: New Study Spots Financial Danger on China's Business Horizon," *China Online News*, November 10, 2000.

56. Ibid.

57. Al Santoli, *China Reform Monitor*, March 12, 2001.

offerings, netting some $24 billion.[58] Roughly $14 billion of these funds were raised through U.S. dollar-denominated debt offerings. During this same period, some 23 Chinese firms were listed on U.S. stock exchanges -- a number of which are no longer actively traded. Dozens more created off-shore subsidiaries that were then listed on Hong Kong's Hang Seng and marketed to international investors.

Prior to 1998, the primary funding vehicles for China were international sovereign bonds and debt offerings by the country's "big four" banks and a number of "ITIC's," or international trust and investment corporations. ITIC's are "vehicles through which Chinese government agencies and local authorities raise money abroad for investments at home."[59] From 1980 through 1998, the PRC raised some $4.2 billion in dollar-denominated bonds under its own name.[60] The Bank of China and People's Construction Bank attracted an additional $3.5 billion. China International Trust and Investment Corporation (CITIC) and other ITIC's offered some $2 billion in dollar-denominated debt.[61] Each of these entities attracted billions more in deutschmark- and yen-denominated bonds during the same period.

Beginning in 1998, Chinese activity in the international markets increased significantly, accompanied by a diversification strategy designed to expand the number and types of PRC-owned or -controlled entities seeking global funds. The *Financial Times* provided an accurate, if understated, confirmation of this trend: "China is set to rely more on...international capital markets next year as the government continues its fast-growing debt issuance program to finance infrastructure spending and boost economic growth."[62]

58. Source: Bloomberg Financial Services, Country Debt Printout.

59. Al Santoli, *China Reform Monitor*, March 12, 2001; and "The Year Of The Living Dead," *Stratfor Global Intelligence Update*, August 3, 2000:
Following the default and subsequent closing of Guandong Investment and Trust Corporation in 1998, many of the country's 240 ITIC's have been shunned by international investors. Shortfalls in foreign capital and unwise property speculation have left many ITIC's under severe financial strain. This raises an interesting dilemma for the government. If it allows additional ITIC's to fail (thereby resulting in substantial losses for foreign investors), it may lead many of these investment groups to face troubling liquidity shortfalls. If the government props up these faltering companies, it will siphon off development capital while not addressing systemic inefficiencies. At this time, Beijing has decided to restructure this sector and is seeking to consolidate the industry into 40 firms, but faces the prospect of undermining successful firms by burdening them with the debt and other problems of the faltering ITIC's.

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. Bloomberg Financial Services, Country Debt Printout

61. Ibid:
A review of the lead managers for these Chinese debt offerings reads like a "Who's Who" list of Wall Street. They include: Goldman Sachs, Merrill Lynch, Morgan Stanley, JP Morgan, Lehman Brothers, Banker's Trust, ING Barings, Credit Suisse First Boston, etc.

62. James Kynge, "China Eyes More Infrastructure Bonds," *Financial Times*, March 1, 1999.

The centerpiece of this strategy to expand access to global capital markets is the "privatization" of state-owned enterprises. By listing these companies on international exchanges, the PRC is able to raise billions of dollars from a diversified funding base. In addition to providing critical capital and helping underwrite both healthy and faltering SOE's, the listings provide legitimacy for China's largely centrally-controlled economy and create global constituencies with vested financial interests in seeing that these companies not only survive, but prosper.

"Privatization" through overseas listings rarely strays from two established patterns. State firms, for example, can simply list in Hong Kong or elsewhere to acquire shareholders and capital (i.e., so-called "H-shares"). More often than not, however, China's SOE's prefer to construct a Hong Kong-domiciled subsidiary and transfer profit-generating projects, divisions or other assets to the subsidiary to bolster share value. In addition to helping attract international investors, this step provides the impression that the listed firms are independent, autonomous entities whose primary mission is to strengthen the company's bottom line.[63] More importantly, it preserves the parent company's ability to forego a number of transparency and disclosure requirements with respect to its operations, management structure or finances. These so-called "red chips" then raise capital through an initial public offering and listing on the Hang Seng and/or other global exchanges.[64]

Unlike U.S. and other Western firms, which often float a majority of their stock when "going public" (thereby creating shareholder-owned companies), China's SOE's tend to offer between 10 and 30 percent of the company. In the case of "red chips," the parent company usually maintains a controlling interest in the subsidiary. According to a 1997 Credit Lyonnais Securities Asia (CLSA) report, "...most red chip parents have maintained a large majority shareholding in their listed vehicles." The report goes on to state that "Many red-chip parents exercise strong control over the 'family' of companies in their groups."[65]

Dominant control (both in terms of management and ownership percentage) by the mainland has given rise to investor-related concerns. Specifically, as primary owners, mainland parent companies control the "red chips'" use of profits and dividends, management structure and, if deemed warranted, can directly intervene in corporate decision-making. If the parent chooses to divert revenues to its own operations, for example, minority shareholders would have few avenues of recourse. While not prevalent, there have been cases in the past when parent companies have diverted the resources of "red chips" to benefit mainland operations.[66] Put simply, "red chips"

63. Irrespective of China's control of Hong Kong, institutional investors distinguish between mainland and Hong Kong companies when evaluating risk. Once a Chinese SOE has created a Hong Kong subsidiary, it has, to many in the markets, separated itself from the "country of risk" concerns associated with mainland Chinese firms. Inexplicably, where a company is incorporated often matters more than ownership structure to many fund managers.

64. Joe Leahy, "HK's Record Run of IPO's Set to Continue," *Financial Times*, January 3, 2001:
According to the *Financial Times*, "H-Shares" are "mainland enterprises listed in Hong Kong." "Red chips" are "the Hong-Kong-listed investment vehicle of mainland entities."

65. Credit Lyonnais Securities Asia, "Is Red for Go?," June, 1997.

66. Ibid.

should not be viewed as entirely independent, irrespective of their Hong Kong headquartering.[67]

Although U.S. capital markets remain the "prize" for China's funding strategists due to the depth, prestige and unimpeded access to American institutional investors that accompanies U.S. listings, Hong Kong presently remains the primary venue for the "privatization" of Chinese SOE's. In 2000 alone, some 65 PRC-controlled or -affiliated firms were listed on the Hang Seng, attracting in the range of $9 billion.[68] These listings accounted for approximately 75 percent of the exchange's initial public offerings that year.[69] (It should be noted that only about one-third of these firms were trading at a level which exceeded the IPO price by year's end.)[70]

The move away from Hang Seng listings, however, has begun in earnest. In the past few years, Chinese firms and their subsidiaries have accelerated their preparation to list on U.S. and other international exchanges. The primary impetus for this strategy is tapping deeper volume markets that are more capable of absorbing large amounts of "China risk" over time. For example, although PetroChina, a subsidiary of China National Petroleum Company, raised $2.89 billion in a "global listing" last year (New York and Hong Kong), the company attracted only about $350 million from the Hang Seng listing (roughly 15 percent of total proceeds).[71] Equally important is the successful launch of Chinese firms to pave the way for hundreds of SOE's to be listed in the coming years.

The PetroChina example underscores the need for China to expand its access to the U.S. debt and equity markets to help attract the large sums of capital required annually by the PRC and its network of enterprises. It also validates the views of many Wall Street and other analysts that the New York Stock Exchange listings of PetroChina and Sinopec (the country's second largest energy concern) in 2000 were preludes to a veritable convoy of Chinese SOE's that will seek to attract funds in the U.S. capital markets over the next decade. Indeed, according to a recent *Reuters* report, "Hoping to capitalize on [the IPO success of 2000], the State Economic and Trade Commission has said it intends to 'cultivate' 30 to 50 large state-owned enterprises over the next five years, culminating with overseas listings."[72]

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67. For a detailed review of the financial and bureaucratic problems facing many of China's SOE's, please see: John Pomfret, "Legacy of Socialism Keeps China's State Firms in Red," *Washington Post*, June 20, 2001.

68. Joe Leahy, "HK's Record Run of IPO's Set to Continue," *Financial Times*, January 3, 2001; and Ibid: By comparison, in 1996, Chinese listings in Hong Kong netted roughly $3 billion.

6967. Joe Leahy, "HK's Record Run of IPO's Set to Continue," *Financial Times*, January 3, 2001.

70. Ibid.

71. Kenneth Wong, "Initial PetroChina Trading Sputters; Goldman Sachs Bolsters Prospects," *Wall Street Journal Interactive Edition*, April 10, 2000.

72. Edwin Chan, "Investors Like Global China IPO's, But 50 of Them?," *Reuters*, March 12, 2001.

Conclusion

China's most reliable and expedient route to meeting massive capital demands is accessing global capital markets. Despite efforts to bolster the development of its domestic markets, China's debt and equity markets remain thin, under-regulated and incapable of generating the large-scale capital infusions China needs to "keep the dragon roaring." An alternative venue is the global -- and most importantly, the U.S. -- capital markets. It can be expected that Chinese SOE's will list on these exchanges with greater frequency and scale in the coming years. Regrettably, certain of these firms will likely be "bad actors," (i.e., PLA-affiliated entities, companies that aid and abet terrorist-sponsoring governments, etc.) seeking funds from unwitting Americans to finance dubious activities.

"Bad Actors" In The Markets

Due largely to the engineering of more efficient financing methods in the 1980's and 1990's, the global funding patterns of "bad actors" have evolved over the past quarter century. Specifically, beginning in the 1980's, Western securities markets began to replace traditional commercial bank syndicated loans and Western government credits as the preferred venue for securing large-scale capital requirements.[73]

It is important to note that the appearance of higher risk foreign entities, or so-called "bad actors," in the securities markets is, therefore, a relatively new phenomenon. Indeed, the penetration of the U.S. capital markets by riskier foreign enterprises and governments was only identified some five years ago. Put simply, U.S. regulators, policy-makers and those American financial institutions that make up the consumer base for foreign securities (i.e., the "demand side") have limited experience with the potentially volatile nexus between national security and human rights and the markets. While this 21st century security challenge has generated wide-spread media attention and repeated attempts to forge legislative remedies in the past few years, America's capital markets and financial institutions remain vulnerable.

The Soviet Example

Prior to the proliferation of securities offerings by foreign entities, prospective and actual U.S. adversaries sought to tap into the global financial system through alternative means in order to fund themselves and their overseas activities. For example, the Soviets were deft at borrowing in the syndicated loan market in the 1970's and 1980's. These loans were primarily "general purpose" credits to be used in any way the borrower deemed indicated (i.e., not tied to any underlying trade transactions or projects). In exchange for undisciplined, large-scale borrowings, Moscow had to pay a small premium -- but it was a modest trade-off for sizable hard-currency infusions for its anemic economy. The result was a steady stream of funds that Moscow could

73. Roger W. Robinson Jr., "Financial Sanctions: How Might They Be Used Against Proliferators?" (Prepared for the Nonproliferation Policy Education Center, 1997):
For the purposes of this report, Japan will be considered part of "Western securities markets," due primarily to the depth of Japanese markets and the size of its economy.

use at its discretion and a substantial build-up of what eventually would become unpayable debt.[74]

Another example of creative fundraising occurred during the twilight of the former Soviet Union. By having developed a network of subsidiary banks (which blur ownership more than branches) located in Western capitals in the 1970's and early 1980's, Moscow was able to attract billions of dollars in so-called interbank deposits. Due to loopholes in global reporting requirements, the transfer of funds to Moscow from these wholly-owned Soviet subsidiary banks was difficult to trace.[75] Ultimately, this complicated, subterranean gambit created, in effect, the equivalent of an estimated $10 billion reserve checking account for Moscow. Moreover, by establishing subsidiaries in Western capitals, Moscow successfully transferred the associated sovereign credit risk of the debt to the countries in which the banks were located, thereby bolstering artificially the Soviet Union’s credit rating.[76]

In addition to illustrating the sophistication with which global “bad actors” have navigated the global financial system, these examples underscore the increased challenge these funding activities pose to regulatory regimes and the internal review mechanisms of commercial and investment banks. In short, financial institutions and fund managers are often ill-equipped to detect these abuses. Moreover, due to the fee-generating structure of financial transactions, a conflict of interest may arise from self-oversight.

Finally, the Soviet interbank deposit example presents an interesting corollary to the funding patterns of today’s questionable foreign firms and governments. Specifically, the creation of subsidiaries to serve as funding vehicles has become an art form of global “bad actors” seeking to obfuscate their identities and activities. Such “carve-outs” also help blur the ownership of the parent company and, in some cases, government agencies. This approach provides a ready opportunity for Western fund managers to claim they are investing in a benign, commercial entity purchased on a “safe” exchange (e.g., Hong Kong) when, in fact, the firm is owned primarily by a foreign government engaged in certain activities or strategies that are anything but benign. This process also expands substantially the base of funding opportunities available to China or other countries of concern.[77]

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74. Testimony of Roger W. Robinson Jr., former Senior Director of International Economic Affairs at the National Security Council, before Senate Banking Subcommittee on Financial Institutions, November 5, 1997.

75. Roger Robinson, “Moscow’s Shell Game,” *Washington Post*, July 23, 1991:
These banks include Moscow Narodny Bank, Ltd (United Kingdom); Banque Commerciale pour l’Europe du Nord SA (Paris); Ost-West Handelsbank AG (Frankfurt); Donaubank AG (Vienna); and East-West United Bank SA (Luxembourg).

76. Ibid:
By transferring the credit risk associated with interbank deposits to the banks, Moscow realized a two-fold benefit. First, Russia’s sovereign credit rating would have probably been negatively affected had it assumed proper repayment responsibility of Western commercial bank deposits in Soviet-owned banks. More importantly, the Western deposits were manipulated by creative accounting to appear as Soviet assets when assessing Moscow’s sovereign credit rating.

77. For example, SOE’s that would normally face greater investor scrutiny due to concerns with respect to their financial strength, efficiency and global activities are able to create seemingly “healthy” subsidiaries by transferring

Shift To Securities Markets

The shift from Western commercial banks and governments to global capital markets in the mid to late 1980's provided a number of advantages for those foreign entities engaged in malevolent activities.[78] In the case of bonds, borrowings are often extended with little, if any, conditionality or collateral. Unlike syndicated project loans -- which required detailed repayment analyses (i.e., proceeds directed toward revenue-generating projects to repay the loans) and often staggered disbursements of funds -- the debt markets provide general purpose loans with few questions asked regarding the use of proceeds. Moreover, these borrowings are based only on the full faith and credit of the country or institution guaranteeing the bond.[79]

Western markets also provide emerging market countries like China and Russia with capital at relatively inexpensive rates. When borrowing multi-billion-dollar sums, even a savings of, for example, twenty-five basis points can make securities a more attractive funding source. Moreover, capital markets provide diversification with respect to funding sources. Whereas global entities would, in the past, be forced to rely on the more expensive and disciplined commercial loan market and Western governments, the advent of issuing securities generated several new classes of lenders and investors.[80] Regrettably, the benefits of these markets also quickly came to the attention of global "bad actors."[81]

Russia Frames The Debate

At the beginning of the 1990's, this country's securities markets catered primarily to U.S. firms and multinational corporations. Although less financially sophisticated countries floated

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profitable divisions and projects. Although the parent company maintains ownership (and, thereby, control over operations and assets), investors only see part of the picture -- notably a profitable, commercial firm. In this manner, hundreds -- even thousands -- of otherwise unmarketable SOE's could be transformed into capital-attracting, listed entities.

78. Testimony of Roger W. Robinson Jr., former Senior Director of International Economic Affairs at the National Security Council, before the Senate Banking Subcommittee on Financial Institutions, November 5, 1997:
As Roger Robinson stated during Congressional testimony in 1997, "The ultimate prize for [higher risk, questionable foreign entities], however, is access to the American [capital markets]."

79. Roger W. Robinson Jr., "Financial Sanctions: How Might They Be Used Against Proliferators?" (Prepared for the Nonproliferation Policy Education Center, 1997).

80. Ibid.

81. The William J. Casey Institute, "Tour d'Horizon: Casey Institute's Robinson Explores Financial Implications of Geopolitical Developments," May 2, 1996:
As Casey Institute Chairman Roger Robinson observed in 1996, "The traditional firewall between breaking geopolitical developments and the markets will be breached with increasing frequency and violence in the period ahead. Accordingly, normal commercial and economic 'due diligence' concerning international projects, transactions and trading activities will, in many cases, no longer be adequate to ensure the level of investor and/or lender confidence *and security* deemed necessary."

sovereign bonds, the markets maintained a "club" mentality, especially with respect to emerging market entrants. This mind-set began to change around 1995, when foreign companies pressed to enter the U.S. and other Western capital markets in record numbers. It was also around this time that entities engaged in activities harmful to U.S. security interests were first identified seeking to attract funds in the U.S. markets.

For example, despite having some $130 billion in Soviet-era debt (the majority of which had to be repeatedly rescheduled) and continually making late payments on $19 billion in international loans acquired since 1991, Russia made an auspicious return to the global debt markets in November of 1996.[82] From the credit rating agencies, such as Moody's and Standard and Poor's (which accorded a financially troubled Russia a more favorable risk rating than that of Brazil, Argentina and Venezuela), to the bond traders whose enthusiastic response led to a 100 percent oversubscribed offering, Russia's inaugural international bond offering in 1996 was deemed an historic success. In all, some 44 percent of the Eurobond offering -- which was yielding a mere 3.5 percent above U.S. Treasury bills -- was purchased by U.S. fund managers.[83]

Russia's floatation, however, was not met with enthusiasm by all concerned. Indeed, the borrowing raised a number of concerns that still underpin the "bad actors" debate some five years later. For example, at the time of the offering, the Russian government was engaged in proliferation activities -- including ballistic missile and nuclear component sales to Iran -- and was actively seeking to destabilize the oil-rich Caspian region.[84] The country was also nearing deployment of the Topil-M mobile inter-continental ballistic missile and undertaking an ambitious and costly strategic modernization program.[85] These troubling activities raised the prospect that the undisciplined funds raised by Moscow in its Eurobond offering could be going to fund the wrong types of Russian projects. At minimum, as money is fungible, the $1 billion raised by Moscow would free up other government funds.[86]

The offering also raised a number of financial concerns. In addition to the unduly favorable credit rating Russia received at the time (especially considering the country's severe structural inefficiencies), international bond offerings are generally not rescheduable due to the nature of the market. Were financial adversity to strike Moscow and the country was rendered unable to service the debt, the roughly $440 million held by Americans in various portfolios would be at risk. The offering also created a U.S. investor constituency with a vested financial interest in opposing U.S. policies toward Russia that might affect that country's repayment capability. Moreover, any future default by Moscow on these loans would introduce the prospect of U.S. taxpayer-funded

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82. The William J. Casey Institute, "If You Liked the Rigging of the Lebed Dismissal, You'll Love the Rigging of the Global Credit and Securities Markets," October 17, 1996.

83. Ibid.

84. The William J. Casey Institute, "Russian Bondage: Moscow's Financial Breakout Gets Underway with Wildly Oversubscribed Eurobond Sale," November 26, 1996.

85. Ibid.

86. Ibid.

bailouts.[87]

Political and financial advocates of Russia's return to the global markets would argue that Moscow would be "disciplined" by the markets. In order to continue to access international funders, Russia, according to these advocates, would be required to implement more prudent financial and political policies. Unfortunately, history proves that supposedly "financially disciplined" governments -- such as those of South Korea and Mexico in the 1990's -- are not immune from debt crises. Moreover, governments such as Russia and China are more likely to engage in serious foreign policy disputes with the United States.

Other analysts dismissed any political concerns about the use of investor proceeds by emphasizing the relatively small amount of funds involved in the Russian offering. While $1 billion is of little concern in the multi-trillion-dollar global economy, the precedent set by Russia's successful return to the markets set the stage for accelerated borrowing.[88] Indeed, Russia went on to issue some $13 billion in U.S. dollar-denominated bonds over the next few years.[89] The country also experienced a financial meltdown in 1998 and was compelled to reschedule tens of billions of dollars in international debt obligations to the Paris and London Clubs of creditors.[90]

China's Financial Breakout

Building on the case of Russia, in 1997 the William J. Casey Institute of the Center for Security Policy (Casey Institute) began alerting the policy and financial communities to the funding activities and patterns of perceived global "bad actors."[91] Due to the scale of China's financial requirements and its status as the largest emerging market economy in the late 1990's, several of the companies that elicited concern were Chinese. Although Capitol Hill, the Securities

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87. The William J. Casey Institute, "If You Liked the Rigging of the Lebed Dismissal, You'll Love the Rigging of the Global Credit and Securities Markets," October 17, 1996:
Indeed, recent history is rife with bailouts of this nature, including the Mexican financial crisis of the early 1990's and the emerging market crisis in 1997-98.

88. "Iran Plans $300M Debut Eurobond," *Financial Time*s, October 21, 1999.
Interestingly, Iran is reportedly planning to issue a $300 billion Eurobond in the near future. Proponents of the offering will likely make several of the same arguments referenced above. Unlike Russia, however, Iran is currently under U.S. sanctions -- which raises the question of whether U.S. entities will be allowed by law to hold Iranian debt in portfolio.

89. Bloomberg Financial Services, Country Debt Printout.

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. The William J. Casey Institute, "The Debate Begins Over Russia's Financial Breakout; Where Will it End for U.S. Taxpayer Interests?," November 4, 1996.

91. To our knowledge, the Casey Institute remains the only non-profit policy group in the country that is exclusively monitoring the nexus between national security- and human rights-related risk considerations and the capital markets. It is likewise the only non-governmental organization that has produced numerous publications with respect to the potential use of capital markets leverage and the need for expanded disclosure requirements and "due diligence risk" assessments.

and Exchange Commission and other agencies of the U.S. government were not engaged in evaluating this new market phenomenon at the time, this public policy initiative gained momentum following the appearance of articles on this subject in *USA Today* and *Insight Magazine* in late 1997.[92]

At the time, the PRC government had raised some $3.2 billion in dollar-denominated sovereign debt. In total, the country attracted roughly $6.75 billion through dollar-denominated offerings between 1993 and 1997 and another $5 billion in yen-denominated debt during this period.[93] China's borrowing activity then accelerated -- the country issued another $7 billion in global debt offerings in 1998 and 1999.[94]

Many of the concerns present with respect to some of China's funding efforts were similar to those involved in the case of Russian borrowings. Specifically, questions were raised as to whether sovereign bond proceeds were contributing to China's purchase of advanced military hardware from Russia (e.g., SU-27 and SU-30 fighter planes, KILO-class submarines, air-to-air missiles, etc.), Beijing's robust military build-up, the country's burgeoning nuclear weapon and ballistic missile programs or new "theater" weaponry with which to threaten Taiwan.[95] In broader terms, the question to some became: Should the U.S. be underwriting a potential adversary through those types of undisciplined loans?[96]

In addition to some of the concerns applicable to the Russian case (e.g., the diversification of funding sources, the potential creation of a "lobby" of bond holders, a lack of conditionality and discipline, etc.), several new ones have emerged with respect to the funding efforts of Chinese entities. For example, a major differentiating factor in the case of China was the "privatization" of state-owned enterprises (SOE's) as an important global fund-raising devise. Regrettably, a number of these SOE's may be connected, directly or indirectly, to China's People's Liberation Army (PLA) or otherwise engaged in activities -- either within China or internationally -- that conflict with important U.S. security, human rights and religious freedom interests.

PLA-Affiliated Companies

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92. The William J. Casey Institute, "*Insight Magazine* Breaks The Code: Chinese Penetration of U.S., Global Financial Markets Has Strategic Implications," May 3, 1997; and The William J. Casey Institute, "*USA Today* Illuminates Case for Urgent Action to Halt Chinese Bondage," May 16, 1997.

93. The William J. Casey Institute, "*Insight Magazine* Breaks The Code: Chinese Penetration of U.S., Global Financial Markets Has Strategic Implications," May 3, 1997.

94. Bloomberg Financial Services, Country Debt Printout.

95. James Hackett, "Financing China's Red Army," *Washington Times*, December 13, 1999.

96. J. Michael Waller, "China Cashes In," *Insight Magazine*, January 14, 2000.
According to Representative Chris Cox, "When you go to governments that are as opaque, nontransparent, as the government of the People's Republic of China, where so much of enterprise is state-run, where accounting is as much creativity as hard figures, I think people are essentially lending money to the state of China, the communist government of China, on the brand name and on the expectation that they will somehow pay it back..."

One of the primary challenges in identifying “bad actors” in China is navigating successfully the intricate web of affiliates, subsidiaries and financial flows that are integral to the Chinese economy. (See Appendix 1.) For example, despite a well-advertised campaign by the Chinese government calling for the divestment of businesses owned and operated by the country’s military apparatus in 1998, it is still believed that the PRC possesses an impressive network of companies with military connections that merit additional scrutiny before being taken into U.S. investor portfolios.[97] According to a 1997 AFL-CIO report,

> “While the true extent of military commercialization in the PRC - including PLA-non-military enterprises as well as defense industry operations - is difficult to discern, estimates suggest that China’s commercial-military complex has some 50,000 companies employing as many as two million people. In 1993, these companies are thought to have earned more than $5 billion. Taken as a whole, the combined earnings of these activities would place China’ s commercial-military operations among the ranks of the top 100 corporations of the Fortune 500...
>
> Whatever the true extent of PLA activities, production from recognized PLA commercial enterprises is said to have made up more than 90 percent of the PLA’s annual output during the last five years, with proceeds from PLA commercial activities making up as much as 20 percent of the PLA’s official budget.”[98]

Given the extent to which the PLA is likely still linked to the commercial activities of a number of China’s SOE’s, it is reasonable to suspect that at least some Chinese “red chips” and other listed entities are also either directly controlled by -- or closely affiliated with -- the PLA. As Representative Spencer Bachus (R-AL) stated in 1999, “There is little doubt that some of this [U.S. investor] money has gone to finance military and intelligence operations [in China].”[99]

Although a complete list of those Chinese companies that are still connected to -- or owned by -- China’s military apparatus is unavailable, a brief review of suspected PLA-associated companies underscores the concern that some military-operated enterprises are tapping the global capital markets to fund military-related activities. (See Appendix 2.) For example, China National Aero-Technology Import/Export Corporation (CATIC) owns a number of subsidiaries, including CATIC Industries, Inc. (U.S.), CATIC Industrial Ltd. (Hong Kong) and others. Were it to be determined that a CATIC subsidiary was listed -- or planning to list -- on the Hang Seng and marketed to U.S. institutional investors, it would likely present a security-related challenge. After

97.“PLA Business Activities Fraught With Abuses,” *Financial Times Asia Intelligence Wire*, November 1, 1998.

98. AFL-CIO Report, “China’s People’s Liberation Army: Where to Find PLA Companies in America, What Products the PLA Sells in America and Who are the PLA’s Customers,” 1997.

99. Eduardo Lachica, “Deutch Report Says Borrowers Pose a National Security Risk,” *Wall Street Journal Asia*, July 12, 1999.

all, CATIC reportedly "sells aircraft and missiles and is a key player in upgrading domestic aircraft production through technology transfer."[100]

A similar scenario could involve China Great Wall Industry Corporation (CGWIC). This company is under the direction of China's Ministry of Aeronautics and Astronautics. More importantly, Great Wall has been linked to -- and, indeed, sanctioned by the U.S. government for -- the exporting of nuclear-capable missile technology to Pakistan.[101] This company also owns a Hong Kong subsidiary.

Funding-related concerns are also warranted when suspected PLA entities are cross-checked against select "red chip" families that have Hang Seng-listed subsidiaries. (See Appendix 3.) China Everbright Holdings is one such organization that has been linked to the PLA and, therefore, may require attention. According to the AFL-CIO report, Everbright Industrial Corporation is "affiliated with the PLA General Staff Department." China Everbright International is a subsidiary of this entity listed on the Hang Seng and presumably held in the portfolios of some American pension and mutual funds.[102] Similarly, China Aerospace Group, which reportedly controls China's satellite, missile and other militarily-relevant programs, could at some point seek to attract foreign capital through its listed arm, CASIL.[103]

Although it is beyond the scope of this report to explore known PLA companies, trading corporations and investment trusts to determine whether "red chips" or other funding vehicles have been employed to attract funds on behalf of PLA-affiliated parent companies, these examples point to the need to conduct more rigorous assessments of China's "red chips." Moreover, were it determined that suspected PLA-owned or -operated firms have indeed been privatized, a number of these entities (i.e., those that are engaged in militarily-relevant activities or doing business with terrorist-sponsoring regimes, etc.) would likely still merit review given the nature of their operations.

Specific Entity Review

In addition to the conceptual concerns referenced in the previous section, a number of questions have been raised with respect to the funding activities of a few specific Chinese entities. This section will give priority to five Chinese entities (and/or their subsidiaries) that are likely held -- or have been held in the past -- in portfolio by one or more U.S. institutional investors: 1) CITIC; 2) Polytechnologies; 3) Cosco; 4) China Resources; and 5) Bank of China and other "big four" banks.

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100. AFL-CIO Report, "China's People's Liberation Army: Where to Find PLA Companies in America, What Products the PLA Sells in America and Who are the PLA's Customers," 1997.

101. Henry Sokolski, "A Tale of Three Firms," *Weekly Standard*, February 24, 1997.

102. AFL-CIO Report, "China's People's Liberation Army: Where to Find PLA Companies in America, What Products the PLA Sells in America and Who are the PLA's Customers," 1997.

103. Ibid.

- **CITIC**: China International Trust and Investment Corporation, or CITIC, is one of the largest and most influential of China's ITIC's. Between 1993 and 1994, the company launched four dollar-denominated debt offerings that attracted some $800 million.[104] According to a 1997 *USA Today* article, CITIC "is actually run by the general staff of China's Military Commission."[105] The California-based Rand Corporation was more explicit in a 1997 report, reportedly stating that CITIC served "as a conduit for military sales and acquisition."[106]

  The activities of CITIC's Chairman, Wang Jun, have also elicited concern. According to a 1998 U.S. House of Representative Select Committee (or so-called "Cox Committee") report entitled, "U.S. National Security and Military/Commercial Concerns With the People's Republic of China:"

  "Wang Jun is the son of the late PRC President Wang Zhen. Wang simultaneously holds two powerful positions in the PRC. He is Chairman of China International Trust and Investment Corporation (CITIC), the most powerful and visible corporate conglomerate of the PRC. He is also the President of Polytechnologies Corporation, an arms trading company and the largest and most profitable of the corporate structures owned by the PLA..."[107] Mr. Wang was also implicated in the campaign finance scandal. According to the *Financial Times*, Wang "was also connected to over $600,000 in illegal campaign donations made to the DNC (in 1996) through Charlie Trie."[108]

- **CITIC Pacific and CITIC Ka Wah Bank**: Although these entities purport to be independent, commercial entities, the true identity of these companies remains questionable. A 1998 book entitled "Red Chips and the Globalization of China's Enterprises" determined CITIC Pacific to be "CITIC's publically-listed arm."[109] The thorough review of "red chips" and their mainland connections undertaken by Mr. Charles de Trenck of Credit Suisse First Boston and four other Hong Kong-based financial analysts went on to state that CITIC has a "controlling interest in the company" and that the

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104. The William J. Casey Institute, "Dangerous Upshot of Clinton-Gore's China Bonding: Strategic Penetration of U.S. Investment Portfolios," April 1, 1997.

105. Peter Schweizer, "You, Too, May Be Funding China's Army," *USA Today*, May 14, 1997.

106. John Berlau, "Chinese Army's Ties to U.S. Money," *Investor's Business Daily*, July 27, 1999.

107. U.S. House of Representative Select Committee, "U.S. National Security and Military/Commercial Concerns With the People's Republic of China," May 25, 1999 (Volume 1, p. 22).

108
. Stephen Fidler, "China 'Princelings' in Web of Espionage," *Financial Times*, May 26, 1999.

109. Charles De Trenck, et.al., Red Chips and the Globalization of China's Enterprises (Hong Kong: Asia 2000 Limited, 1998).

subsidiary "appear[s] to bow to political pressure from Beijing."[110] The book also touches on CITIC Ka Wah Bank which it observes "has remained directly in the hands of CITIC Beijing."[111] The stock of both of these Hang Sang-listed funding vehicles were held in portfolio by the California Public Employees Retirement System (CalPERS) as of 1999 as well as other U.S. public pension funds and private mutual funds.[112]

- **Polytechnologies** (Poly): The AFL-CIO report on PLA companies referenced earlier lists this company as a "military-related foreign trading company," citing the firm's role as "a procurement arm of the PLA, General Staff Department."[113] The *Financial Times* also underscored the PLA-related activities of Poly, noting "[Mr. Wang is] chairman of Polytechnologies, an arms trading company..."[114] "The Year of the Rat," a 1998 book by China experts Ed Timperlake and Bill Triplett more bluntly defined Poly's corporate activities. "Poly is China's leading arms smuggler and the conduit for Russian arms transfers to China."[115] The company's stock has reportedly been held by the Arkansas State Teachers Fund and possibly other U.S. public pension firms.

- **COSCO**: China Ocean Shipping Company, or Cosco, was deemed by the U.S. House of Representatives Task Force on Terrorism and Unconventional Warfare to be a military-related entity. According to the Task Force report, "Although presented as a commercial entity, Cosco is actually an arm of the Chinese Military."[116] The shipping firm was reportedly denied its request to lease a Long Beach naval base due primarily to national security considerations according to an *Investor's Business Daily* report and was implicated in the delivery of advanced weaponry and, possibly, proscribed proliferation-related materials from China to Pakistan and Iran.[117] A Cosco ship was also involved in the failed 1996 attempt by China to smuggle automatic weapons to California street gangs.[118] More recently, the company was cited by the *Washington Times* for its role in

110. Ibid.

111. Ibid.

112. John Berlau, "A New Type of Calpers Effect: Funds' Investments in Chinese Companies Raise Red Flags," *Investor's Business Daily*, September 7, 1999.

113. AFL-CIO Report, "China's People's Liberation Army: Where to Find PLA Companies in America, What Products the PLA Sells in America and Who are the PLA's Customers," 1997.

114. Stephen Fidler, "China 'Princelings' in Web of Espionage," *Financial Times*, May 26, 1999.

115. Ed Timperlake and William Triplett, Year Of The Rat (Washington D.C.: Regnery Publishing, Inc., 1998).

116. Correspondence from Representative Spencer Bachus to Texas State Representative Suzanna Gratia Hupp, October 12, 1999.

117. John Berlau, "Chinese Army's Ties to U.S. Money," *Investor's Business Daily*, July 27, 1999.

118. Ibid.

transporting weapons to Cuba.[119]

The stock of Cosco Pacific, the "red chip" funding vehicle of Cosco, is held by a number of U.S. funds. According to Cosco Pacific's web-site, the company "enjoys strong business ties and a high degree of synergy with its parent, the China Ocean Shipping Company."[120] In September 1999, the Texas State Teachers Retirement System (TRS) divested its shares in Cosco Pacific shortly after concerns with respect to the company were raised by a Texas state legislator.[121] TRS recently renewed its investment in Cosco Pacific, purchasing some 2 million shares in the first half of this year.[122]

- **China Resources**: In a letter from Congressman Spencer Bachus to Texas State Representative Suzanna Gratia Hupp in 1999 regarding specific Chinese entities held in portfolio by the Texas State Teacher Retirement System, the Representative stated, "[China Resources] has been cited by Senator Fred Thompson, Chairman of the Senate Government Affairs Committee, and a former Defense Intelligence officer as being used as a conduit for Chinese intelligence-gathering activities. According to Senator Thompson, the company is 'an agent of espionage – economic, military and political – for China.' Former Defense Intelligence officer Nicholas Eftimiades states, 'For example, a vice president of China Resource Holding Company in Hong Kong [China Resources' Hong Kong "red chip"] is traditionally a military case officer for Guangzhou. This officer coordinates the collection activities of other intelligence personnel operating under Hwa Ren [Chinese military intelligence] cover.'"[123]

  The company's subsidiary, China Resources Holding, is owned by a number of U.S. funds.

- **China's "Big Four" Banks**: Bank of China, China Construction Bank (now Construction Bank of China) and China Development Bank (now Industrial and Commercial Bank of China) have together attracted some $4 billion in U.S. dollar-denominated bond offerings since 1985. While the banks have not been directly implicated in security-related matters (notwithstanding allegations that Bank of China served as the banking intermediary for fund transfers made to Johnny Chun and Charlie Trie during the campaign finance scandal), there remains little transparency or disclosure regarding the loan portfolios of these banks

119. William Gertz, "China Secretly Shipping Cuba Arms," *Washington Times*, June 12, 2001.

120. John Berlau, "Chinese Army's Ties to U.S. Money," *Investor's Business Daily*, July 27, 1999.

121. Correspondence from Representative Spencer Bachus to Texas State Representative Suzanna Gratia Hupp, October 12, 1999.

122. Source: Thompson Financial Services.

123. Correspondence from Representative Spencer Bachus to Texas State Representative Suzanna Gratia Hupp, October 12, 1999.

or the end-use of bond proceeds.[124]

Given the "enabling" role played by these banks in underwriting the country's SOE's, it is likely that funds raised by the banks could find their way to military-related activities and/or PLA-affiliated companies. As Peter Schweizer opined in a 1997 *USA Today* editorial, "The trouble is, this money can be diverted to modernize the armed forces, acquire military-related technologies or even serve as supplier credits [by Chinese banks] for missile sales to Iran and Pakistan."[125]

An example of this type of diversion of Western funds -- albeit not in a security-related area -- to potentially troubling projects was evident in 1999 when environmental organizations protested a $500 million China Development Bank bond offering that they claimed would channel proceeds to the controversial Three Gorges Dam project. In a letter to the lead U.S. underwriter, the groups cited the precedent set by the 1998 Chinese sovereign bond case. In that case, $200 million of the bond proceeds allegedly "found its way to the project" according to the correspondence.[126] The underlying message from the group was that it remains difficult to ensure that general purpose borrowings will be "firewalled" from undesirable Chinese activities.

The Bank of China is now reportedly constructing a Hong Kong subsidiary to serve as the listing vehicle for a proposed multi-billion NYSE and Hang Seng initial public offering later this year.[127]

Governmental Confirmation

In 1998, two bipartisan, government reports cited the risk that select Chinese or other "bad actors" have penetrated the U.S. markets or will seek to do so. According to the so-called Cox Committee report on China:

> "The Securities and Exchange Commission collects little information helpful in monitoring PRC commercial activity in the United States. This lack of information is due only in part to the fact that many PRC front companies are privately-held and ultimately – if indirectly – wholly-owned by the PRC and the CCP itself. Increasingly, the PRC is using U.S. capital markets both as a source of central government funding for military and commercial development and as a means of cloaking U.S. technology acquisition efforts by its front companies with a patina of regularity and respectability."[128]

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124. Testimony of Roger W. Robinson Jr., former Senior Director of International Economic Affairs at the National Security Council, before the Senate Banking Subcommittee on Financial Institutions, November 5, 1997.

125. Peter Schweizer, "You, Too, May Be Funding China's Army," *USA Today*, May 14, 1997.

126. "Wall Street Firms Urged Not to Help Finance Chinese Dam," *Bloomberg*, May 6, 1999.

127. Edwin Chan, "Investors Like Global China IPO's, But 50 of Them?," *Reuters*, March 12, 2001.

128. U.S. House of Representative Select Committee, "U.S. National Security and Military/Commercial Concerns With the People's Republic of China," May 25, 1999 (Volume 1, p. 57).

The Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction, or the so-called Deutch Commission report (named after it's Chairman, former Director of the CIA John Deutch), went further in describing the extent of the problem. In addition to underscoring the concern that proliferating countries, as well as proliferating firms and their subsidiaries, are likely accessing capital from the U.S. markets, the Deutch report raised the prospect of new national security-related risks to investors:

> "For example, the Commission is concerned that known proliferators may be rasing funds in the U.S. capital markets...Because there is currently no national security-based review of entities seeking to gain access to our capital markets, investors are unlikely to know that they may be assisting in the proliferation of weapons of mass destruction by providing funds to known proliferators. Aside from the moral implications, there are potential financial consequences of proliferation activity – such as the possible imposition of trade and financial sanctions – which could negatively impact investors.[129]

Early Recommended Solutions

It is important to note that despite mounting evidence that global "bad actors" are accessing the U.S. debt and equity markets, at no time have there been calls for the explicit denial of access to these markets for all Chinese entities or even state-owned enterprises. Indeed, at least in the case of the Casey Institute, the primary focus of recommended steps has always been expanded transparency and disclosure requirements for overseas market registrants. The importance of maintaining the free flow of capital into and out of the U.S. as a pillar of this country's economic growth and financial competitiveness has not been lost on those who have sought to raise attention to this burgeoning national security challenge. Nor have there been calls for capital controls or undue government intervention in the markets. Nevertheless, as the Deutch Committee and others have recommended, more detailed study of this emerging security-related field and possible steps to curtail market access for known, egregious wrongdoers would be useful.

As a leading advocate for national security-related risk assessment, the Casey Institute has recommended a number of non-disruptive, market-oriented remedies since 1997. Among these is the creation of a voluntary public-private sector partnership whereby Wall Street firms seeking to underwrite certain emerging market enterprises -- and/or investment funds considering the purchase of overseas debt and equity offerings -- could work with the appropriate Executive Branch agencies to help ensure that these investments were free of national security-related concerns. Similarly, the Institute has called for an internal SEC review of those rules and regulations that govern the disclosure requirements for foreign entities doing business with U.S. sanctioned countries as well as overseas exemptions that allow qualified U.S. institutional investors to purchase securities offered through foreign markets.[130]

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129. Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction, "Combating Proliferation of Weapons of Mass Destruction," July 14, 1999 (pp. 77-78).

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. The William J. Casey Institute, "Key Commission Reports, Rep. Bachus Call for Security-Minded Surveillance of U.S. Capital Markets: Possible Next Steps," July 30, 1999.

The Casey Institute has also proposed the creation of an interagency working group that could review -- on those rare occasions necessary -- foreign registrants from a national security perspective. This so-called "Committee on Foreign Financing and Borrowing," or COFFAB, could include representatives from the Treasury Department, the National Security Council, the Departments of State, Justice and Defense and the CIA. It was recommended that Treasury and NSC co-chair a COFFAB-like group to ensure the proper integration of global finance and national security. It was also envisioned that this senior inter-governmental working group would be authorized to recommend to the President the denial of access to U.S. markets in cases of especially onerous national security and human rights concerns.[131]

In addition to these recommended steps, former Senator Lauch Faircloth (R-NC) and former Rep. Gerald Solomon (R-NY) co-sponsored legislation entitled the U.S. Markets Security Act of 1997. Far from seeking to legislate any steps that would have restricted capital flows, this bill -- which was never acted upon -- would have merely constructed a monitoring capability within the SEC to determine the scope of the problem.[132] Specifically, the legislation called for the establishment of a one-person Office of National Security at the SEC that would report to relevant Congressional committees the names of those foreign firms seeking to access the U.S. debt and equity markets on a quarterly basis.[133] This legislation was resurrected by Representatives Spencer Bachus (R-AL) and Dennis Kucinich (D-OH) in 1999, but also never exited the committees of jurisdiction.

Conclusion

The ascendence of the global securities markets as the primary funding vehicles for those foreign companies and governments that require large-scale, annual capital infusions has, regrettably, given rise to the troubling prospect that some dubious foreign entities may be funding themselves and/or their international activities in our markets. There still remain, however, more questions than answers regarding the extent of this 21st century "financial security" challenge. Regrettably, the U.S. government -- with the exception of the SEC and some on Capitol Hill -- has yet to take the steps necessary to evaluate adequately this new issue area and implement appropriate safeguards. As a result of undue delays in this process, national security, human rights and religious freedom concerns have already collided with the markets in three high-profile cases.

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131. Ibid.

132. Former Senator Lauch Faircloth and former Representative Gerald Solomon, "U.S. Market Securities Act of 1997" (S.1315).

133. Ibid.

Case Studies

Prior to 1997, the most well known example of perceived "bad actors" in the markets could be found in the context of the South African anti-apartheid campaign of the early 1980's. Recalling the expanded definition of "bad actors" provided earlier (e.g., including companies whose business activities help aid -- and/or generate revenue streams for -- rogue regimes), it was effectively argued that those companies doing business with the South African government were helping underwrite that country's racist policy of apartheid. Due to public pressure exerted by non-governmental organizations (NGO's), U.S. pension and mutual funds and commercial banks began divesting the stock of -- and terminating lending to -- those entities that had significant business ties with South Africa to devastating effect. U.S. and other Western firms also rapidly severed ties with the government in response to the stock sell-offs as South Africa was designated, in a relatively short period of time, a pariah state by the global financial community as well as among many Western governments.[134]

More recent cases involving the clash of national security and human rights and the markets demonstrate an evolution of NGO activism from utilizing isolation and public censure to pressure companies in the case of South Africa to a more surgical activism approach designed to strike at the financial heart of the targeted "bad actor." It is this latter, more sophisticated NGO strategy that formed the basis for three recent case studies on the nexus between national security/human rights and the capital markets: 1) Gazprom's 1997 U.S. bond offering; 2) the CNPC/PetroChina New York Stock Exchange listing and IPO of 2000; and 3) the ongoing Talisman Energy Inc. divestment campaign.

Gazprom

The debate that ultimately derailed Gazprom's proposed $3 billion New York bond offering in the fall of 1997 -- and, indeed, the larger issue of whether foreign firms that underwrite or otherwise contribute to the financial strength of potential adversaries should be allowed to issue securities in the U.S. -- was framed by Senator Sam Brownback (R-KS) in a letter to President Clinton on October 3, 1997. According to the Senator,

> "Potential adversaries of the United States and companies like Gazprom which engage in activities harmful to the U.S. cannot and should not expect the privilege of raising funds in

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134. For a detailed history of this case study, please see the Institute for International Economics' "Case Studies in Economic Sanctions, Cases 62-2 and 85-1." (http://iie.com/topics/sanctions/southafrica1.htm)
This form of financial leverage has been consciously undermined by multinational firms, financial institutions and, indeed, an international community that often resists participation in U.S.-led attempts to pressure governments engaged in egregious national security and/or human rights abuses. For example, following the South Africa campaign, many institutional investors constructed policies prohibiting "social investing," (i.e., the use of investment policy to advance social concerns). Influential companies and business coalitions have likewise been effective in lobbying those in government to dismantle or neutralize economic sanctions and other financial penalties as a policy option. When sanctions are levied, the willingness of those firms in the EU, Asia and elsewhere to continue doing business with the targeted government(s) undermines the leverage brought to bear.

our markets."[135]

At issue was Gazprom's involvement in a consortium led by France's Total that had signed a $2 billion agreement to develop Iran's so-called South Pars offshore natural gas fields. The investment was determined to be in violation of ILSA, (the U.S. Iran-Libya Sanctions Act, 104-172; 50 USC 1701), which was enacted to discourage foreign investment in Iran's energy sector due to that country's ongoing terrorist-sponsoring activities.[136] The act is triggered by an investment in Iranian energy development in excess of $20 million (or $40 million in Libya) and authorizes the President to impose a range of financial and other sanctions against foreign energy firms that violate the statute.[137]

At the outset of the announced deal, two primary concerns commanded the attention of lawmakers. The most pressing of these reflected the logic that underpinned the legislation during its formative stages. As former Senator Alfonse D'Amato (R-NY) and Rep. Benjamin Gilman (R-NY) stated in a letter to the President at the time:

> "Money is fungible. Investments in Iranian energy release funds for expenditure elsewhere, and help generate an expanding revenue stream that will support the growth of Iranian power."[138]

In addition, many in Congress feared that a decision to waive sanctions against Total, Gazprom and Malaysia's Petronas (the third firm that made up the consortium) would both undercut U.S. efforts to halt Iran's support for international terrorism and send a debilitating signal to other foreign energy companies that this law was merely a "feel good" exercise for U.S. policy practitioners.[139]

While those on Capitol Hill and in the Administration debated the wisdom of an Executive Branch decision to undertake a thorough review before acting, Gazprom's scheduled $3 billion U.S. bond offering in the same window as its investment in Iran came into focus.[140] Of primary

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135. Correspondence from Senator Sam Brownback to President William Clinton, October 3, 1997.

136. Correspondence from former Senator Alfonse D'Amato and Representative Benjamin Gilman to President William Clinton, October 1, 1997.

137. Robert Greenberger and Laurie Lande, "Russia's Gazprom Appears Vulnerable to U.S. Pressure Over Iranian Gas Deal," *Wall Street Journal*, October 17, 1997:
One such option would be to freeze the U.S. assets of the violating firm. Interestingly, Total had given this matter careful consideration prior to signing the contracts. Anticipating a forceful U.S. response, the company reportedly liquidated its U.S. assets prior to finalizing the deal.

138. Correspondence from former Senator Alfonse D'Amato and Representative Benjamin Gilman to President William Clinton, October 1, 1997.

139. Ibid; and Steve Erlanger, "Clinton Hesitates to Punish Nations for Iran Oil Deals," *New York Times*, March 21, 1998.

140. According to public reports at the time, Gazprom was slated to raise some $1 billion from its bond offering. It was later determined, however, that the company intended to attract roughly $3 billion. The company eventually

concern was whether U.S. investors should be helping finance Gazprom's activities in Iran -- a move which certainly violated the spirit, if not the letter, of ILSA. Technically, some also questioned whether a company in violation of U.S. law could legally tap the U.S. debt and equity markets.

Former Senator D'Amato and Rep. Gilman highlighted these issues and, more broadly, helped frame the debate regarding the efficacy of financial sanctions in a letter to Vice President Gore. It stated,

> "In view of Gazprom's recent very large tax payments to the government and its extensive need for capital to modernize its domestic and Euro gas networks, where would it find the resources to fund this natural gas contract?"[141]

Attention to the offering was further heightened by requests of former Banking Committee Chairman D'Amato to hold hearings on the prospective bond offering. Whereas during the initial stages of the bond controversy the issue was predominantly the activities of Gazprom in Iran, this request broadened the scope to include the destabilizing activities of Gazprom's home government, Russia.[142] In seeking hearings on Gazprom, Senators Brownback and Jon Kyl (R-AZ) wrote:

"It is our view that the efforts of Russian entities to provide missile and nuclear technology to Iran are incompatible with Russia's goal to fund activities via this [Gazprom] convertible bond offering or future bond offerings in our debt markets."[143]

Within weeks of the Total announcement, press reports had shifted their focus on the ILSA violation almost exclusively to the Gazprom bond offering. By mid-October 1997, Congressional scrutiny and a number of national opinion editorials and articles had helped catalyze a legal review of Gazprom's fundraising efforts by the Executive Branch.[144]

Although the ILSA statute did not include the denial of access to the U.S. debt and equity markets in its menu of optional Presidential sanctions, Senators D'Amato, Brownback and Kyl

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raised in the range of this latter amount in the European syndicate loan market on less advantageous terms in the wake of the U.S. controversy.

141. Correspondence from Senator Alfonse D'Amato and Representative Benjamin Gilman to Vice President Al Gore, October 8, 1997.

142. Correspondence from Senators Sam Brownback and Jon Kyl to Senators Alfonse D'Amato and Paul Sarbanes, October 8, 1997:
In addition to the proliferation concerns cited in the Brownback and Kyl letter, Russia's assistance in the development of two nuclear reactors in Iran was also a contentious matter at that time.

143. Ibid.

144

. George Gedda, "U.S. Reviewing Russia Oil Company," *Associated Press*, October 16, 1997:
"U.S. government lawyers are looking into the efforts of a giant Russian energy company to raise money in the U.S. and other financial markets."

had succeeded in expanding the debate to include this critical point.[145] As Senator D'Amato stated in a lengthy speech introducing hearings on this matter on October 30, 1997,

> "Should foreign companies engaged in activities which violate U.S. laws and undermine our policies be allowed unrestricted access to our capital markets? Should Russian companies that are providing missile aid to Iran or financing gas deals with them be able to seek financing in our markets...? Should the United States just sit back and allow Gazprom to do business as usual?
>
> I don't believe so. Gazprom should not be entitled to do business on the basis that all is well and that we have an unrestricted free capital market, because the fact of the matter is that their conduct is in blatant violation of our law..."[146]

The final blow to Gazprom's borrowing strategy in the U.S. bond market was likely dealt in the course of this hearing and a second Senate Banking session on November 5, 1997. Although these hearings sought to address both Gazprom's $750 million in Export-Import Bank loan guarantees and its scheduled bond offering, the tone for the day was set early on when members of the committee made clear that denying Ex-Im credits only to see Gazprom raise considerably more funds on Wall Street seemed to represent a "bridge too far." While a complete review of the hearings are beyond the scope of this report, a number of statements made at the October 30 session merit reference.

- "Senator D'Amato, the message of the day is simple: We know Iran is aggressively pursuing a nuclear weapons program. U.S. agencies and institutions should not underwrite companies willing to generate profits for Tehran to buy or build that bomb." -- *Senator Mitch McConnell* (R-KY)[147]
- "Now, I'd like to say right at the outset that this is not a case of being out to get Russia or to prevent U.S. companies from doing business with Russia. That is not the intent at all. Gazprom's investments in Iran and Libya, however, and its attempts to fund these activities on the U.S. market are a matter of national security and one which, if nothing else, needs to be brought to the attention of the American people who might invest in these companies. We're talking about U.S. investors in Iran and Libya via Gazprom." -- *Senator Sam Brownback*[148]

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145. Robert Greenberger and Laurie Lande, "Russia's Gazprom Appears Vulnerable to U.S. Pressure Over Iranian Gas Deal," *Wall Street Journal*, October 17, 1997:
Capital markets leverage was, however, considered at the time of ILSA's drafting. According to the *Wall Street Journal,* "However, an earlier draft [of ILSA] would have barred offending companies from U.S. financial markets. That sanction was replaced by narrower penalties after heavy lobbying by the U.S. banking industry, led by Citibank's Citicorp."

146. The Center for Security Policy, "Sen. D'Amato's Committee Serves Notice on Those Who Aid and Abet U.S. Adversaries: No Fund-Raising on American Capital Markets," October 30, 1997.

147. Ibid.

148. Ibid.

- “Gazprom is a centerpiece of Russian hard currency earning structure and is very closely linked to the Old Guard Russian leadership... However, Gazprom is short on the cash it needs to get the South Pars project up and running. And in an act of sheer gall, the company is planning to get U.S. investors to pay for this by selling convertible bonds on Wall Street.” -- *Senator Sam Brownback*[149]
- “Though Gazprom claims the funds will be raised and go towards other projects, the fact is that the income will free up cash for South Pars. This convertible bond -- as well as others planned in the amount of some $6 billion [over the next two years] -- will ensure that Gazprom is able to continue with impunity its activities, some of which pose serious threats to U.S. national security interests. Such bonds will also provide the company with new investors who will have a vested financial interest in opposing sanctions or international penalties in the future.” -- *Senator Sam Brownback*[150]
- “Essentially, the matter boils down to this: Should American investors fund Iranian ballistic and nuclear missile development? And of course the answer is ‘No.’ And yet that is essentially the deal that Gazprom will be offering to unsuspecting American investors when it launches its bond next month.” -- *Senator Sam Brownback*[151]
- “...A Russian state-owned firm is insulting the U.S. by openly defying our sanctions laws against Iran. Then they come to Wall Street saying, ‘Can we use your deep pockets to help us finance this deal?’ Well, Wall Street’s deep pockets are simply the mutual funds and pension funds of this country. Why should America’s small investors and retirees finance the development of Iran’s natural gas reserves? And when it boils back down to it, that’s exactly who’s doing it.” -- *Senator Lauch Faircloth*[152]
- “Why should we finance projects for our enemies? I cannot understand anybody with any common sense wanting to be part of this deal. I think Wall Street should say ‘No’ to the deal, and if they do not, then I think we should block it by legislation.” -- *Senator Lauch Faircloth*[153]

Less than two weeks after the Banking Committee convened these two sets of hearings, Gazprom withdrew its $3 billion bond offering from the U.S. debt market. The company and its Wall Street investment bank cited “market conditions” as the official explanation for the withdrawal. Nevertheless, the company tapped the European syndicate loan market under the same “market conditions” roughly three weeks later to raise the $3 billion at a higher interest rate and shortened maturity schedule.[154] More importantly, a number of unwitting Americans likely did not end up underwriting a company partnering with a terrorist-sponsoring state and in

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149. Ibid.

150. Ibid.

151. Ibid.

152. Ibid.

153. Ibid.

154. The William J. Casey Institute, “Tilt: Heritage Panel, Casey Institute’s Robinson Warned Last Month of Unsustainability of IMF’s Russia Rescue Effort,” August 14, 2000.

violation of U.S. law.

The New York Times offered a slightly different perspective on the withdrawal: "Facing extraordinary pressure from Washington, a major Russian partner in a project to explore for natural gas in Iran today postponed a bond offering to raise up to $3 billion."[155]

China National Petroleum Company/PetroChina

During the summer of 1999, reports surfaced detailing China's growing ties with Sudan. As referenced earlier, China's burgeoning energy requirements have led Beijing to secure overseas energy supplies on an accelerated basis, concentrating its efforts on a number of countries that are generally off-limits to U.S. oil companies (i.e., terrorist-sponsoring states).[156] In the case of Sudan, China's flagship oil company, China National Petroleum Company (CNPC), had already invested some $1.5 billion in Sudan's energy sector and had reportedly allocated billions more for oil exploration and development. The PRC government had also reportedly committed some $15 billion over an unspecified period of time to Khartoum for "infrastructure development."[157]

CNPC's investment had secured the company a forty percent stake in Sudan's Greater Nile Petroleum Operating Company (GNPOC), the country's primary energy exploration and development consortium. In addition to building two wells and an oil refinery, CNPC helped design and build a critical one-thousand-mile pipeline linking Southern reserves to a northern refinery and export terminal. According to published reports, the company undertook these projects at virtually no profit in exchange for the drilling rights to more than 40,000 square kilometers in southern Sudan.[158]

With China's assistance, the export of Sudanese crude became operational in August, 1999. Within a short time, the country was generating millions of dollars in revenues. In many African countries, this type of progress would be touted as a success story. In Sudan, however, these significant revenue flows raised new concerns for the international human rights, religious freedom

155. Steven Erlanger, "Russian Partner in Iran Deal Postpones Its Bond Offering," *New York Times*, November 12, 1997.

156. "Giant Oil Deal Moves China Onto World Stage," *Asia Times*, June 6, 1997; and John Berlau, "Is China Stock a Security Risk?," *Investor's Business Daily*, October 5, 1999:
At the time, CNPC had contracted to develop the estimated one billion barrel al-Ahdab oil fields in Southern Iraq. The company's Chairman, Zhou Yong-kang, said at the signing in Baghdad that "[CNPC] would finance part of the project, while international investors would be tapped for the rest." According to the report, CNPC was also seeking to help develop Iraq's Halfaya fields estimated to hold some five billion barrels of oil. Energy industry newsletter reports indicate that CNPC was also seeking a foothold in Iran at that time: "CNPC plans to build a 1000 kilometer pipeline from Kazakstan to Iran, tapping the gradually opening Iranian oil market."

157. Correspondence from Representative Frank Wolf to SEC Chairman Arthur Levitt, September 30, 1997:
Representative Frank Wolf provided a detailed assessment of CNPC's activities in Sudan in his correspondence to SEC Chairman Arthur Levitt. "CNPC, China's state-owned oil company, is heavily involved in financing and constructing an oil pipeline and oil production -- both upstream and downstream -- in the African country of Sudan."

158. Ian Johnson, "China Cuts Sudan a Deal on Nile Oil Project," *Wall Street Journal*, December 20, 1999.

and national security communities.

The reasons are clear. Sudan is engaged in an eighteen-year war of oppression that has claimed the lives of some two million -- mostly African Christians and animists in the South -- and displaced over four million.[159] Khartoum is reportedly the only government in the world today engaged in chattel slavery.[160] It repeatedly, and deliberately, targets hospitals, churches, schools and other civilian targets in bombing raids.[161] Moreover, the U.S. Commission on International Religious Freedom, U.S. Catholic Bishops, the Holocaust Museum and the U.S. House of Representatives have formally described Khartoum's policies as "genocidal."[162]

In 1997, President Clinton imposed broad economic sanctions against the extremist, Islamic regime in Khartoum citing, "sponsorship in international terrorism, its efforts to destabilize neighboring countries and its abysmal human rights record."[163] Indeed, the country was cited for its terrorism-sponsorship by the State Department in its "Patterns of Global Terrorism 2000." According to the report, "Sudan, however, continues to be used as a safehaven by members of various groups, including associates of Usama Bin Ladin's al Qaida organization, Egyptian al-Gama's al-Islamiyya, Egyptian Islamic Jihad, the Palestine Islamic Jihad and HAMAS. Most groups use Sudan primarily as a secure base for assisting compatriots elsewhere."[164]

Rather than serving as a springboard to peace and prosperity for the long-suffering people of Sudan, many activists correctly feared that the new revenues would enable Khartoum to increase the tempo and lethality of its war efforts and dismiss attempts to broker peace.[165] These fears were validated when Agence France Presse quoted Sudan leader Hassan al Turabi as revealing that the oil revenues would "be used to finance new factories to produce tanks and missiles."[166] In addition to intensifying the brutality and scope of its campaign, Khartoum has consistently resisted efforts to negotiate with Southern opposition since oil exports came online. As the

159. Freedom House, Center for Religious Freedom, "Sudan Campaign of Conscious Brochure 2001."

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. Ibid.

161. Ibid.

162. Freedom House, Center for Religious Freedom, "Sudan Campaign of Conscious Brochure 2001."

163. Correspondence from Representative Frank Wolf to NYSE Chairman Richard Grasso, September 23, 1997.

164. U.S. Department of State, "Patterns of Global Terrorism, 2000," April, 2001.

165. Correspondence from Rabbi David Saperstein, former Chairman, U.S. Commission on International Religious Freedom to President William Clinton, October 22, 1999:
As the U.S. Commission on International Religious Freedom wrote to President Clinton in October, 1999, "Revenues from the pipeline would insulate the Khartoum government from the impact of economic sanctions, and thus undermine the peace process. Flush with new oil money, the National Islamic Front would have little incentive to engage in negotiations."

166. John Berlau, "Is China Stock a Security Risk?," *Investor's Business Daily*, October 5, 1999.

Washington Post observed in November 1999,

"Now, however, peace hopes have been buried by the recent completion of an oil pipeline, promising $200 million a year or more in revenues. Rather than negotiate, the north declares that it will use its new oil wealth to stock up on military gear and win a victory on the battlefield...Once it has control of these [yet unexploited oilfields], it will purchase yet more tanks and missiles."[167]

On September 6, 1999, the *Investor's Business Daily* reported that CNPC was planning to list on the New York Stock Exchange (NYSE) and Hang Seng.[168] It was estimated that the company would raise some $10 billion through an equity float, making it the largest overseas offering in the history of the NYSE.[169] Almost immediately, non-governmental organizations expressed deep concern at a U.S. offering that would provide proceeds from American investors for a company implicated in the horrors of Sudan. As the Casey Institute stated at the time,

> "American institutional and individual investors could well find themselves effectively underwriting a totalitarian government in Africa engaged in the acquisition of weapons of mass destruction, terrorism, slave trading and a brutal civil war..."[170]

A similar reaction was registered by those Members of Congress long active on the Sudan front. In letters to SEC Chairman Arthur Levitt and NYSE Chairman Richard Grasso, Representative Frank Wolf (R-VA) cited the immorality of the offering.[171] These concerns were echoed by the U.S. Commission on International Religious Freedom following testimony by Roger Robinson, former Senior Director of International Economic Affairs at the National Security Council, regarding the possible tapping of U.S. capital markets by foreign energy companies to help finance oil development activities in Sudan and, by extension, provide economic life-support to the reprehensible Khartoum regime. In a letter to President Clinton dated October 22, 1999, the bipartisan, Congressionally-mandated Commission wrote:[172]

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167. "Exploiting Sudan's Agony," *The Washington Post*, November 15, 1999.

168. The William J. Casey Institute, "China Petroleum's IPO Would Provide Economic and Military Life-Support for Terrorist- and Slavery-Sponsoring Sudan," September 24, 1999.

169. Ibid.

170. Ibid.

171. Correspondence from Representative Frank Wolf to NYSE Chairman Richard Grasso, September 23, 1997; and Correspondence from Representative Frank Wolf to SEC Chairman Arthur Levitt, September 30, 1997:
In his letter to Chairman Grasso, Wolf wrote, "I believe this company at this time would be inappropriate and am writing to urge you to delay this listing." The Congressman went further in his correspondence with the SEC: "I have some serious concerns about CNPC and wanted to bring them to your attention in hope that the SEC will take a careful look at whether this company should be allowed access to our capital markets. It could have serious national security implications for the U.S. and could lead to the death of tens of thousands more people in the country of Sudan."

172. Eduardo Lachica, "U.S. Religious Task Force to Scrutinize CNPC's Stock Offer for Sudanese Ties," *Wall Street Journal Asia*, December 22, 1999:
The Commission later established a "Capital Markets Task Force," the first official markets-related entity of its kind.

> "The Commission would like to emphasize one of its recommendations for strengthening the peace process in Sudan: apply your 1997 Executive Order [levying sanctions against the government of Sudan] to bar the Chinese government's China National Petroleum Company and other companies from using the U.S. stock exchanges to finance Sudan's new oil pipeline."[173]

Initial non-governmental and Congressional objections to the proposed offering were not lost on CNPC and its lead U.S. investment bank. Initial public offering (IPO) proceeds and the potentially hundreds of millions of dollars in investment bank fees for the transaction were not the only matters of concern. Indeed, Beijing hoped to use CNPC as a flagship for listing scores of SOE's in New York in the coming years. Rather than risk political fall-out and possible U.S. governmental action against CNPC, the company was hastily restructured to exclude Sudanese and other overseas assets. As the *Wall Street Journal* reported, "Seeking to quell U.S. opposition to a fund-raising plan, CNPC will restructure a holding company it hopes to take public, removing a Sudanese oil venture."[174] Within a few weeks, the world's fourth largest energy company, PetroChina, was born.[175]

The shedding of its Sudan operations did little to diminish U.S. opposition to the now-PetroChina offering. Of primary concern was the ownership structure of the new entity, 90 percent of which was still controlled by CNPC. Of course, both entities were, at the time, 100 percent owned by the Chinese government. Due to the fungibility of money, the ownership structure and issues of corporate governance, it was maintained that CNPC would benefit directly from this offering and could use some U.S. investor proceeds to advance its operations in Sudan.

These concerns were reinforced when it was determined from the company's SEC registration statements that the parent company was to receive some 10 percent of the IPO proceeds directly and that PetroChina would take on roughly $15 billion of CNPC debt, some of which may have been incurred from the company's Sudan activities. Even were it proved that the IPO proceeds could be effectively firewalled from CNPC (as asserted by PetroChina's investment bank) and the debt was not incurred in Sudan, it was difficult to argue that the IPO would not free

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The mandate of the task force was, among other duties, to study capital markets security more broadly and monitor the CNPC/PetroChina stock offering.

173. Correspondence from Rabbi David Saperstein, Chairman, U.S. Commission on International Religious Freedom to President William Clinton, October 22, 1999.

174. Eduardo Lachica and Peter Wonacott, "China National Petroleum Revises Sudan Venture for U.S. Investors," *Wall Street Journal Asia*, November 3, 1999.

175. David Ottaway, "Chinese Fought on NYSE Listing," *Washington Post*, January 27, 2000:
David Ottaway of the *Washington Post* also commented on the opaque nature of this maneuver, stating, "The most important [CNPC step to blunt the U.S. religious and human rights campaign] was to create a separate company, PetroChina...that will operate inside China only." This 27 January article also marked the first time that press accounts estimated IPO proceeds to be in the range of $5 billion -- down from an originally-targeted $10 billion (July, 1999) and $7 billion according to reports in December, 1999.

up other capital for CNPC that could be used in Sudan. As Nicholas Lardy observed, "PetroChina could declare a dividend and transfer money to the parent, and the parent could then use it to develop their reserves in Sudan.[176]

Rather than blunting opposition to the listing, an expanding coalition of NGO's and Members of Congress intensified their activism.[177] In addition to scores of articles being generated by this so-called "PetroChina Coalition," those in the Sudan community sent a direct plea to President Clinton signed by over two hundred religious and civic leaders including former Treasury Secretary William Simon and former National Security Advisor William P. Clark, urging him to deny U.S. market access to CNPC or a restructured entity. As stated,

> "The [1997 Executive] order should be construed or amended to bar CNPC from accessing the U.S. capital markets so long as it continues to be a 40% partner in the GNPOC project, and so long as that venture provides the regime with millions of dollars in annual revenues."[178]

As resistance to the PetroChina IPO grew, the *Financial Times* reported in the wake of the restructuring that PetroChina would be seeking to raise some $7 billion in its IPO, down from July reports of $10 billion.[179] The broad-based opposition was likewise recognized by the SEC and

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176. John Berlau, "Chinese Oil Firm's Listing on NYSE Faces Fight Due to Terrorist Links," *Investor's Business Daily*, March 10, 2000; and "China CNPC to Postpone IPO Roadshow Until Feb," *Dow Jones*, January 26, 2000: Interestingly, the CNPC/PetroChina affair was generating scores of mainstream press reports internationally on a monthly basis by February 2000. Although it had been some three months since PetroChina was created, many press items still referred to the IPO as "CNPC's." For example, on Wednesday, January 26, the *Dow Jones* reported that "China National Petroleum Corporation has postponed the road show for its initial public offering..." While the name "PetroChina" was used with greater frequency in the weeks before the IPO, many members of the press still use the two names interchangeably.

177. Jane Lampman, "Battle Against Oppression Abroad Turns to Wall Street," *Christian Science Monitor*, March 3, 2000:
Jane Lampman of the *Christian Science Monitor* documented the new capital markets focus of religious, human rights and national security public policy organizations: "Now a coalition of religious and human rights groups in the United States is targeting the money trail in an effort to stop what they believe is a war of genocide in [Sudan]. It is part of an emerging strategy to focus on Wall Street as a way to curb religious persecution and other human rights abuses around the world. It is winning allies in Congress and the national-security community concerned about the rising risks of global 'bad actors' tapping the US financial markets...Now the religious and human-rights groups are exploring a new kind of sanctions - which focus not just on stock portfolios but capital markets."

178. Correspondence from religious and civic leaders to President William Clinton, December 9, 1999:
The letter went on to forcefully question the credibility of CNPC's creation of PetroChina. "Reportedly, CNPC and its investment bank, Goldman Sachs, will shortly seek to avoid the Executive Order and public censure by a 'restructuring' scheme purporting to withhold IPO funds from CNPC's commitment in Sudan, Iraq and other terrorist states. The fungibility of money and the scale of CNPC's activities in Sudan thoroughly undermine the credibility of this contrivance."

179. Ho Swee Lin and James Kynge, "Chinese Oil Group Seeks $7bn IPO in New Year," *Financial Times*, December 23, 1999; and Ho Swee Lin and James Kynge, "Investors to Tread Warily in China Oilfields," *Financial Times*, December 23, 1999:
It should likewise be noted that in December and January a number of financial issues were raised with respect to the

NYSE, both of which launched an investigation into PetroChina's planned use of proceeds. Interestingly, the justification provided for the inquiry by the NYSE was not, as might be expected, financial in nature. According to the *Dow Jones*, "NYSE wants to make sure that CNPC's funds won't be used for [those] countries under the U.S. sanctions."[180]

In late January 2000, Sudan activists and religious freedom and national security advocates took the unusual step of expanding the opposition campaign beyond the international press and government channels and into the markets themselves. Seeking to dampen demand for the stock offering in the likely event the IPO were allowed to proceed, a number of the same signatories on the above-referenced letter to the President directed their concerns to this country's fifty state treasurers and the senior managers of over two hundred U.S. pension and mutual funds. (See Appendix 4.) Their letter to these fund managers included a nine page list of the names and titles of other recipients.[181]

Addressing both the PetroChina offering and outstanding U.S. shareholders in Talisman Energy Inc., a 25 percent partner in the GNPOC, the civic leaders stated: "We write to urge you in the strongest terms to divest any Talisman holdings you may have and, should it become available, to avoid the purchase of 'PetroChina' stock." The letter did not only couch its concerns in moral terms, but raised an important financial argument to eschew the stock as well. Citing a particularly impressive divestment campaign underway against Talisman -- which had resulted, at the time, in a roughly twenty percent decline in Talisman's share price -- the advocates raised the prospect of similar losses for prospective PetroChina shareholders:[182]

> "It is also likely that PetroChina will face a divestment campaign similar to the one directed against Talisman if this holding company, or CNPC itself, proceeds with its multi-billion dollar IPO."[183]

By most accounts, the letter to fund managers and ongoing press coverage was having a substantial impact. By February 2000, according to the *Washington Post*, the activism had "already helped persuade a number of big U.S. public pension funds to divest their holdings in a

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now-PetroChina offering. Chief among these were reports that IPO proceeds were to be earmarked for "debt repayment and severance package repayment" rather than exploration and other revenue-enhancing projects. The concerns were sufficiently serious that the Chinese Minster whose division was in charge of CNPC was forced to clarify publically CNPC/PetroChina's use of funds. It has been speculated that more in depth financial reviews of PetroChina were catalyzed by the broad array of reports addressing the company's IPO.

180. "China CNPC to Postpone IPO Roadshow Until Feb," *Dow Jones,* January 26, 2000; and Ho Swee Lin, "US Regulator Holds Up Chinese Oil IPO," *Financial Times*, February 3, 2000.

181. The William J. Casey Institute, "Human Rights and Religious Leaders Urge Hundreds of Pension and Mutual Funds to Forego Imminent PetroChina IPO on NYSE," January 28, 2000.

182. Correspondence from religious and civic leaders to U.S. State Treasurers and pension and mutual funds, January 24, 2000.

183. Ibid.

Canadian oil firm associated with the Chinese in the same oil project."[184] The same article also revealed that "At least two of these public pension funds are among the largest in the country and have also decided not to participate in [PetroChina's] stock offering."[185]

The implications of public announcements by TIAA-CREF, the massive teacher's pension system, and the California Public Employees Retirement System (CalPERS) -- America's two largest public pension funds -- that they would eschew PetroChina stock cannot be overstated. It is almost unprecedented for pension funds to decline publically to purchase a stock, let alone prior to the company registering with the SEC.[186] Moreover, PetroChina was to be China's groundbreaking NYSE-listed firm due to its stature and size. It was attractively priced during a period of rising oil prices and was expected to be greeted enthusiastically by the U.S. financial community, thereby paving the way for future listings by other Chinese SOE's.[187]

As regards the letter, the decision by activists to take aim directly at the "demand side" of the capital markets may have unwittingly, yet fundamentally, altered some of the parameters for investment in foreign companies. For the first time since South Africa, human rights, national security and religious freedom concerns had emerged as material risk factors in the markets -- an historically important development. Whether a firm was doing business with a terrorist-sponsoring state was chief among these new risk elements and heightened market sensitivities. As *Washington Post* reporter David Ottaway commented,

> "The campaign against the [PetroChina] IPO marks a new direction in the widening involvement of church and human rights groups in various foreign policy issues. Now for the first time they have decided to focus on the behavior of foreign companies registered on U.S. stock exchanges."[188]

Indeed, by February 2000, the national security, human rights and religious freedom communities had "broken the code" on the potential impact of linking finance -- in the form of fundraising in the U.S. capital markets -- to their respective policy concerns. By doing so, they were helping change market and SEC calculations concerning risk assessment and management.

The above-referenced delay in the listing of PetroChina caused by more exacting NYSE and SEC reviews of the prospective offering provided the time needed for intensified opposition to the

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184. David Ottoway, "Chinese Fought on NYSE Listing," *Washington Post*, January 27, 2000.

185. Ibid.

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. Given their size and importance within the industry, CalPERS and TIAA-CREF are often said to play an influential role in the investment strategies of other U.S. public pension funds.

187. Ho Swee Lin, "Investors Lukewarm on PetroChina," *Financial Times*, March 31, 2000:
According to the *Financial Times*, "Failure for the offer would have depressed the outlook for the many other state-owned enterprises queuing up for international funds."

188. David Ottoway, "Chinese Fought on NYSE Listing," *Washington Post*, January 27, 2000.

company, thereby further affecting PetroChina's public reception. Beginning in February 2000, the "PetroChina Coalition" expanded substantially in numbers. The Tibet freedom community, environmental groups and the AFL-CIO joined the fray in opposition to the offering.[189] Together, these groups could employ a wide range of coordinated activities and techniques to thwart demand for the IPO and influence U.S. policy-makers and public opinion. Some held marches, others pamphleted the headquarters of PetroChina's lead U.S. investment bank and organized labor initiated a "counter-roadshow" in the same window that the IPO was being marketed to U.S. fund managers and institutional investors.[190] With combined NGO memberships totaling as many as 20 million Americans, the PetroChina Coalition, between February and April, 2000, helped generate hundreds of mainstream, Internet and other news pieces on PetroChina as well as interventions by Members of Congress with the SEC and the White House. More importantly, by the time of the April IPO, over $1 trillion of funds-under-management had announced that they would not hold PetroChina stock in portfolio.[191]

The powerful opposition to the PetroChina offering catalyzed increased attention from Congress in the weeks leading up to the NYSE-listing. Two letters from Congressional members, each with twenty-five signatures, arrived at the White House in the first week of April seeking to persuade President Clinton to deny PetroChina's access to the U.S. capital markets. The first, so-called "Sudan letter," focused on the flaws inherent in the company's attempts to "firewall" funds from its parent company, CNPC. According to the letter,

> "Your powers should be used to bar CNPC and its surrogate PetroChina from access to the U.S. capital markets so long as they generate revenues to the Sudanese regime. The fungibility of money, the scale of CNPC activities in Sudan and the $15 billion debt PetroChina is assuming from CNPC, thoroughly undermine assertions that PetroChina is "firewalled" from CNPC's Sudan operations."[192]

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189. International Campaign for Tibet, "Controversial Chinese NYSE Listing Opposed by Tibetan Advocacy Group," February 15, 2000; The William J. Casey Institute, "AFL-CIO Joins Effort to Block PetroChina's Bid to Penetrate U.S. Capital Markets," March 1, 2000; and James Cox, "AFL-CIO Flexes Muscle Against China IPO," *USA Today*, March 10, 2000:
According to a press release by the Campaign for Tibet, "PetroChina is now looking for Americans and their capital to finance the further exploitation of the Tibetan Plateau." Similarly, citing human rights, corporate governance, ethical issues and potential lay-offs, the AFL-CIO press release announcing its opposition on March 1, 2000 stated, "The PetroChina IPO has many risky financial holes, and they are covered in an intricate patchwork of human rights and environmental violations."

190. Stephan Fidler and John Labate, "Left and Right Unite in Protest Over PetroChina Offering," *Financial Times*, March 21, 2000:
The *Financial Times* provided a preview of the activities of the new members of the Coalition: "Arthur Levitt, Chairman of the Securities and Exchange Commission, should expect to be bombarded by e-mail from thousands of students this week."

191. Phyliss Plitch, "On Eve of PetroChina Roadshow, Questions Swirl Around IPO," *Dow Jones*, March 10, 2000:
As Bill Patterson, Director of AFL-CIO's Office of Investment proclaimed, "We have yet to talk to a pension fund that it going near [the PetroChina IPO]. My sense is that the marketing universe for Goldman [Sachs] is shrinking."

192. Correspondence from U.S. Congressmen to President William Clinton, April 3, 2000.

The second, so-called “Tibet letter,” focused primarily on Tibet-related, environmental and labor concerns. Nevertheless, the message to the President was similarly forceful and direct. It stated:

> “Accordingly, we request that you use your authority to block any IPO brought to the U.S. capital markets by CNPC, and/or PetroChina, until an acceptable use of proceeds therefore has been assured.”[193]

During this same period, SEC Chairman Arthur Levitt was likewise the recipient of numerous correspondences regarding PetroChina. In March alone, Chairman Levitt was contacted on at least three occasions by Members of Congress seeking two actions by the SEC. The first was to ensure that PetroChina complied fully with all relevant disclosure requirements. Of particular concern was PetroChina’s proposed use of proceeds, the explicit receipt by CNPC of IPO proceeds and its use of those funds as well as the disclosure of all *material* considerations that could impact on the value of the stock. The second was a request by both Senator Brownback and Representative Bachus that the SEC effect a ninety-day “cooling down” period prior to granting PetroChina permission to proceed with the IPO so that those interested Congressional Members could study the controversial offering in greater detail. This latter request was declined.[194]

PetroChina officially filed for entry into the U.S. equity market on February 29, 2000. At the time, the firm still hoped to attract in the range of $5 billion -- a substantial downsizing from the originally-targeted $10 billion amount.[195] Revelations in the registration statement stimulated yet another round of concerns. Specifically, it was stated that CNPC would directly receive an unspecified amount of IPO proceeds. (That amount was later reported to be 10 percent, or some $289 million.) Similarly, no mention was made in the prospectus of the Sudan controversy, the effective IPO opposition campaign by the NGO coalition or the planned divestment campaign against PetroChina publically announced in the letter to fund managers from Sudan advocates. Given the material financial impact of such a divestment campaign on Talisman Energy Inc., it could be argued that a similar campaign would represent a material concern to PetroChina investors.[196]

Moreover, PetroChina’s SEC filings did not reveal that, according to an interpretation by Treasury’s Office on Foreign Asset Controls, were CNPC to transfer IPO proceeds to its Sudan

193. Correspondence from U.S. Congressmen to President William Clinton, March 31, 2000.

194. Correspondence from Senator Sam Brownback to SEC Chairman Arthur Levitt, March 17, 2000; Correspondence from Representative Spencer Bachus to SEC Chairman Arthur Levitt, March 16, 2000; and Correspondence from Representatives Spencer Bachus and Michael Oxley to SEC Chairman Arthur Levitt, March 7, 2000.

195. “PetroChina Files for U.S. IPO,” *Reuters*, February 29, 2000.

196. The William J. Casey Institute, “PetroChina Prospectus Only Intensifies Concerns About IPO,” March 10, 2000.

operations, U.S. investors could be in violation of the U.S. sanctions regime against Sudan.[197] Finally, the prospectus seemed to validate the principal concern of many of those opposing the IPO, namely, that PetroChina was entirely controlled and managed by CNPC. As the Casey Institute referenced in its analysis of PetroChina's SEC filings,

> "PetroChina states that '[China National Petroleum Company's] ownership share will enable CNPC to elect our entire board of directors without the concurrence of any of our company's other shareholders.'
>
> Lest there be any doubt as to the completeness of CNPC's control of PetroChina, the prospectus goes on to say that CNPC will be in a position to: '1) control the policies, management and affairs of our company; 2) determine the timing and amount of dividend payments; 3) otherwise determine the outcome of most corporate actions; 4) cause our company to effect corporate transactions without the approval of minority shareholders; and 5) CNPC may seek to influence our determination of dividends with a view toward satisfying its cash-flow requirements'"[198]

Notwithstanding the tireless efforts of those in the "PetroChina Coalition" and concerned Members of Congress or the moral and financial concerns raised by the PetroChina offering, the company came to market with what was represented by the *New York Times* to be "a whimper" on April 6, 2000.[199] Despite what some observers viewed as "firesale" pricing, in its first day of trading the company's share price fell some $1.25 on the New York Stock Exchange -- a drop of roughly eight percent.[200] According to the *Wall Street Journal Interactive Edition*, the trading was

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197. Correspondence from Representative Frank Wolf to Acting SEC Chairman Laura Unger, March 8, 2001:
Rep. Wolf's correspondence quoted a letter from Richard Newcomb, Director of the Office of Foreign Assets Control, to U.S. Senators with respect to the use of U.S. capital markets proceeds in Sudan-related projects. According to that letter, "Section 2(d) [of the 1997 Executive Order effecting sanctions against Sudan] would prohibit U.S. persons from contracting to underwrite or purchase shares in a new public offering[s] if the proceeds were for use to support a project in Sudan after the effective date of the Order."

198. The William J. Casey Institute, "PetroChina Prospectus Only Intensifies Concerns About IPO," March 10, 2000.

199. Mark Landler, "China's No. 1 Oil Company Goes Public With a Whimper," *New York Times*, April 8, 2000.

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. Ibid; Ho Swee Lin, "Chinese Oil Producer Hopes to Raise Up to $7bn Through IPO; and William J. Casey Institute, "Casey's Robinson Testifies Before California Legislature on Prospect of Global 'Bad Actors' Penetrating State Portfolios," January 14, 2000:
It was eventually learned that PetroChina's initial public offering would be priced at a price/earnings (p/e) ratio in the range of 8 to 1. A company's p/e area is a determining factor in the pricing of an offering and, therefore, the total proceeds raised. Put another way, by adjusting the p/e ratio, a firm can increase or decrease in scale its initial public offering. The importance of this cut-back in expectations by the firm was captured by the Casey Institute at the time: "According to the *Financial Times* of 12 January [2000], the price-earnings (p/e) ratio of the prospective offering is anticipated to be in the range of 10 times expected Year 2000 earnings for the parent company. While such a p/e ratio falls into line with some high-tech and other recent IPO's, a ratio of this nature falls well short of that of most global energy companies, which are, according to a Bloomberg energy industry composite, priced on average at *26 times earnings*. Evidently, this sort of deal sweetening is deemed essential to market an increasingly controversial offering."

sufficiently disappointing to catalyze a large-scale intervention by PetroChina's lead investment bank: "However, institutional buying – especially from lead underwriter Goldman Sachs, which piled up the buy orders from the opening bell – prevented the stock from falling further, traders said."[201]

In the end, the company raised $2.89 billion, over 71% less than it originally hoped to attract.[202] Even the funds raised were not easy to procure. The public campaign had been so effective that U.S. institutional demand for the stock was substantially curtailed.[203] In the end, the political cloud over the IPO was sufficient to catalyze a type of "private placement" of the stock prior to the listing to ensure the floatation's success.[204] Indeed, in addition to the four Hong-Kong firms (Cheung Kong Holdings Ltd. and Hutchinson Whampoa Ltd -- both controlled by Li Ka-shing -- as well as Sun Hung Kai Properties and Chow Tai Fook Nominee Ltd.) that reportedly pledged to purchase some $350 million in PetroChina stock, the company was also forced to extend concessions in its retail gasoline market to BP Amoco in exchange for the British oil firm's commitment to take what turned out to be a roughly 20 percent stake (some $560 million).[205]

Talisman Energy Inc.

Despite clear warnings from Canada's Foreign Ministry (which was concerned for the safety of Canadian nationals operating in a civil war zone), and over the objections of non-governmental organizations and church groups (which lamented the human rights implications of a partnership between a Canadian oil firm and Sudan's government), Talisman Energy Inc. of Canada (Talisman) acquired Arakis Energy in 1998, thereby securing a 25 percent stake in Sudan's GNPOC.[206] By so doing, Talisman stimulated one of the most effective divestment campaigns

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201. Kenneth Wong, "Initial PetroChina Trading Sputters; Goldman Sachs Bolsters Prospects," *Wall Street Journal Interactive Edition*, April 10, 2000.

202. The William J. Casey Institute, "Broad-Based Coalition Plays Pivotal Role in PetroChina's IPO -- and Market's Bleak View of Chinese State-Owned Enterprises," April 13, 2000.

203. Ho Swee Lin, "Investors Lukewarm on PetroChina," *Financial Times*, March 31, 2000:
"Response from U.S. institutional investors was said to be particularly poor, reflecting rising opposition to PetroChina after allegations linked it with terrorist funding in Sudan..."

204. Ibid:
"It is understood that several "red chips" – the HK-listed window companies of mainland enterprises – were corralled into taking stakes as China moved to ensure the offering went smoothly."

205. Peter Wonacott and Eduardo Lachica, "PetroChina Recruits Several Allies in Hong Kong as Investors in Issue," *Wall Street Journal Interactive*, March 22, 2000.

206. Interview with Dr. Eric Reeves, Professor, Smith College, May 10, 2001:
The bulk of the information provided in this section was contributed by Dr. Reeves during an interview by the author. Dr. Reeves is one of the world's foremost authorities on Sudan and related capital markets leverage. His single-minded efforts against those foreign oil companies that have been deemed complicit in the horrors of Sudan (due to the revenue-generating role their activities play for the Khartoum government) have been noteworthy and effective. In taking an extended sabbatical from his teaching duties at Smith College to raise the visibility and

since South African apartheid.

The moral objections levied against Talisman are similar to those referenced regarding CNPC/PetroChina – namely, the fueling effect of oil revenues on the Sudanese government's brutal campaign against southern Christians and animists. It has likewise been argued that the Canadian firm provided critical Western technology and expertise in developing the central Sudanese pipeline system that helped bring Sudanese oil -- and attendant revenues -- on-stream. Unlike CNPC and Petronas, however, Talisman provided -- knowingly or unknowingly -- "moral cover" for some of the government's actions. Specifically, Talisman is a Western energy firm domiciled in a country known for its human rights advocacy. By partnering with Khartoum in the development of oil fields that had reportedly been cleared through "scorched earth" tactics, the company seemed to many observers to be sparing the regime even sharper criticism from abroad.207 This specter became more troubling to activists as Talisman publically defended its operations in Sudan, noting that it does not take sides in the conflict.208 The company's primary argument has been that economic development fuels progress that will ultimately benefit all Sudanese.209 It may be argued that this line of reasoning discounts substantially the brutality and objectives of the Khartoum regime.

Talisman, unlike CNPC/PetroChina, was already listed on the New York and Toronto Stock Exchanges when the company initiated its Sudan operations. While oil analysts and others in the financial world initially rewarded Talisman for its efforts in the energy-rich nation, the company probably did not anticipate the impact of the wide-reaching and surprisingly effective divestment campaign that would ensue.210

Although a more detailed review of the Talisman case is beyond the scope of this report, a brief description of the campaign is merited. In July of 1999, the American Anti-Slavery Group issued a press release calling for divestment of Talisman's shares. The next month, Dr. Eric Reeves (see endnote 165) published an editorial -- which has since been widely republished -- in the *Los Angeles Times* laying out the case against Talisman in detail.211

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priority accorded Sudan and wage an effective divestment campaign against Talisman Energy and CNPC/PetroChina, Dr. Reeves has advanced the future use of capital markets leverage. He has published extensively on this subject and testified before a number of Congressional committees and non-governmental organizations.

207. Christian Aid [UK], "The Scorched Earth: Oil and War in Sudan," March, 2001 (pp.1-5).

208. Talisman Energy, "Corporate Social Responsibility Report 2000," April, 2001.

209. Ibid.

210. "Exploiting Sudan's Agony," *The Washington Post*, November 15, 1999:
As the *Washington Post* editorial opined in 1999, "Talisman Energy Inc., the Canadian company that operates the new pipeline, has rightly become the target of a divestment campaign."

211. Dr. Eric Reeves, "As in South Africa, It's Time to Let Our Wallets Do the Talking," *The Los Angeles Times*, August 30, 1999.

In little more than a year, the divestment campaign had persuaded a number of significant public pension fund holders of Talisman shares in the United States to sell. This list includes: the largest private pension system in the world, TIAA-CREF; arguably the most influential U.S. public pension system, CalPERS; both the City and State pension funds of New York; the state of Wisconsin; the Texas Teachers Retirement System, the Presbyterian Church [U.S.]; and the 700,000 share stake of the State of New Jersey.[212] Much like the PetroChina campaign, strong moral- and national security-related arguments were augmented by significant media attention to Talisman's role in Sudan both in the U.S. and Canada.

Like most successful divestment campaigns, the negative media attention and NGO activism took its toll on the Canadian energy company in a number of ways. For example, Talisman was forced to divert corporate time and energy to defending both its Sudanese operations and the company's reputation. It reportedly hired Hill and Knowlton, a public relations firm, to help counter Sudan advocates in the press and has often had to manage breaking stories from the Sudan front that, directly or indirectly, linked the company to the horrors on the ground.[213] A number of these reports have indicated that government forces were utilizing a Talisman-owned airstrip to conduct air raids on civilian targets in the South.[214]

The real impact of the divestment campaign, however, has been on Talisman's share price. Due to the sell-off of millions of shares by U.S. and Canadian financial firms in a relatively short time-frame, the market became, in effect, temporarily saturated with Talisman securities. By December of 1999, Talisman's share price was sufficiently depressed by the divestments that the firm was forced to take the unusual step of executing a share buy-back to boost its value. As Canada's *National Post*, quoting Talisman's President and CEO, James Buckee, noted at the time,

> "However, [Buckee] acknowledged the [Sudan-related] criticism has hurt Talisman's share price and prompted the board to launch the buyback, which is the company's first. 'If there is abnormal pressure on us, as there is at the moment, then that calls for abnormal responses...To that extent, yes, [the concerns] have brought that about.'"[215]

At the time, the company's stock had dropped from $49 Canadian to some $34 Canadian, representing a loss of some $1.8 billion in market value.

Notwithstanding the $250 million share buy-back, significant profits in 2000 (reflected in a rising share price) and the decision earlier this year to launch a second buy-back -- also valued in the range of $250 million -- Talisman's stock remains significantly undervalued in the view of

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. Dr. Eric Reeves, "Rapacious Instincts in Sudan," *The Nation*, June 4, 2000.

213. Steven Chase, "Talisman Head Mounts Defense of Sudan Project," *The Globe and Mail*, November 19, 1999.

214. Minister of Foreign Affairs [Canada], "Human Security in Sudan: The Report of a Canadian Assessment Mission," January 2000 (p.65).

215. Paul Waldie and Charlie Gillis, "Talisman to Embark on Share BuyBack: Buckee Admits Sudanese Operations Have Hurt Stock Price," *National Post*, December 15, 1999.

many analysts.[216] According to Dr. Reeves, consensus industry analysis projections indicate that Talisman's stock will likely trade at a level of roughly three times cash flow projections per share in 2001.[217] By way of contrast, a healthy multiple for an energy firm such as Talisman (i.e., profit-generating) would be around five times cash flow projections per share.[218] At minimum, the multiple should be in the range of four times.[219]

By examining the numbers, it is possible to gain some insight into the financial impact of the divestment campaign. According to industry analysts, Talisman's per share cash flow for 2001 should be roughly $22 Canadian. Trading at a depressed multiple of three, Talisman's Canadian price per share should therefore equate to $66. At this writing it is trading at around $59. Again, according to the *National Post* in December 1999, "[Talisman CEO James Buckee] noted that the shares are trading at three times cash flow, compared with the normal rate of five times cash flow. 'We should be a screaming buy,' he said."[220] At Buckee's multiple of five, the stock should be moving toward a price of some $110 Canadian. Due, in large part, to a divestment campaign that has eroded Talisman's public image as well as demand for its stock, it can be stated with some confidence that Talisman's shares are trading at a discount of between $29 and $51 Canadian.[221]

The impact of this type of financial pressure on a company is material. Talisman is primarily an upstream energy concern that many believe should be utilizing profits to acquire assets and consolidate its position in the industry. Instead, the firm has committed roughly $500 million to shore-up an undervalued stock and, in recent months, announced a $100 million annual dividend designed to mollify dismayed investors.[222] The most telling figure, however, may be Talisman's total loss in market capitalization which Dr. Reeves estimates to be approaching roughly $3 billion Canadian as of May 7, 2001.[223]

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216. Talisman Energy Inc. News Release, "Talisman Renews Normal Course Issuer Bid," February 28, 2001.

217. Interview with Dr. Eric Reeves, Professor, Smith College, May 10, 2001.

218. Ibid.

219. Ibid.

220. Paul Waldie and Charlie Gillis, "Talisman to Embark on Share BuyBack: Buckee Admits Sudanese Operations Have Hurt Stock Price," *National Post*, December 15, 1999.

221. Interview with Dr. Eric Reeves, Professor, Smith College, May 10, 2001:
Put another way, if Talisman was trading at an average multiple of four times per share cash flow for 2001, the current stock price should be moving toward $88 Canadian -- roughly $19 Canadian more than its level at this time. Similarly, if Mr. Buckee's multiple of five were employed, the stock could be determined to be trading in the range of $51 Canadian more than its level at this writing.

222. Talisman Energy Inc. News Release, "Talisman Announces Dividend Sixty Cents Per Share Annualized," May 1, 2001.

223. Interview with Dr. Eric Reeves, Professor, Smith College, May 10, 2001.

At this time, the campaign has focused its attention on Fidelity Investments, which reportedly owns some 5 million shares of Talisman. For example, beginning in March of this year, press reports on Talisman began to reference specifically the Fidelity stake.[224] Naturally, should Fidelity decide to divest a substantial portion -- if not all -- of its Talisman shares, the pressure on Talisman would intensify further.

In the past few months, Talisman has demonstrated some signs of succumbing to the pressure exerted by the divestment campaign. Indeed, the *Financial Times* recently indicated that the company has taken steps to evaluate a potential market for its Sudan assets. According to the report,

> "PetroChina and Petronas of Malaysia - both partners with Talisman and Lundin Oil in GNPOC - seem to be the only potential buyers [of Talisman's Sudan stake]. The report mentions the pressure on Talisman from the human rights community and speculates that the U.S. capital markets sanctions prospect may be keeping Western buyers at bay."[225]

Conclusion

The cases of Gazprom, CNPC/PetroChina and Talisman affirm that higher risk foreign entities, or so-called "bad actors," are attracting -- or seeking to attract -- funds in the U.S. capital markets. More importantly, these cases suggest that national security, human rights and religious freedom have likely become a permanent part of the "material risk" market landscape. For example, the effective use of such capital markets activism is becoming better understood by a number of NGO's across the political spectrum. Moreover, the asymmetrical leverage successfully applied against these companies has illustrated the sophistication of modern capital markets activism and portends the expanded use of this type of leverage in the future. The effectiveness of "capital markets leverage" as well as the systemic and risk-related issues raised by these cases are the subject of the next two sections of this report.

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224. Elizabeth Neuffer, "Critics Decry Oil Investors' Link to Sudan War," *Boston Globe*, March 26, 2001; Karl Vick, "Oil Money is Fueling Sudan's War; New Arms Used to Drive Southerners From Land," *Washington Post*, June 11, 2001; and "Fidelity Urged to Divest Talisman Stake," *Boston Globe*, April 27, 2001.

225. Stacey Mattingly, "Calls for Capital Market Sanctions Intensify Sudan Debate," *Newsroom Online*, April 10, 2001.

Systemic Shortcomings

The U.S. financial system is ill-prepared at this time to address adequately the concerns raised by "bad actors" accessing the U.S. capital markets. In addition to governmental inattention to this new security issue area, there are a number of systemic shortcomings that merit review in the context of "capital markets security" including government oversight, the purchasing process and the evaluation of risk in the marketplace.

The three case studies reviewed in the previous section provide examples of controversial foreign offerings that have been perceived by many market activists as higher risk securities, or "bad actors," in the U.S. debt and equity markets. The Gazprom, PetroChina/CNPC and Talisman examples also highlight a number of the systemic shortcomings. Of primary concern have been: 1) disclosure exemptions; 2) the adequacy of transparency and disclosure requirements; and 3) institutional investor attention to new material risk factors in the markets.

Capital Raising "Loopholes"

The U.S. capital markets are regulated by the Securities and Exchange Commission (SEC), which has been provided the broad mandate of "investor protection." A central component of its mandate is to ensure the proper disclosure by registrants and listed companies of material risks to investors. The SEC also determines what constitutes a material risk. With the exception of cases involving fraud, insider trading and other forms of market manipulation, it is largely left to investors to gauge the risks and invest accordingly.

This oversight becomes more complicated when considering foreign entities. When overseas companies or state-owned firms seek to list on American stock exchanges or raise capital in the U.S. debt markets (including the issuance of sovereign debt), they are subject to many of the same disclosure rules as domestic entities. There are, however, alternative means by which foreign firms or governments can attract U.S. capital without adhering to otherwise rigorous U.S. disclosure requirements. For example, a Chinese company can list in Hong Kong and sell its securities to larger U.S. institutional investors through certain established channels (i.e., exemptions).

On the "demand side," institutional investors seek to mitigate risks attendant to a globally integrated financial system by diversifying their holdings.[226] This may be accomplished by owning various types of financial instruments (e.g., stocks, bonds, government debt, derivatives, etc.). They might also hold securities from regional markets and companies of varying sizes and industries. For example, a large public pension fund might have domestic portfolios for small-cap, mid-cap and large-cap companies. It might also own an "emerging market" portfolio as well as

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226. The "demand side" may be loosely defined as any U.S. entity that purchases foreign securities. Although individual investors fall into this category, the bulk of U.S. demand is made up of large institutional investors (e.g., pension and mutual funds, insurance companies, hedge funds, banks and other financial institutions, etc.). These entities wield immense purchasing power and, indeed, have the ability to help shape not just the U.S. capital markets, but international exchanges as well.

other investment categories divided by region or level of risk.

U.S. investors primarily invest in the securities of overseas entities by purchasing American Depository Receipts (ADR's). ADR's are certificates for shares in foreign companies that are held in the foreign branches of U.S. banks. In practice, if a U.S. entity were to purchase one thousand shares of a Chinese "red chip," its broker in Hong Kong would buy the shares and deposit them into a Hong Kong branch of a U.S. bank. The American buyer would then receive an ADR certificate indicating ownership.[227] Similarly, institutional investors can take on the debt of foreign governments and companies through global debt offerings.

Regrettably, those ADR's not actively traded on U.S. exchanges are not required to meet U.S. disclosure requirements before being marketed to American investors. For example, "Level I" ADR's are traded in the so-called "over-the-counter" market after providing what JP Morgan's ADR Reference Guide terms "minimal SEC registration" (i.e., summaries of public reporting documents required by the firm's home market).[228] This investment process allows small- to mid-sized foreign firms to float stock on marginal exchanges, "test the waters" of the global investor community and access U.S. investors seeking more exciting returns through riskier portfolios. In the absence of robust reporting requirements, however, this process may also allow front companies, firms engaged in dubious activities and other questionable foreign firms to more easily navigate the international investment pool.

In 1990, an important new SEC regulation was promulgated that further facilitated the purchase of unregistered foreign securities. Rule 144 (a) enables unregistered securities to be sold to Qualified Institutional Buyers (QIB's) through private placements without SEC oversight.[229] These QIB's are subject to a "holding period" before fund managers are allowed to resell the instruments to other U.S. investors.[230]

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227. "American Depository Receipts - Over the Odds," *Economist*, January 15, 2000.

228. JPMorgan, "The ADR Reference Guide." (ADR.com)

229. Simon Beck, "China Shares Probe Sought," *South China Morning Post*, October 12, 1997.

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. Testimony of Randolf Quon, before Senate Banking Subcommittee on Financial Institutions, November 5, 1997; and The William J. Casey Institute, "Will China's Latest Bond Offering Penetrate U.S. Markets, Institutional Portfolios Through a 'Backdoor'?," December 9, 1998:
Rule 144 (a) is designed to protect investors from the risks associated with purchasing unregulated overseas securities. This exemption assumes that QIB's are either able to access more information about these companies than individual investors or are more adept at assessing the risks involved in purchasing unregulated securities. Both of these assumptions are flawed in some respects. If there is little information available regarding a foreign company and/or its securities are offered through an exchange that does not require adequate disclosure, QIB's may find it difficult to make an informed investment decision. More to the point, QIB's may end up funding "bad actors" and others seeking to avoid U.S. disclosure requirements. Similarly, risk is measured in a number of different ways. The belief that QIB's are more secure from the potential dangers of unregistered securities discounts unduly the likelihood that these risks may not be adequately disclosed under foreign regulations. Put simply, it is difficult to evaluate risks if those risks (including national security, human rights and/or religious freedom concerns) have not been properly identified.

Accordingly, if a foreign company lists on the Luxembourg Exchange, for example, it can still access U.S. capital by exercising SEC exemptions without having to disclose any one of a number of items that the SEC considers to be material for domestic and foreign registrants.[231] Through what some view as the Rule 144 (a) "loophole," an element of non-transparency is introduced to the portfolios of large U.S. institutional investors.

These and other disclosure exemptions are designed to enhance the efficiency of the markets. With respect to global "bad actors," however, the advantages of these looser regulations governing the purchase of overseas securities are apparent. As Randolf Quon stated in Congressional testimony in 1997,

> "Many of the Chinese and Russian securities and bonds are unable to meet the rather strict registration requirements of the SEC. That is why they are being sold to U.S. institutional investors through the exemptions under existing securities laws."[232]

By listing on a foreign exchange, a "bad actor" can blur the investors' understanding of its corporate identity and overseas activities of potential concern. It can, nonetheless, still raise substantial funds from U.S. investors by privately placing its securities with QIB's.[233] In choosing this strategy, foreign companies and/or governments can also help avoid the type of U.S. political opposition encountered in the Gazprom and PetroChina cases.

In 1998, a $1 billion Chinese government "yankee bond" illustrated this point. Although listed in Luxembourg and Hong Kong, the offering was dollar-denominated and offered to U.S. institutional investors through 144 (a).[234] What the prospectus likely failed to reference were a number of security- and human rights-related issues associated with the PRC that American investors (on whose behalf "QIB's" were purchasing the debt) may have considered material to their willingness to subscribe to the offering. For example, would the funds be used to advance

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231. Even without taking advantage of Rule 144 (a), foreign firms and governments can access U.S. demand. Specifically, foreign securities can be marketed to *all* U.S. investors by off-shore entities (as long as that "middle man" entity was not the issuer or affiliated with the offering). An example could be useful. A Chinese sovereign debt offering could be purchased by a U.S. off-shore institution located in the Bahamas through Regulation S. The Chinese debt -- which has not met SEC levels of disclosure or utilized the 144 (a) exemption for QIB's -- could then be sold to U.S. investors without restrictions following a forty day "seasoning period." Although in practice this rarely occurs due to the relative illiquidity of the market (i.e., it is difficult to resell the paper), this nevertheless raises an important question: namely, if the risk to non-QIB's is sufficiently great to merit regulatory protection from unregistered foreign securities, how has that risk been mitigated over the course of that forty-day period?

232. Testimony of Randolf Quon, before Senate Banking Subcommittee on Financial Institutions, November 5, 1997.

233. The William J. Casey Institute, "Will China's Latest Bond Offering Penetrate U.S. Markets, Institutional Portfolios Through a 'Backdoor'?," December 9, 1998.

234. Ibid:
As the William J. Casey Institute noted at the time of the offering, "In contrast with SEC procedures, Luxembourg...requires, according to one Wall Street insider, 'form over substance.'"

China's military modernization? Would it free up funds that Beijing could then use to suppress religious freedoms? With respect to financial considerations, were repayment risks associated, for example, with a possible future flare-up in the Taiwan Straits adequately disclosed? It is not difficult to envision how complicated the process could become when subsidiaries, affiliates and parent companies are added to the mix.

Another troubling systemic process involves the use of indices by QIB's to purchase debt and equity on a mass scale. "Passive management," as it is known in the industry, is the practice by which large institutional investors buy baskets of stocks and bonds that have been chosen by indexing agencies such as Morgan Stanley Capital International (MSCI) to serve as a benchmark for an exchange or region. Rather than reviewing each Chinese stock it plans to purchase, for example, a large public pension fund could simply invest in MSCI's "China Free" index to increase its exposure to that country.[235]

MSCI's most important Asian index is the AC Far-East Free Ex-Japan index. Recently, the MSCI decided to introduce fifteen new Chinese companies, some of which were "red-chips," to the index.[236] Almost instantly, these Chinese firms were able to attract scores of U.S. institutional investors that might have otherwise eschewed their purchase. The implications of this investment vehicle are clear. Potentially problematic Chinese "red chips" and other firms can not only list in Hong Kong and access U.S. investors, but are almost automatically integrated into the portfolios of unwitting American investors once added to regional indices. At minimum, the use of indices, especially in the case of foreign firms for which material information may not be readily available, should raise "yellow flags" for U.S. pension and other funds. In an ideal world, U.S. fund managers would actively manage all foreign purchases to ensure that "bad actors" are not slip-streaming into their portfolios.

The broader institutional investing process also adds an element of concern considering the way in which global "bad actors" raise capital. In the case of public pension funds, in particular, fund managers often rely on their "external fund managers" to build and administer diversified portfolios. CalPERS, for example, contracts some ten external fund managers to oversee parts of its portfolio. Contracts are renewed based on financial performance.

Unfortunately, there is, at times, a close connection between external fund managers and the Wall Street firms that underwrite foreign offerings. For example, many Wall Street firms have subsidiary corporations that manage assets and often contract to do so for large institutional investors. This corporate linkage between underwriters and the external fund managers of this nations' larger public pension funds can result in a conflict of interest. Much like Wall Street firms have a financial incentive to minimize the possibility that its client may be engaged in activities inimical to U.S. security and human rights interests, the closely-connected asset management firms would presumably have little reason to object to a foreign offering -- especially one underwritten by its parent company -- on these grounds. This often symbiotic relationship makes it unlikely that external fund managers will serve as reliable industry watchdogs with respect to material

235. Sarah McBride, "MSCI to Add Red-Chip Firms to its Indexes," *Wall Street Journal Asia*, March 19, 2000.

236. Ibid.

national security, human rights and religious freedom concerns in the future.

It is appropriate to note, however, that external fund managers are not given unlimited latitude when it comes to purchasing foreign securities for large pension systems. For example, CalPERS sets investment parameters with respect to "permissible countries" to be brought into its portfolio. According to Section D, part VI (c) of a report by CalPERS in 2000,

> "The [external fund] Manager(s) shall operate under a set of specific guidelines that shall outline the Manager(s)' investment philosophy and approach, representative portfolio characteristics, permissible and restricted securities and procedures, and performance objective.
>
> The implementation of this Program shall comply at all times with CalPERS' investment policies including, but not limited to: 1) Permissible Country Debt and Equity Policies..."[237]

In the same CalPERS report, the "Permissible Country" debt and equity lists are provided in Section I. China, among other countries, is listed on the "Prohibited" list for both debt and equity. Although reunified with China in 1997, Hong Kong appears separately on the list of appropriate countries.[238] This seeming inconsistency was explained by CalPERS administrators to be a function of their policy bias toward exchanges, rather than companies and governments. Put another way, the "Prohibited" list are those foreign exchanges from which CalPERS will not purchase stocks or bonds.[239]

This position raises a number of issues. Does it imply, for example, that CalPERS would purchase Chinese sovereign debt if offered in the Hong Kong debt market, but not if offered in Shanghai? Given the ability of foreign firms and governments to offer their securities through a number of international exchanges, CalPERS' policy seemingly suggests that material political risks related to a foreign company or government are somehow mitigated by the location of the exchange. Moreover, irrespective of their affiliations or business activities, Chinese companies can be held by CalPERS as long as they are listed on the Hang Seng, NYSE or elsewhere. Perhaps this helps explain China's determination to have its SOE's listed internationally. To cite an extreme example, would a public pension fund like CalPERS be willing to hold a suspected proliferator front company in portfolio so long as the firm managed to list in Luxembourg or on another acceptable exchange? As Casey Institute Chairman Roger Robinson stated in a letter dated March 13, 2001 to Wilshire Associates, a consulting firm charged with expanding CalPERS' risk

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237. Untitled CalPERS Report to the Joint Legislative Audit Committee of California, Summer 2000: CalPERS' extensive report to the Joint Legislative Audit Committee of California was prepared following January 5, 2000 Committee hearings regarding State Senator Ray Haynes' request for a security-minded audit of the CalPERS system to determine the extent to which CalPERS had invested in PLA-affiliated companies. (See Appendix 5.)

238. Ibid.

239. This "exchange bias" is likely related to the nature -- and extent -- of disclosure required of firms seeking to list on a specific foreign exchange.

assessment criteria,

> "In this connection, it would also be short-sighted of CalPERS to focus on the political conditions of the country or territory in which the relevant stock exchange is located (e.g., Hong Kong), rather than where the company is headquartered and doing the bulk of its business. Simply because a foreign company is able to get itself listed on a "permissible" stock exchange does not mean that the kind of expanded, politically-oriented "due diligence" CalPERS claims to now favor can be given less weight or ignored altogether."[240]

Transparency and Disclosure

Problems arising from offshore "loopholes," cozy partnerships between Wall Street underwriters and external fund managers and troubling fund policies, while important, are manageable with proper attention. The larger systemic challenge is two-fold: 1) the difficulty in identifying global "bad actors" is exacerbated by inadequate transparency and disclosure requirements; and 2) national security, human rights and religious freedom concerns have yet to be integrated into the risk assessment methodologies of public and private fund managers and were only recently introduced as potentially material risk factors in the markets.

Fortunately, due to the nature of the free market process, it should not be difficult to incorporate these new, value-relevant considerations into the U.S. capital markets. After all, material information is the cornerstone of the markets. Were investors given the information required to include national security, human rights and religious freedom concerns in their due diligence assessments of overseas entities, the markets could, over time, largely self-regulate. If a company were deemed a "bad actor" or politically problematic and the markets were apprised of such evidence, they would likely penalize the company for its activities (e.g., reduce the value and/or marketability of the securities in question). The Talisman "Sudan discount," for example, provides an illustration of how a market adjustment might work.

The existence of these new risk factors and the ability of the market to self-correct has underpinned the aforementioned William J. Casey Institute's five year "Capital Markets Transparency Initiative." Specifically, the Institute has promoted the idea that prior to May 8, 2001, SEC disclosure requirements were not adequate to address the new types of material risks illustrated by the Gazprom, CNPC/PetroChina and Talisman cases. By expanding SEC disclosure requirements to include more information about the global activities and identities of foreign firms and governments, the markets would, in time, begin to factor these considerations into their purchasing decisions. The specific efforts to achieve this important milestone merit review.

As referenced earlier, some in the U.S. government and the media began paying closer attention to "capital markets security" in 1998. At the time, one of the primary concerns that surfaced was the dearth of transparency and disclosure with respect to foreign entities seeking to enter the U.S. debt and equity markets. As Representative Chris Cox stated at the time,

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240. Correspondence from William J. Casey Institute Chairman Roger Robinson to Ms. Rosalind Hewsenian, Managing Director, Wilshire Associates, March 13, 2001.

> "But we also need to take a look at the degree to which disclosure...by foreign borrowers and foreign users of our capital markets does not measure up to disclosure by our own domestic companies."[241]

Similarly, the Deutch Commission was sufficiently troubled by disclosure shortcomings that it recommended enhanced transparency as a first step to ensure that Americans do not unwittingly underwrite proliferators of weapons of mass destruction and ballistic missile delivery systems:

> "[A National Director for combating proliferation should] assess options for denying proliferators access to the U.S. capital markets. Options considered should include ways to enhance transparency, such as requiring more detailed reporting on the individuals or companies seeking access or disclosure of proliferation-related activity, as well as mechanisms to bar entry of such entities into the U.S. capital markets."[242]

The insights of Representative Cox and the recommendation of the Deutch Commission reflect a basic concept: in order to thwart attempts by genuine "bad actors" to access unwitting U.S. investors, those in government and the financial community must first be able to identify these entities. In the event that expanded disclosure revealed an actual or prospective "bad actor" in the course of the registration process, institutional investors would play a significant role. For example, were a foreign shipping company forced to disclose its involvement in the transport of proscribed nuclear materials to a rogue nation, investors would be better prepared to evaluate the company's political/financial risks. Barring a U.S. government decision to sanction the company and/or deny it access to the U.S. capital markets, however, this information would be useless if those evaluating the risk simply ignored these types of corporate activities. Strengthened transparency and disclosure is, therefore, a critical first step -- but not a panacea. To be effective, the markets will have to utilize this information in their decision-making processes, including valuation, risk assessment and the willingness to hold such securities in portfolio.

Regrettably, at this time, most institutional investors do not perform such expanded "due diligence" with respect to national security, human rights and religious freedom concerns. Indeed, it can be stated quite authoritatively at this writing that not one pension or mutual fund in this country currently conducts national security-related "due diligence" assessments before purchasing foreign stocks and bonds. Brad Pacheco of CalPERS underscored this point in a 1999 *Investor's Business Daily* article, "[National Security] is not screened as part of our review."[243] Human rights- and religious freedom-related risk factors do not fare much better.

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241. J. Michael Waller, "China Cashes In," *Insight Magazine*, December 24, 1999.

242. Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction, "Combating Proliferation of Weapons of Mass Destruction," July 14, 1999 (pgs. 77-78).

243. John Berlau, "Chinese Army Ties to U.S. Money: Do California Pension's Investments Risk Retirements?," July 27, 1999.

While those in the financial industry may argue that this is a problem for the U.S. government, such a view is short-sighted in light of the publicly-available information regarding such suspect companies. Congressional reports, opposition campaigns of the type encountered in the PetroChina case, the company's global activities and partnering arrangements and the print media would be a good place to start in determining whether a company or government is involved in business ventures that could impact adversely upon the value of its securities.

Disclosure Deficiencies

The case of a recent NYSE listing and initial public offering by China's second largest energy concern, China Petroleum and Chemical Corporation, or Sinopec, is emblematic of potential disclosure-oriented problems that may arise with respect to foreign registrants. Some have argued that the company failed to disclose adequately material business activities that may have negatively impacted upon its share price. These alleged omissions are partly due to systemic shortcomings referenced earlier regarding the nature -- and scope -- of political risk disclosure required by the SEC. It is also the case, however, that U.S. institutional investors seemingly did not have national security, human rights and religious freedom risk factors on their "radar screens" when evaluating this offering. As a result of this inaction by both regulators and purchasers, a company deemed questionable by many activists across the political spectrum is held by some of the most influential public and private investment funds in this country.

Sinopec was originally slated to list on the NYSE in June, 2000 and attract some $6 billion following what was expected to be the successful market debut of PetroChina. Likely due, at least in part, to the "adverse market conditions" shaped by the PetroChina controversy, Sinopec postponed its offering until October of last year. The company also scaled-back its expected proceeds and eventually raised some $3.4 billion.

Roughly one week before Sinopec came to market, a troubling *Wall Street Journal* article by Peter Wonacott appeared that raised awareness of the company's possible ties to Sudan. According to the article,

> "China Petroleum & Chemical Corp., which is promoting plans to raise as much as $3.5 billion in a global stock issue, held an investment until June similar to one that nearly sank the initial public offering of its rival [CNPC/PetroChina]: It had business ties to the pariah state of Sudan."[244]

Although the firm had reportedly transferred its Sudan assets -- which reportedly included a $30 million joint venture to conduct surveys and drill at least four wells in the "Sudan 6" oilfield -- to CNPC in July, 2000 for undisclosed terms, the *Journal* account exposed inconsistencies between claims that an authentic transfer had taken place and activities on the ground.[245] For example, the

244. Peter Wonacott, "Sinopec's Ties to Sudan May Hurt Its $3.5 Billion Global Stock Issue," *Wall Street Journal*, October 11, 2000.

245. Ibid:
It is, naturally, easier to transfer assets to a rival energy firm that is already engaged in Sudan when both entities are owned by the same government.

article observed that Sinopec still maintained an office in Sudan. Moreover, according to both a Chinese embassy official in Sudan and an on-site Sinopec executive, "Sinopec's work has continued on the oil field."[246]

While the true nature of Sinopec's activities in Sudan, if any, remains unclear, the market implications of this revelation are more difficult to contest: ties to Sudan can disrupt an offering and/or impact upon share value following the float.[247] The *Journal* article, as might have been expected, stimulated a flurry of activity by the Sudan community and other NGO's that had opposed PetroChina on similar grounds. In the week before the Sinopec listing, the SEC reportedly received "a veritable flood of e-mails" seeking disclosure of this business venture in Sinopec's filing.[248] The SEC also received a communication from the U.S. Commission on International Religious Freedom (USCIRF) on this matter. The letter recommended that the SEC investigate the "accuracy and adequacy" of Sinopec's material disclosure. According to USCIRF,

"American investors who may be considering investing in Sinopec may consider it material to their investment decisions to know whether the registration statement of Sinopec is adequate and accurate in its disclosure about that company's possible ongoing business interests in Sudan."[249]

At the time, the SEC did not specifically seek to clarify the overseas business activities of registrants such as Sinopec that could pose national security-, human rights- or religious freedom-related risks to investors. Given the potent impact of Sudan-related operations on the market activities of PetroChina and Talisman, a strong argument was made that this information was material to the investor's consideration of Sinopec. Nevertheless, Sinopec did not reference in its SEC registration statement the firm's recent Sudan activities before going forward with its IPO and NYSE listing.[250]

In January, 2001 (some 90 days after its IPO), new allegations surfaced regarding the international activities of Sinopec. Specifically, the company signed contracts with the National Iranian Oil Company totaling some $163 million to explore oil in Zavareh, Kashan and upgrade Iran's Tehran and Tabriz refineries. The deal also included assistance in the design and building of

246. Ibid.

247. Ibid:
Wonacott went on to remark: "Sinopec's removal of Sudanese operations marked a more radical attempt [than that of PetroChina] to distance itself from the controversial country."

248. The William J. Casey Institute, "Sinopec Comes to Market as China Taps Unsuspecting U.S. Investors for Funds to Support Nefarious Activities," October 19, 2000.

249. Correspondence from Elliott Abrams, Chairman, U.S. Commission on International Religious Freedom to David Martin, SEC Director of Corporation Finance, October 20, 2000.

250. The William J. Casey Institute, "Sinopec Comes to Market as China Taps Unsuspecting U.S. Investors for Funds to Support Nefarious Activites," October 19, 2000:
Sinopec also had inked contracts with Iraq to develop some 24 oilfields upon the lifting of U.N. sanctions.

the so-called "Neka" oil port in the Caspian Sea. The Iran energy development project exceeded the $20 million threshold allowed by the Iran-Libya Sanctions Act (ILSA), technically constituting a violation of U.S. law. If enforced, Sinopec could be subject to sanctions by the U.S. government.[251]

This case highlights a number of disclosure concerns. Any ongoing or former Sudan-related activities should probably have been disclosed given the Talisman and CNPC/PetroChina precedents. If the company had indeed severed its ties with Khartoum, the details of its past business activities and transfer of assets could have been made clear to investors. Equally troubling, Sinopec chose not to disclose an imminent multi-million dollar deal with Iran that eclipsed the ILSA threshhold. It is somewhat difficult to imagine that the company was not aware of the possibility of U.S. government sanctions. It is also doubtful that the company was able to enter into complex negotiations and sign such a sizable energy agreement with Iran in the three month period following its registration with the SEC. Potential sanctions would seem to represent a material risk to investors. It has since been learned that the U.S. State Department discussed this matter with Sinopec prior to its offering. According to a Department official,

> "In light of our [Caspian] policies, we have long been concerned about the Neka project. We have expressed those concerns to the government of China, to Sinopec and to other companies which have been reported to have been interested in the project."[252]

Due to SEC policy, it is not known whether the company is currently under investigation for possible material omissions. It is likewise not clear to what degree these political concerns contributed to, what was for a period of time, a roughly 30 percent drop in Sinopec's share price from its IPO level. What is clear is that some U.S. investors are holding in portfolio a Chinese entity that is doing business with at least one State Department-designated terrorist-sponsoring state and could be subject to U.S. sanctions in the future.

Expanding Disclosure Requirements

In the absence of SEC attention to these new categories of material risk, in August, 1999 U.S. Representatives Spencer Bachus and Dennis Kucinich (referenced above in connection to their reintroduction of the U.S. Markets Security Act of 1999) took the unusual step of introducing this new challenge to the fifty states. In a communication to all fifty state treasurers and attorney

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251. The William J. Casey Institute, "Insult to Injury: Sinopec's Iranian Deal Constitutes Apparent ILSA Violation," January 16, 2001; Campion Walsh, "Untitled," *Dow Jones Wire Service*, January 16, 2001; and "U.S. to Investigate Oil Pact Between Sinopec and Iran," *Bloomberg News*, January 19, 2001:
Within days of the announcement, Chinese and Sinopec officials sought to minimize the potential fall-out of the agreement. A *Bloomberg Financial* article reported the Chinese claim that the agreement was between China PetroChemical (Sinopec's parent) and Iran and therefore should not implicate "its listed unit." This claim was contradicted by Beijing's *China Daily*, which reported that "Sinopec Group, one of China's largest oil companies, signed an agreement with National Iranian Oil Company." China went on to suggest that the contract did not technically violate ILSA as the venture entailed engineering and technical exchanges rather than monetary exchanges.

252. Campion Walsh, "China Firm's Oil Deal May Revive US Sanctions on Iran," *Dow Jones News Wire*, January 17, 2001.

generals, the Representatives wrote:

> "We are writing to bring to your attention a challenge to U.S. national security which may be relevant to your state's management of pension funds and other investment tools...Given the increasingly sophisticated financial engineering employed by potential adversaries, "due diligence" needs to be expanded to encompass these largely unprecedented concerns."[253]

In a follow-up letter to those state officials of November 8, 1999, the Representatives went on to recommend that states conduct a national security audit of their existing overseas investments. Regrettably, at the time, the concept of higher risk "bad actors" had not been clearly defined and it was difficult to capture exactly what pension funds and other investment firms might be seeking in such a portfolio review. Put another way, the operative question became "how does one identify a 'bad actor?'"

Working with those in Representative Bachus' office and the staff of Senator Sam Brownback, the Casey Institute sought to answer that question in the spring of 2000. A bill, with the working title of "The U.S. Investor Protection Act of 2000," was envisioned by some on Capitol Hill to legislate expanded disclosure requirements by the SEC for foreign entities. It was determined that new transparency requirements that sought information with respect to a firm's ties to -- or business activities with -- their home country's national military or intelligence services would help indicate whether U.S. investor proceeds could end up benefitting the wrong sorts of activities. Similarly, more detailed disclosure was sought regarding the end-use of proceeds by both foreign firms and governments as was more explicit information with respect to the principal ownership and senior management structures of the foreign entity.

At the core of the draft legislation, however, was the concern that foreign entities may be utilizing funds raised in the U.S. to finance business activities in those countries under U.S. sanctions regimes. To minimize this prospect, it was recommended that the SEC require a detailed accounting of the operations of foreign registrants in countries that fall on the State Department's list of terrorist-sponsoring nations as well as other countries subject to U.S. sanctions. It bears repeating that such disclosure would help reconcile a fundamental contradiction in U.S. foreign policy: namely, that Americans can underwrite the activities of foreign companies that operate in locales that are off-limits by law to U.S. firms.[254]

A second motivation was present as well. Specifically, it was determined that those firms that have been suspected of being "bad actors" were often the same companies that were partnering with those countries cited by the U.S. government for wrong-doing. It is sometimes the

253. Correspondence from Representatives Spencer Bachus and Dennis Kucinich to state treasurers and attorney generals, August 3, 1999.

254. David Ottaway, "Chinese Fought on NYSE Listing," *Washington Post*, January 27, 2000.
As Nina Shea of Freedom House stated plainly, "But if American companies can't invest in Sudan, why should we be capitalizing companies who do it?"

case that EU and other Western firms are somewhat reluctant to do business with countries sanctioned by the U.S., even if the efficacy of those sanctions is doubted. Regrettably, it is often Chinese, Russian and other non-Western firms that choose to fill this gap.

There are other advantages associated with strengthened disclosure. In its most basic form, investor's can make more informed decisions when provided additional information about a prospective investment candidate. Moreover, these changes would not require additional bureaucracy and could be, in almost all cases, effected with almost no SEC rule changes. Most importantly, however, is the potential knock-on effect of such transparency enhancements. Taking their cue from the SEC, fund managers would likely begin to assess material national security-, human rights- and religious freedom-related risks when evaluating the securities of foreign firms and governments. In this manner, the "demand side" of the markets could help better discipline the system through its purchasing decisions.

While the "U.S. Investor Protection Act of 2000" was never introduced, this SEC "disclosure scenario" came to a head in April-May of this year. Equipped with empirical evidence of disclosure shortcomings, the faltering share values of certain perceived "bad actors" due to successful divestment campaigns and the impact of negative publicity and Congressional attention on the market activities of foreign companies, Rep. Frank Wolf -- a long-time human rights advocate and Chairman of the House Appropriations Subcommittee on Commerce, Justice, State and the Judiciary -- sent a groundbreaking correspondence to Acting SEC Chairman Laura Unger on April 2, 2001. In addition to seeking an investigation into suspected disclosure omissions by PetroChina and Talisman, the Congressman recommended a series of additional disclosure requirements for foreign firms doing business in Sudan and other countries under U.S. sanctions regimes.[255] Stating his case for these new measures, Congressman Wolf noted,

> "The PetroChina and Talisman examples underscore the material shortfalls regarding information available to U.S. investors with respect to foreign entities. Not only are material "Risk Factors" often omitted due to inadequate SEC disclosure requirements -- raising the prospect of significant losses for U.S. investors -- but inadequate information flows make it more difficult for investors to judge both risk and whether the firm's operations reflect their values. As a result, investors often end up unwittingly helping finance companies whose global activities are in contravention to American security interests and values.
>
> Specifically, the SEC's disclosure requirements for foreign entities do not currently include: the electronic listing of the foreign entrants' filings; information regarding the operations of parent companies, subsidiaries or affiliates of the prospective entrant (thereby creating the impetus for "cut-out" companies such as PetroChina to serve as funding vehicles);

255. Notwithstanding a promised divestment campaign, the precedent set by Talisman, ongoing non-governmental action, significant Congressional attention and the publically-announced decisions by leading financial institutions to eschew the stock, PetroChina chose not to disclose these and other possible material risks associated with the connection of its parent company to Sudan. It similarly did not alert investors to the circumstances surrounding its rather hasty establishment or describe how CNPC incurred the roughly $15 billion of debt ultimately transferred to PetroChina.

sufficient information with respect to the Board of Directors of the companies and pertinent corporate governance issues; notification of where the company is doing business globally and with whom (e.g., with a country on the State Department's list of terrorist-sponsoring nations, etc.); or sufficient protection of minority shareholder rights."[256]

Building on research efforts by the Casey Institute and others on Capitol Hill who had previously called for enhanced transparency criteria, Representative Wolf recommended, among other steps, that the SEC require electronic filings for all foreign registrants and more information regarding the activities of those registrants doing business in U.S.-sanctioned countries:

> "***Global Operations***: Foreign companies should disclose their operations -- as well as those of their parent companies, subsidiaries and affiliates -- in countries which are listed on the following U.S. government lists:
>
> - CIA List of Acquiring and Supplying Nations as cited in its annual report to Congress on The Acquisition of Technology Relating to Weapons of Mass Destruction and Advanced Conventional Munitions
> - U.S. State Department List of State Sponsors of Terrorism
> - U.S. State Department-Designated Countries of Particular Concern for Violations of Religious Freedom
>
> Companies should also disclose their business relationships -- as well as those of their parent companies, subsidiaries and affiliates -- with companies from countries which appear on these lists."[257]

Following weeks of intensive study of these proposed new areas of material risk, the SEC responded to Representative Wolf by promulgating a series of sweeping "process biases" designed to broaden the SEC's view of what constitutes material risk with respect to foreign companies doing business in countries off-limits to U.S. firms.[258] As the *Financial Times'* Ted Alden noted in breaking the story on May 11, 2001,

> "The SEC, under its existing authority to require full disclosure, has declared that investments in countries under U.S. sanctions are a significant material risk to investors...[This] decision will also put new pressure on mutual funds and pension funds to expand their assessments of the political risks of investing in certain companies."[259]

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256. Correspondence from Representative Frank Wolf to Acting SEC Chairman Laura Unger, April 2, 2001.

257. Ibid.

258. The SEC determined that several of the "expanded disclosure requirements" sought by Rep. Wolf included information already required by the SEC from foreign firms. In affirming the existence of these new, material risk factors, however, the SEC acknowledged that the disclosure process was not sufficiently registering these risks. Put another way, the information required was not necessarily presented in such a way sufficient to alert investors to these new material political risks.

259. Edward Alden, "Watchdog Chief to Inherit Disclosure Bombshell," *Financial Times*, May 11, 2001.

In a six-page letter from Acting Chairman Unger to Representative Wolf -- accompanied by a detailed memorandum from the SEC's Director of Corporation Finance, David Martin, to Ms. Unger – the SEC outlined its "Initiatives to be Undertaken." (See Appendix 6.) According to Acting Chairman Unger,

> "U.S. Sanctions administered by OFAC prohibit American companies from investing or doing business in [countries under U.S. sanctions]. Those sanctions do not, however, prohibit foreign companies from doing so. Foreign companies that do business in Sudan, or any other country subject to OFAC sanctions, may list on U.S. securities exchanges and offer their stock to investors in U.S. markets...
>
> The SEC does, however, have the statutory authority to require that U.S. investors receive adequate disclosure about where the proceeds of their securities investments are going and how they are being used. The federal securities laws are founded on the principle that the best way to protect investors is to ensure that they have access to *material* information about the companies and securities in which they are considering investing...
>
> The fact that a foreign company is doing material business with a country, government, or entity on OFAC's sanctions list is, in the SEC staff's view, substantially likely to be significant to a reasonable investor's decision about whether to invest in that company. Therefore, in accordance with existing disclosure rules and the SEC's investor protection mandate, the staff of the Division of Corporation Finance will seek information from registrants about material business in, or with, countries, governments or entities with which U.S. companies would be prohibited from doing business under economic sanctions administered by OFAC."[260]

According to the Unger letter, the SEC will effect one rule change (e.g., require electronic filing for all foreign registrants) and adjust its interpretation of existing disclosure requirements in three categories. As described by Casey Institute Chairman Roger Robinson in a draft *Wall Street Journal* editorial, the SEC will henceforth "1) seek to review all filings with respect to foreign firms doing material business in countries under U.S. sanctions regimes 'or with persons or entities in those countries;' 2) seek [additional] information from foreign registrants about material business in or with countries, governments or entities with whom U.S. firms are barred from doing business due to official sanctions; and 3) cooperate with appropriate U.S. federal agencies...to help ensure enforcement of existing U.S. sanctions."[261] The groundbreaking nature of these new SEC measures merits an expanded review beyond the scope of this report. A brief discussion, however, would prove useful.

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260. Correspondence from Acting SEC Chairman Laura Unger to Representative Frank Wolf, May 8, 2001: David Martin, the SEC's Director of Corporation Finance, provided a more detailed review of materiality and the SEC's role in accounting for risk in the marketplace in a ten-page memorandum attached to Ms. Unger's letter. (See Appendix 6.)

261. Roger Robinson, Draft *Wall Street Journal* Editorial, "SEC Expands Investor Protection," May 30, 2001: Mr. Robinson's editorial was published in the *Wall Street Journal* on July 6, 2001 under the title "Are You Investing in Rogue States?" It was also published in the European and Asian editions of the *Journal* some days later.

Upon successful completion of the necessary rule change, the SEC will henceforth require all foreign firms to file electronically their SEC documentation. This will allow investors to access more efficiently information regarding the securities of foreign firms of interest.

With respect to disclosure requirements, the SEC already calls on applicants to declare those foreign markets in which they have material operations. From this point forward, however, those foreign registrants that disclose business activities in countries under Office of Foreign Asset Control (OFAC) administered sanctions will be accorded largely automatic -- and closer -- scrutiny by the agency.[262] This could often include SEC requests for additional information from the registrant to ensure that any material risks (e.g., those emanating from divestment campaigns, the possible imposition of U.S. sanctions, negative publicity, etc.) are properly disclosed to investors. Although "materiality" was broadly defined in the SEC correspondence, given the fact that U.S. companies cannot have any business ties to countries under OFAC sanctions, the threshold for disclosure could be interpreted to be *any* business activities of the foreign registrant in the designated countries, irrespective of the financial value of those dealings.

The SEC also committed to work closely with OFAC in relevant cases. By doing so, the agency validated the assessment that some foreign registrants may raise security-related issues that exceed the SEC's traditional oversight. Similarly, the SEC referenced its support for the creation of an inter-agency capital markets working group that could review those foreign filings pertinent to Sudan and presumably other problematic national security, human rights and religious freedom concerns. It is reasonable to expect that some of these "complex issues," as Ms. Unger termed them in her letter, would be best considered by other government agencies.[263]

While the systemic knock-on effects of the SEC's new disclosure measures will likely not be clear for some time, investors should benefit in a number of respects. Specifically, the SEC will be requiring more detailed information with respect to the global operations of foreign firms, especially as relates to countries under U.S. sanctions. This type of information will allow investors to better judge the political risks attendant to the foreign firm. It should likewise help illuminate those risks created by increased activism in the markets (e.g., NGO campaigns, Congressional opposition, etc.). As the *Los Angeles Times* wrote, "Investors said [the SEC changes] should, however, make it easier to evaluate foreign firms that don't have the same level of openness as U.S. firms."[264]

It is expected that there are a limited number of foreign firms that are doing material business in OFAC-sanctioned countries *and* seeking to access the U.S. debt and equity markets. There is, however, reason to believe that those foreign firms tagged by the new SEC "process biases" and subject to expanded disclosure will include some Chinese firms -- not to mention the

262. These disclosure reviews will not affect U.S. corporations, which are, in most cases, prohibited by law from doing business in the U.S.-sanctioned countries cited by the SEC.

263. Correspondence from Acting SEC Chairman Laura Unger to Representative Frank Wolf, May 8, 2001.

264. Evelyn Iritani, "SEC Raises Watch on Foreign Firms for Political Risks," *Los Angeles Times*, May 14, 2001.

Chinese government itself -- that have ties to one or more of these "off-limits" states.[265] This additional information about Chinese companies should help the Commission evaluate the degree to which unfettered PRC access to the U.S. capital markets could pose national security and other risks to this country.

Although it is difficult to dispute the SEC's determination that new material risks exist, a number of political objections have surfaced. The first is the "slippery slope" argument which maintains that the SEC decision has set the stage for the ultimate denial of U.S. market access for select foreign firms. This argument is speculative and beyond the statutory authority of the SEC. An interagency working group could be formed and provided with the power to recommend that the President take such a step in extreme cases. Nevertheless, a carefully-crafted interagency group could actually reduce the chances of creeping "capital controls" by setting strict parameters for review of potentially problematic foreign firms or governments. In the event that a foreign firm seeking market access is judged to be damaging U.S. security interests, it would still likely take Presidential authority or Congressional legislation to deny market access on security grounds.[266]

A second concern may be raised by allies and those in other foreign governments. The "extraterritoriality" argument suggests that these new disclosure measures are politically motivated and designed to impose U.S. foreign policy preferences on the companies and governments of other countries.[267] This concern should be allayed by the SEC's apolitical determination that activities in OFAC-sanctioned countries represent a material risk to investors. In other words, the SEC is not seeking to dissuade a foreign firm from doing business in, for example, Iran. By compelling the firm to disclose this activity and the potential downside consequences for its share value, the SEC is merely protecting the investor, not engaging in any political or moral judgements. Moreover, the SEC is suggesting that irrespective of one's views regarding the efficacy or merit of

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265. As referenced earlier, China has signed energy contracts with a number of countries under U.S. sanctions regimes over the past two years. Moreover, the government has, at least in the case of Sudan, made financial commitments to rogue governments. (See page 26.)

266. An example may be instructive. Roughly 150 foreign entities applied for U.S. capital markets access last year. Relatively few of these had links to U.S.-sanctioned countries that would trigger SEC review under the new process. Possibly three or four of these entities could raise sufficiently complex issues as to merit interagency review. Even this number might be reduced assuming that the new SEC disclosure requirements would give pause to future "bad actors" considering fundraising in the U.S. capital markets. This kind of notional scenario is unlikely to "cast a pall" over the markets. Moreover, using the Committee on Foreign Investment in the U.S. (CFIUS) as a model would indicate that such an interagency working group would only have the authority to *recommend* that a foreign entity be denied access to our markets.

267. "Total Madness," *Wall Street Journal Europe*, October 6, 1997.
Interestingly, the *Wall Street Journal* offered an opinion regarding the question of "extraterritoriality" in a 1997 editorial that considered the controversial violation of ILSA by France's Total, Gazprom and Malaysia's Petronas. According to the *Journal*, "In fact, a lot of laws all over the globe are extraterritorial in the sense of exacting punishment when foreign interests conflict with some domestic interest. [Former Senator] D'Amato seeks to curb access to the U.S. market and U.S. financial resources by firms investing large amounts of money in Iran's energy sector. It has the sole and explicit aim of denying Iran funds to develop weapons of mass destruction. Whether that is "extraterritorial" we'll leave to the lawyers to decide but French law is not free of extraterritoriality in some similar sense either."

sanctions, the reaction of the American people and government can influence the value of certain securities.

Risk in the Market

To understand the potentially momentous nature of the May 8 SEC determinations, the role of risk in the marketplace warrants treatment. In the United States, disclosure is a function of risk. If past precedents indicate that the value of a company may be affected due to a risk factor, the SEC -- if it deems the risk "material" -- will seek disclosure of the matter. By so doing, the investor is able to make a more informed decision when purchasing the securities of the firm. Similarly, risk is a function of market forces. If the markets perceive a company's decision or direction to be detrimental to the value of the firm, it will express this determination in terms of risk, revise its valuation and act accordingly. The markets may choose to penalize the firm by paying less for its debt or equity or eschew its securities altogether if the risk is sufficiently great.

Conversely, disclosure may also serve as a determinant of risk for market players. Put another way, the markets may not adequately understand or address new risk factors. Expanded SEC disclosure requirements (or revised methods for reviewing existing disclosure) can, therefore, occasionally signal to the markets that new risks have emerged that merit attention. For example, the markets may take account of the impact of an IPO opposition or divestment campaign on the demand for a certain stock. It may not, however, have made the leap to the broader market trends evidenced. As Prudential Analyst James Lucier, Jr. stated at the height of the PetroChina controversy, "There is a whole new political risk equation that Wall Street is not prepared to deal with."[268] By acting on this trend, the SEC has, in effect, cued the markets to evaluate new risks in future purchasing decisions.[269]

It should come as little surprise that new risks emerge naturally in the evolution of the markets. Indeed, the prospective impact of U.S. public opposition to a foreign company's business practices was foreshadowed at the time of the South Africa divestment campaign. Given the market's more recent sensitivity to issues related to corporate governance and accountability, it was only a matter of time before national security, human rights and religious freedom activists began targeting the overseas activities of foreign companies to advance their agendas. By successfully lobbying market-moving institutional investors, in select cases debt and equity values were altered. Upon demonstrating a track record of success in impacting on the value of targeted securities, new market risks were born.

268

. John Berlau, "Chinese Oil Firm's Listing on NYSE Faces Fight Due to Terrorist Links," *Investor's Business Daily*, March 10, 2000.

269. John Labate and Stephen Fidler, "Sudan Ties Jeopardize Chinese Oil Listing," *Financial Times*, October 6, 1999:
Alan Hevisi, Comptroller of New York City, underscored the importance of political risk factors in a letter to Talisman CEO James Buckee in September 1999: "As long-term investors, [New York City Employees Retirement System] believes a company that is cavalier about its moral and social responsibility represents an unacceptable risk. The expanding divestment campaign against Talisman for alleged complicity in the horrors in Sudan is just one indication of that risk."

The SEC's affirmation of the existence of these new material risks could have historically important systemic implications. For example, these new disclosure interpretations should signal to the markets that robust forms of political opposition or activism need to be taken into consideration in investment decisions. Beginning with institutional investors and trickling down to individual players, new layers of "due diligence" incorporating these potentially material factors, over time, will likely be added to the assessments of foreign securities. Specifically, the markets should begin to evaluate the potential impact of a company's overseas and other activities as they relate to national security, human rights and religious freedom concerns.

Theoretically, a self-regulating market, based on disclosure and investor choice, would likely penalize foreign firms if their corporate activities have resulted in serious U.S. political opposition and/or market activism. For example, the markets may downgrade their projections for a targeted firm's profitability -- thereby reducing the market value of the stock -- as long as the company continues to follow controversial business strategies. Given the potent nature of these issue areas, however, it might also be the case that U.S. institutional investors would decline to purchase such a firm's securities altogether rather than face negative public reaction to its investment.

In a dynamic, free market system, demand for stocks and bonds (in part determined by risk assessments) should influence the decisions of a company. If a foreign firm faces a substantial contraction in the liquidity of its stock or its market capitalization due to these new political risk considerations, senior management may be forced to adjust or abandon certain business plans. Moreover, the possibility of market unrest or even "street theater" by activists may persuade the targeted entity to avoid global activities that could be deemed to conflict with U.S. national security, human rights or religious freedom concerns.[270] The possibility of this kind of defacto privatization of foreign policy was considered by the *Economist* -- widely viewed to be a barometer of important economic and political developments:

> "The new rules could affect foreign firms in a more evolutionary way. They may force American portfolio managers to take account of newly revealed political risks, or face lawsuits from aggrieved shareholders. If so, market caution could end up extending America's sanctions regime in a way that no amount of government posturing could achieve."[271]

An important "real world" case study of this theory may already be underway in California and elsewhere at the state public pension system level. The Congressional letter to state

270. The development of environmental risk in the markets may prove to be a constructive analogy. Following the Three Mile Island nuclear accident in 1979, environmental issues began to be identified by the markets as representing more serious financial risks. Over the past two decades, a number of institutional investors have created methodologies to account for this risk. By so doing, they have altered the perception of firms that are considering environmentally-sensitive projects. Put simply, firms are forced to weigh the costs of market backlash against the gains of pursuing the business activity in question.

271. *Economist*, "A Long Arm for Securities Law: A New Move to Use Securities Disclosure to Enforce Sanctions Abroad," May 19, 2001.

treasurers referenced earlier and an incendiary *Investor's Business Daily* article by John Berlau compelled some California state legislators to inspect more closely the holdings of that state's public pension systems in 1999.[272] An article in the *Pittsburgh Tribune Review* later stimulated similar actions in Pennsylvania.[273]

A two year clash ensued in California concerning the alleged existence of "bad actors" in the portfolios of its state employees that included a security-minded state audit of existing foreign holdings, legislation calling on CalPERS and CalSTRS to report publically all new foreign holdings and a second bill that called for the creation of a "capital markets task force" in the state legislature to review this matter. California's giant pension fund systems resisted these attempts to redress what some, including California Treasurer Phil Angelides, viewed as systemic flaws and denied the existence of "bad actors" in their portfolios.[274]

For example, CalPERS consistently denied the possibility that its "red chip" holdings could be associated with China's People's Liberation Army. CalPERS' initial response to the *Investor's Business Daily* (*IBD)* article that launched this issue in California set the tone for this financial policy dispute. According to a press release by CalPERS' Investment Chairman Charles Valdes, the *IBD* piece was "inflammatory and inaccurate" and "modern day McCarthyism at its worst."[275] Indeed, some two years after this issue surfaced, CalPERS sponsored a Washington D.C. symposium on the role of national security in the markets, primarily seeking to refute allegations regarding specific CalPERS holdings.[276]

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272. John Berlau, "Chinese Army Ties to U.S. Money: Do California Pension's Investments Risk Retirements?," July 27, 1999:
"IBD has learned that some of the funding for companies believed to have connections with Chinese military or intelligence operations have come from America's largest public pension fund [CalPERS]."

273. Thomas Olson, "Pennsylvania Pensions Bankrolling Violence," *Pittsburgh Tribune-Review*, January 21, 2001; and Correspondence from CalPERS consultants Vienna, Gregor & Associates to Mark Esper, U.S. Senate Committee on Governmental Affairs, March 6, 2001:
This type of scrutiny has also surfaced in Arkansas, Colorado, Iowa, Massachusetts, New Jersey, New York, Tennessee and Texas.

274. An examination of those actions undertaken in California should be considered in the context of a broader determination of the role played by institutional investors in the capital markets. Although it is beyond the scope of this report, many of the steps taken by CalPERS, the state auditor and others in California are of interest. In short, rather than accepting the possibility that CalPERS may be unwittingly helping fund companies of security and human rights concern and evaluating remedies, the pension system chose, at key junctures, to deny that any problems existed.

275. CalPERS News Release, "Investment Chairman Issues Objections to Erroneous, Misleading Article Published in Investor's Business Daily," July 27, 1999.

276. Correspondence from CalPERS consultants Vienna, Gregor & Associates to Mark Esper, U.S. Senate Committee on Governmental Affairs, March 6, 2001:
Inviting Mr. Esper to speak at a symposium, the letter stated, "The [CalPERS] Board of Administration would benefit from hearing your views on U.S. investors with investments in foreign companies, particularly those that may pose national security concerns for the United States Government."

In addition to its efforts to disprove concerns raised with respect to its Chinese "red chip" holdings, CalPERS maintained that national security is the exclusive purview of the federal government.[277] According to those in CalPERS' government affairs office, the pension system is not comfortable with determining what constitutes a national security risk and has gone so far as to argue that such a determination would usurp the discretionary authority of the federal government to conduct foreign policy.[278] In a letter to Wilshire Associates -- a firm that is contracted to help CalPERS expand its definition of political risk -- of March 13, 2001, Casey Institute Chairman Roger Robinson addressed this claim:

> "In addition, CalPERS would be well-advised to reevaluate its present argument that national security-related transgressors are the exclusive purview of the federal government and that public pension funds cannot be expected to equip themselves with the expertise to review security-related risk factors. CalPERS properly acknowledges that such new risk factors can detract from the value of such a firm's securities. Although it is true that the federal government should be considerably more active with regard to providing timely and accurate guidance on national security-related risks for the public pension funds of this country, a seemingly rigid CalPERS position of seeking to offload the entire problem onto the shoulders of the U.S. government is not credible or sustainable. While the federal government can and should decide which emerging market firms or governments should be denied access to the U.S. capital markets for egregious activities, CalPERS has the authority -- and, indeed, the obligation -- to determine if a company's global activities pose a risk to its stock value and other financial equities."[279]

In claiming that national security is solely the concern of the federal government, CalPERS failed to acknowledge a critical point, namely, that the global activities of foreign firms can have national security-related implications that may, in turn, reverberate in the markets. Indeed, while the question of whether specific CalPERS "red chip" and other Chinese holdings constitute security risks merits additional review, it can be argued that CalPERS has a fiduciary responsibility to determine whether the global activities -- including in the areas of national security, human rights and religious freedom -- of a foreign holding can impact on the value of its debt or equity. Another correspondence from Mr. Robinson -- this time to the Board of Directors of the nine public pension systems that were represented at the CalPERS-sponsored Washington D.C. symposium referenced earlier -- highlights these new political risk factors and prospective actions that might be undertaken by pension systems to help mitigate these risks:

> "In the meantime, your system can play a proactive role in helping manage and take

277. CalPERS drafted a "white paper" outlining legislation for the California state legislature that called on the federal government to determine those foreign entities that constitute a national security risk. (See Appendix 7.)

278. Interview with CalPERS government affairs office.

279

. Correspondence from Casey Institute Chairman Roger Robinson to Ms. Rosalind Hewsenian, Managing Director, Wilshire Associates, March 13, 2001.

> account of the intensifying impact of these new political risk factors on portfolio values. An analogy may be constructive. Currently, most public pension funds factor environmental risks into their "due diligence" criteria. This does not imply, however, that the fund *is determining whether the company is a despoiler of the environment*. Should the fund decide not to invest in the company, that decision would be a reflection of the fund's determination that the activities of the company may result in negative publicity, activism and/or other measures that could adversely affect the value of the stock or bond in question.
>
> Were a public pension fund similarly to factor national security and human rights criteria into their purchasing decisions -- particularly with regard to emerging market entities -- it would not be classifying that company as a national security threat. It would simply be determining that the company's international activities could result in national security- and/or human rights-related measures or activism that degrades the value of the stock. In other words, what we are recommending is merely an expanded form of political risk assessment.
>
> In the absence of an official list of "bad actors" supplied for this purpose, pension fund managers could be guided by lists of companies that have been publically cited as playing a role in the proliferation of weapons of mass destruction. Similarly, fund managers could consult the CIA's list of proliferating countries and factor that information into their risk assessments. This would be the type of useful, national security-relevant information fund managers would benefit from acquiring.
>
> At a minimum, public pension funds would be well-advised to consider where a company seeking underwriting in the U.S. capital markets and its parent company, subsidiaries and affiliates do business in the world, and with whom. If a company has extensive activities, for example, in Iraq, Iran or Sudan, fund managers need to recognize that pressure may arise from non-governmental organizations and/or Capitol Hill to divest such investments at risk of penalty to the fund for providing material assistance to terrorist-sponsoring "rogue nations." Another possibility is that unflattering media attention could be precipitated by investments in such companies as investors are linked to the unsavory activities of those whose paper they hold. A case in point may be found in the harm done to funds that came to be associated with apartheid policies simply because they were invested in companies that had business links to South Africa. In either case, pension funds can and should include these sorts of considerations in their risk assessment of overseas companies."[280]

Regrettably, this nation's public pension systems have yet to treat adequately the now-acknowledged new material risk factors in the markets and take steps to expand their "due diligence" assessments to account for these considerations. It is hoped that the SEC's detailed explanations and rationale outlined in its May 8 correspondence to Representative Wolf will prompt a second look at this issue by public pension fund managers. If so, an important first step

280. Correspondence from Casey Institute Chairman Roger Robinson to Public Pension Fund Boards of Directors, April 10, 2001.

in ensuring that U.S. investors are better protected will have been taken.

Conclusion

While transparency and disclosure enhancements may, over time, have a significant impact on the ability of perceived "bad actors" to raise capital in the U.S. markets, there remain broader policy concerns that require active attention by the federal government. In addition to studies, policy debates and other measures that could be undertaken to determine the true extent of this security problem, it may be appropriate to take steps to correct systemic shortcomings and develop a review mechanism for those rare occasions when problematic foreign firms are seeking to access the U.S. capital markets. Moreover, the growing success of opposition campaigns and other forms of market activism has given rise to a new policy tool. Specifically, policy practitioners and those in the NGO community are increasingly seeking to leverage the global dominance of the U.S. capital markets to advance foreign policy objectives. The efficacy of "capital markets leverage" is considered in the next section.

Capital Markets Leverage

Although strengthened SEC transparency and disclosure requirements and other adjustments to the U.S. capital markets should help protect investors and stem the flow of global "bad actors" into their portfolios, there remains the question of how to manage those foreign registrants whose activities put at direct risk U.S. national security interests and/or fundamental values (e.g., terrorism, proliferation, genocide, slavery, forced labor, etc.). What steps could be taken if fund managers were confronted with a company that has disclosed militarily-relevant activities in, for example, Iraq, yet still wishes to raise funds in our markets. Despite the financial risk, U.S. institutional investors could still potentially purchase the securities of such a company. Moreover, offshore exemptions introduce the troubling prospect that foreign firms could fail to disclose problematic business activities and/or material relationships with, for example, terrorist-sponsoring governments while still accessing U.S. capital.

These scenarios underscore important new policy questions that have been referenced by the bipartisan Deutch Commission, the U.S. Commission on International Religious Freedom, concerned Members of Congress and NGO's: Is it possible to leverage the globally dominant U.S. capital markets to influence positively the activities of global "bad actors?" Moreover, can the U.S. capital markets be utilized to advance U.S. foreign policy objectives? The short answer to both questions is yes; but such policy tools have to be carefully crafted to allay the often legitimate concerns of detractors seeking to safeguard the competitiveness and vitality of our markets. Even then, there will remain constituencies here and abroad intractably opposed to exercising this extraordinary source of U.S. leverage in the 21st century.

It has been argued that the denial of capital markets access for specific foreign firms is appropriate in cases involving egregious national security and/or human rights abuses. For example, in calling for, in effect, the "delisting" of PetroChina and Talisman from the New York Stock Exchange, the Sudan community has adopted this position. Such selective action, it is asserted, would send a powerful message to the odious Khartoum regime. It would also signal to global energy firms that partnering with terrorist-sponsoring states could conflict with corporate fundraising objectives.

Some in the national security community have taken a broader policy view. Specifically, a case has been made that access to U.S. investor dollars is a privilege, not a right. Accordingly, the U.S. capital markets could be used as, in the words of the Deutch Commission, "carrots or sticks," to influence foreign governments as well as companies in extreme circumstances.[281]

Indeed, as the field of capital markets security develops, policy options in several issue areas have come to include market-related penalties and other financial disincentives. The *Financial Times* picked up on this trend in addressing legislation introduced by Senator Fred Thompson last summer to curtail Chinese proliferation activities: "[the legislation] reflects a growing body of opinion that the U.S. should leverage the supremacy of its markets to help achieve foreign policy goals." The title alone of that article -- "U.S. Markets Could Be Foreign Policy Tool" -- was quite revealing.[282]

For good or ill, capital markets leverage has likely become a permanent fixture on the foreign policy landscape of this country. Regrettably, despite repeated market-related controversies, governmental commission findings and calls to action by an increasing number in the Congress and the NGO community, the Executive Branch has yet to adopt measures to mitigate the security threats posed by the wrong sorts of foreign enterprises and governments funding themselves and their nefarious overseas activities in the U.S. capital markets. Moreover, it is unlikely that the federal government has even conducted a serious study of this matter.

The seeming unwillingness of the Executive Branch to devise an interagency review mechanism for suspect foreign registrants and/or parameters for the possible, selective use of capital markets leverage in extreme circumstances has given rise to less discriminate calls for such measurers by those outside of government and on Capitol Hill. Unfortunately, an ad hoc approach to identifying global "bad actors" -- and calls for the use of this type of potent policy tool -- may potentially prove detrimental to the competitiveness and attractiveness of the U.S. debt and equity markets.

Case Studies

The cases of Gazprom, PetroChina and Talisman represent examples of the exercise of

281. Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction, "Combating Proliferation of Weapons of Mass Destruction," July 14, 1999 (pgs. 77-78): According to the report, "Access to U.S. capital markets, access to U.S. technologies, financial assistance, and influence in international financial institutions are among the wide range of economic levers that could be used as carrots or sticks as part of an overall strategy to combat proliferation."

282. Thomas Catan and Joshua Chaffin, "U.S. Markets 'Could Be Foreign Policy Tool,'" *Financial Times*, May 24, 2000; and Evelyn Iritani, "Curbs Urged on Foreign Firms' Wall Street Access," *Los Angeles Times*, February 13, 2000:
A *Los Angeles Times* article which also appeared during the PetroChina controversy headlined a similar assessment: "Curbs Urged on Foreign Firms' Wall Street Access."

different types of capital markets leverage. In the Gazprom controversy, negative Congressional attention and the *threat* of legislative action against the firm, and possibly its lead investment bank, was sufficiently alarming to be the primary contributor to the decision to withdraw its $3 billion bond offering. Gazprom's subsequent decision to tap the European syndicate loan market on less advantageous terms suggests that the denial of U.S. market access can impose a financial penalty on a foreign firm or government, irrespective of that entity's ability to raise funds elsewhere.

With respect to PetroChina and Talisman, the IPO opposition and divestment campaigns levied against those foreign firms provide empirical evidence that companies may experience a significant financial loss related to activities that have been deemed to contravene U.S. security and human rights interests. Indeed, it is not difficult to make the case that the 71 percent downsizing of PetroChina's IPO proceeds from an originally-targeted amount of $10 billion and Talisman's significantly depressed share value (not to mention a tarnished corporate image) are valid indicators that capital markets activism can have a material affect on foreign firms and governments.

Given the growing attention to global "bad actors" in the markets and the publicity accorded these cases, it is not surprising that those in the policy-making community have begun to utilize capital markets leverage in bills targeting specific foreign companies and/or governments.[283] As one Congressional aide commented, "This is going to be the sanctions wave of the future."[284] Over the past year, a number of legislative initiatives and recommendations by governmental commissions have pointed to this policy option.

USCIRF Recommendations

According to its legislative charter, the U.S. Commission on International Religious Freedom (USCIRF) is required to provide an annual assessment of -- and make recommendations regarding -- international religious freedom. Since its inception, one of the Commission's priorities has been the appalling execution of religious persecution in Sudan. Following testimony by Roger Robinson and other experts, it was determined by the Commission that targeted U.S. capital markets leverage exercised against those foreign oil firms doing business in Sudan would apply effective pressure on the Sudanese government. Such action -- it has since been argued by the entire Sudan coalition -- is urgently required due to the oil-generated revenue streams that have buttressed Khartoum against growing international outrage and the opposition efforts of Southern rebels. The language in the Commission's 2000 annual report was unambiguous:

> "[USCIRF] recommends increasing economic pressure on Khartoum by tightening current U.S. sanctions on the Khartoum government and constricting the ability of foreign-organized firms doing business with Sudan to raise money in U.S. capital markets...
>
> The U.S. government should prohibit any foreign corporation from seeking to obtain

283. It may be argued that the federal government's unwillingness to take action regarding the highly controversial and public PetroChina controversy helped catalyze legislation involving capital markets sanctions.

284. Edward Alden, "U.S. Legislators Want Markets to Sway Sudan," *Financial Times*, November 2, 2000.

capital in the U.S. market as long as it is participating in Sudanese oil-field development."[285]

This call for the denial of U.S. capital markets access may well have been the first governmental recommendation of its kind in American history. The Commission went on to renew and strengthen these recommendations in its 2001 annual report, released earlier this year.

Although the Commission's counsel has not been acted upon by the Executive Branch, it is important to understand the implications if such a policy approach were adopted. A denial of market access, if properly structured, could inflict substantial damage on a company seeking to raise investor funds with some regularity. In addition to reducing demand for a particular stock (thereby likely driving down the share price), the perceived risk associated with the company would almost surely increase. Moreover, given the global attention that would likely be attracted by a precedent-setting sanction of this nature, these companies -- and their governments -- would probably be subject to considerable media coverage of the type that worries many investors. Similarly, the public profile of Sudan -- a country once deemed by former Secretary of State Madeline Albright to be "not marketable to the American people" -- would be elevated internationally.[286]

Sudan Peace Act

In the fall of 2000, the U.S. House of Representatives passed the largely-symbolic Sudan Peace Act.[287] Among other measures, this legislation called on the federal government to proscribe the sale of certain foreign securities.[288] Specifically, Section 7 (b) stated,

"It is the sense of Congress that the sanctions in subsection (a) and in the President's Executive Order of November 4, 1997, should be applied to include the sale of stocks in the United States or to any United States person, wherever located, or any other form of financial instruments or derivatives, in support of a commercial, industrial, public utility, or government project in or with Sudan."[289]

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285. Report of the U.S. Commission on International Religious Freedom, May 1, 2000 (www.uscirf.gov).

286. Sebastian Mallaby, "Taking Foreign Policy Private," *The Washington Post*, May 29, 2000.

287. The Senate did not have sufficient time to consider the statute prior to the end of the 106th session.

288. Edward Alden, "U.S. Legislators Want Markets to Sway Sudan," *Financial Times*, November 2, 2000:
The prospective impact of financial sanctions of this type was noted by the financial press. As the *Financial Times* observed, "...if enacted, [the legislation] would effectively de-list from the New York Stock Exchange companies doing business with the Sudanese regime."

289. Senator William Frist, "The Sudan Peace Act" (S. 1453, passed by U.S. House of Representatives on October 24, 2000):
The Sudan Peace Act, introduced in the Senate by Senator Bill Frist, contained language that interpreted President Clinton's 1997 Executive Order as including capital markets sanctions against oil companies operating in Sudan. This language was removed prior to the bill's release from the Senate Foreign Relations Committee, upon which the Sudan Peace Act passed the Senate. Upon reaching the House of Representatives, the language was returned to the bill in the form of a "sense of Congress" and passed by the House of Representative on October 24, 2000.

On June 14 of this year, the 2001 version of the Sudan Peace Act was amended to include a considerably more potent type of capital markets sanctions than constructed in the "sense of Congress" the previous year. Specifically, the so-called Bachus amendment (named after its author Rep. Spencer Bachus) -- which passed on a "voice vote" -- would seem to require a mandatory interruption in the trading of securities by U.S. entities of any foreign energy firm operating in Sudan. If passed, it would also deny access to the U.S. capital markets for those foreign firms that are involved in oil development efforts in Sudan that are not currently listed on U.S. exchanges. According to the language offered by Representative Bachus:

> "The President shall exercise the authorities he has under the International Emergency Economic Powers Act to prohibit any entity engaged in the development of oil or gas in Sudan --
> (1) from raising capital in the United States; or
> (2) from trading its securities (or depository receipts with respect to its securities) in any capital market in the United States."[290]

The amended Sudan Peace Act passed the U.S. House of Representatives on June 14, 2001 by a vote of 422-2. The Senate excluded the Bachus Amendment in its version of the Sudan Peace Act, passed in late July. The House and Senate are expected to convene a conference in late September or early October to reconcile the two versions of the bill.

Both the 2000 "sense of Congress" and the recent amendment to the 2001 Sudan Peace Act highlight an improved understanding by those in Congress of the ways in which this policy lever may be constructed. For example, rather than only denying access to the U.S. markets, the 2001 amendment goes the additional step of addressing the trading of securities by U.S. entities. Depending on how the language is interpreted, it may, in effect, preclude U.S. entities from holding -- or trading -- the stock of those foreign energy companies operating in Sudan, irrespective of the exchange on which the targeted entity is listed.

China Non-Proliferation Act

Capital markets leverage has not only been sought to penalize those foreign oil companies partnering with Khartoum. During the debate regarding permanent normal trade relations (PNTR) with China, Senator Fred Thompson (R-TN) -- along with co-sponsor Senator Robert Torricelli (D-NJ) -- introduced legislation seeking to deter China from its continued proliferation activities.[291] The legislation, entitled "The China Non-Proliferation Act," would have called on the President to implement mandatory penalties for offending Chinese firms as well as graduated

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290. Representative Spencer Bachus, Amendment to the Sudan Peace Act (H.R. 2052), "Prohibition on Trading in U.S. Capital Markets," June 14, 2001.

291. Eventually fifteen Senators from across the aisle co-sponsored the legislation. It was deemed to be sufficiently important that former National Security Advisor "Sandy" Berger and others in the Administration reportedly met with Senator Thompson on at least one occasion to discuss the legislation and, presumably, China's proliferation activities more broadly.

sanctions against the PRC government were that country -- or its companies -- determined to be proliferating components for weapons of mass destruction. A menu of sanctions options directed against the Chinese government was provided in the bill from which the President could choose an appropriate response. Were Chinese entities to continue to proliferate, those options would become increasingly more onerous in years two and three of the sanctions regime.

While the legislation received substantial attention in the sensitive political window of PNTR, much of the debate focused on the capital markets-related penalties offered the President. Specifically, the President was provided the authority in year one to prohibit Chinese state-owned or -affiliated enterprises from offering bonds in the U.S. market. In a second year of proliferation abuses, this option was strengthened to include the denial of access to the U.S. equity markets for these entities. A "Tier III" option existed in year three that would, according to a summary of the legislation, "[Deny] access to the debt and equity markets of the U.S. by any company owned or controlled by nationals of the PRC."[292]

The China Non-Proliferation Act, while eventually withdrawn, highlights how capital markets leverage could be applied against governments engaged in activities deemed inimical to the vital security interests of the United States. By targeting the problematic government's funding activities -- and those of its state-owned enterprises -- the U.S. could prohibit American investors from underwriting or holding the securities of those foreign entities party to proliferation-related trade. Speaking at the Heritage Foundation on March 15, 2000, Senator Thompson underscored the potency of such sanctions, commenting, "This is leverage. Perhaps enough to cause China to reconsider some of those nuclear missile sales."[293]

The China Desubsidization Act

For some time there has been interest on Capitol Hill in introducing legislation that would prohibit Chinese state-owned enterprises from accessing the U.S. debt and equity markets. Although never formally introduced, according to a summary of prospective legislation, "The China State Desubsidization Act of 2001" would seek to "bar access to the United States capital markets to enterprises owned or controlled by the People's Republic of China."[294] It is likely that prior to its introduction, this legislation would be strengthened to include a prohibition on the purchase of offshore SOE securities (i.e., those listed on foreign exchanges) by U.S. institutional and other investors.

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292. Senator Fred Thompson, "Summary of 'The China Nonproliferation Act," May, 2000.

293. Bill Gertz, "Senator Ties China's Behavior to U.S. Trade," *Washington Times*, March 4, 2000.

294

. U.S. Senate Foreign Relations Committee, Draft Legislation entitled: "Chinese State Desubsidization Act of 2001," May, 2001:
A version of this bill, entitled the "China Free Enterprise Act of 2001," was introduced in the Senate in August, 2001. Likely due, at least in part, to the August recess and September terrorist attack against the U.S., no action has yet been taken on this legislation. Unfortunately, it was not possible prior to the release of this report to examine fully the similarities between the draft legislation and the final bill or the prospective impact of the China Free Enterprise Act.

This draft legislation touched on a broader theme: Should the U.S. help fund the PRC government through the purchase of securities offered by that government and/or its state-owned companies? The findings section of the draft China Desubsidization Act provided at least one Congressional response. According to the summary:

> “(3) resources given to state-owned enterprises empower the repressive apparatus of an autocratic government in the People’s Republic of China to perpetuate human and labor rights abuses, the subjugation of Tibet, the despoiling of the environment, and suppression of religious freedoms...
>
> (4) investment made available to state-owned enterprises affiliated with the complex of military and technology industries in the People’s Republic of China would be particularly inimical to United States interests, given China’s military buildup directed against the United States, Chinese military policies in the Taiwan Strait and South China Sea, and arms proliferation efforts destabilizing to the democracies of the Asia-Pacific region and the already volatile Persian Gulf region...
>
> (9) a limitation on access to the United States capital markets by Chinese state-owned enterprises will do no appreciable harm to United States investors or the free flow of capital into and out of the United States.”[295]

The above-listed findings make clear the connection between the U.S. markets and at least some problematic Chinese activities. For example, U.S. investors fund certain Chinese SOE’s that are directly or indirectly engaged in activities deemed harmful to U.S. interests. That financing could be used for these unsavory activities or free up other government funds for such purposes. As these firms are directly owned or controlled by the government, most proceeds ultimately flow back to the government of the PRC -- which has proven to be a cause for concern to some on Capitol Hill and many in the NGO community.

In its concluding section, the draft legislation also addresses the challenge of Hong Kong-based “red chips” by expanding the definition of SOE’s to factor in these entities:

> “the term ‘state-owned enterprise’ means any entity, not less than 50 percent of the assets of which are owned by any agency or instrumentality of the Government of the People’s Republic of China (including any agency or instrumentality thereof), either directly or through a subsidiary, parent company, or other affiliate, including those located in Hong Kong or elsewhere.”[296]

In the unlikely event such legislation were enacted, it would seemingly prohibit the U.S. listing and/or debt offerings of PRC-owned firms as well as those subsidiaries and/or affiliates serving as intermediaries for their mainland parents. It is not clear whether legislation of this nature would

295. Ibid.

296. Ibid.

also impact upon Chinese "red chips" seeking U.S. capital through offshore exemptions or the sale of ADR's, but such a provision seems plausible. Finally, this more sophisticated understanding of China's funding patterns is an indication that capital markets sanctions will likely evolve and prove an effective policy tool in the years to come.[297]

Depth of the U.S. Capital Markets

While there is little question that capital markets leverage is rapidly becoming an option in the tool kit of American policy-makers, there has been some debate regarding the effectiveness of this instrument. Due to the globalization of the securities industry, the U.S. debt and equity markets are by no means the only venue in which foreign entities can raise capital.[298] Nevertheless, there remain important reasons why non-U.S. entities seek to access the U.S. capital markets.

It is widely accepted that America's capital markets are the world's deepest and most competitive. There is also an element of prestige that is associated with doing business on Wall Street and choosing a "name" U.S. investment bank to manage an offering. Quantifying the scope and depth of the U.S. market, however, is a challenging task. Market capitalization, aggregate firms actively traded and the trading level of leading indices, while helpful, do not adequately capture the dominance of the U.S. markets.

In order to determine whether the loss of access to the U.S. capital markets would be detrimental to foreign firms, the "demand side" of this market must be considered. Indeed, it is the broad network of U.S. fund managers that serves as Wall Street's engine. Put simply, the U.S. "demand side" is immense. It is that diversified demand market that brings foreign firms and governments to New York to offer securities and, accordingly, provides the basis for capital markets leverage.

As referenced earlier, large U.S. public pension systems like CalPERS give weight to the exchange on which an entity is listed or the market in which it has offered debt. (Insurance companies, banks, mutual funds and other portfolio managers presumably operate according to similar guidelines.) Accordingly, if a Chinese firm is listed on the Shanghai exchange, it would have a more difficult time attracting American investors. Moreover, in the case of CalPERS, the firm would find itself on a "Prohibited Country" list. Alternatively, were that same firm to list in Hong Kong or, more importantly, on the New York Stock Exchange, it would find attracting U.S. investors a more likely prospect. Likewise, a firm that floats bonds in the domestic Chinese market would attract few global investors compared to a firm that accesses the U.S., Eurobond

297. It should be noted that most advocates of the selective use of capital markets leverage would prefer a case by case approach rather than a broad prohibition of the type sought by the sponsors of the bill.

298. It should be noted, however, that Wall Street is considered the most advanced financial center in the world. Much like any other industry, if a firm is forced to turn to lesser players in the global markets there are likely losses in efficiency, expertise and, specific to the sale of securities, the placement or marketing of the financial instrument. All of these -- as well as the potentially higher costs of funds in other markets -- could be involved in even the temporary loss of access to the U.S. capital markets.

and/or Japanese debt markets.

In sum, once a foreign firm has ascended to the New York Stock Exchange, it can be expected that the firm's stock will be widely held by U.S. investors -- a major incentive for registering with the SEC. A question remains, however: How deep are America's capital markets compared to their counterparts overseas?

Although quantifying aggregate funds under management, or the "demand side," -- let alone locating comparable figures for overseas markets -- is a difficult task, some basic statistics would be helpful in estimating the depth and size of the U.S. demand market.[299] Three statistical analyses are presented to illustrate the competitive advantage held by the U.S. markets: 1) market volume; 2) dollar-denominated debt offerings by foreign entities; and 3) a breakdown of mutual fund equity holdings. Once again, China will serve as a case study.

The market capitalization of the New York Stock Exchange and NASDAQ at the end of 2000 was roughly $15 trillion.[300] The aggregate market capitalization of the world's other stock exchanges was in the range of $16 trillion.[301] In terms of new capital raised in 2000, roughly $556 billion was attracted in the U.S. equity markets.[302] That same year, some $106 billion was raised in London, Paris, Frankfurt and Tokyo combined.[303] While market capitalization and listing proceeds are imperfect indicators, they, nonetheless, demonstrate the relative size of the U.S. equity market. In short, it appears that roughly one-half of the world's equity has been issued through U.S. exchanges. The relative size advantage indicates that the U.S. institutional and private demand for equity is substantially greater than that of foreign markets.

A second comparison involves the total debt issued by China in global markets. Between 1983 and the end of 1998, Chinese entities floated some 195 bond offerings in overseas markets, attracting in the range of $24.3 billion.[304] Of the proceeds gained from these transactions, roughly

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299. Like most economic indicators, investment figures of the type required for this report change regularly and are subject to shifting market conditions. For example, were Asia to experience another precipitous economic downturn, the markets would respond and U.S. fund managers would likely reduce their exposure to Asian securities accordingly.

300. The International Federation of Stock Exchanges (www.fibv.com):
This determination excludes the market capitalization of those foreign firms that have been listed on the exchange(s) referenced. This was likely done by IFSE to reduce the risk of "double counting" those firms listed on multiple exchanges.

301. Ibid.

302. Ibid:
This figure does not include capital raised in secondary offerings by those domestic firms already listed on the exchange(s) referenced.

303. Ibid.

304. Source: Bloomberg Financial Services, Country Debt Printout.

$13.5 billion was raised in dollar-denominated notes.[305] Although it was not possible for this report to determine the exact percentage of dollar-denominated bonds underwritten by U.S. entities (i.e., dollar-denominated bonds can also be purchased by foreign financial institutions and investors), it is reasonable to assume that the bulk of this debt was purchased by U.S. investors. For example, if some 55 percent of China's bonds were dollar-denominated, it can be estimated that between 80 and 90 percent of those dollar-denominated bonds were purchased by U.S. entities (i.e., most Japanese firms would have little appetite to buy dollar-denominated Chinese bonds when they can purchase those denominated in yen).[306] Accordingly, the U.S. represents an especially important market for Chinese debt offerings, perhaps as much as 50 percent.[307]

It is also useful to examine a cross-section of the U.S. demand market for Chinese equity offerings. Kleiman International Consultants (Kleiman), a Washington D.C.-based financial consulting firm, estimates that between 60 and 65 percent of mutual funds worldwide can be classified as U.S. entities.[308] Regrettably, similar statistics are not readily available for pension and hedge funds, insurance companies or other institutional investors.

Kleiman's study also cited China's weighting on the Morgan Stanley Capital Index (MSCI) as .26 percent of total global index capitalization.[309] Based on the MSCI index, Chinese firms included in the index account for $47.24 billion.[310] Under MSCI's "free float" provision, Chinese firms with total capitalization of some $47 billion are readily accessible for purchase by international institutional investors.[311] As referenced earlier, indices such as the MSCI are widely employed by institutional investors that use the index to direct overall country allocations or for direction in specific stock purchases. Kleiman estimates that U.S. entities likely hold some 60-65

305. Ibid.

306. These estimates were based on composite interviews with economists and other financial market experts, including an official at the Securities and Exchange Commission.

307. It bears repeating that the decision to float bonds in a specific market reflects both the view that the chosen market will produce greater proceeds at a lower borrowing cost *and* an objective of tapping investors from that market.

308. Kleiman International Consultants, Inc., "Analysis of U.S. Institutional Involvement in Global Financial Markets," June 4, 2001:
According to Investment Company Institute data supplied by Ms. Elizabeth Morrissey, Managing Partner, the combined assets of all open-end mutual funds -- the most common mutual funds -- in some 36 countries was roughly $12 trillion as of September 30, 2000. As of that same date, the assets of U.S. open-end mutual funds was some $7.3 trillion. Accordingly, U.S. mutual funds account for roughly 65 percent of the mutual fund market worldwide.

309. Ibid:
MSCI released a revised version of its All Country World Index in May, 2001, in which China accounts for 0.26 percent.

310. Ibid.

311. Ibid:
Based on this estimated market capitalization, it is reasonable to assume that global investors are currently holding roughly $47 billion in equity of those Chinese companies listed on the MSCI.

percent of this roughly $47 billion in Chinese equities based on its conclusion that U.S. mutual funds account for some 60-65 percent of the mutual fund demand market worldwide. This equates to between $28.3 billion and $30.7 billion in U.S. holdings of Chinese equity.[312] This estimate does not include U.S. institutional holdings in Chinese companies that have not been included in the MSCI index or U.S. institutional allocation to Chinese debt, which is not reflected in a comparable index.

Breaking down these statistics one level further could also prove useful. According to Kleiman's study, 59 percent of all global emerging market equity funds are U.S.-based institutions.[313] Global emerging market funds have Chinese exposure of roughly 4 percent or some $1.3 billion.[314] Moreover, U.S. institutions own some 49 percent of country-specific "China" and "Greater China" (e.g., China, Hong Kong and Taiwan) funds.[315] These statistics may be interpreted to indicate that U.S. institutions represent at least one-half of the global market for "China" and "emerging market" funds.

According to these analytic surveys, it can be conservatively estimated that the U.S. percentage of global demand for Chinese debt and equity -- including those securities purchased through global, regional and country mutual funds or secured through more direct avenues such as depository receipts, bond issues or the purchase of equities of Chinese firms not included in the MSCI index (e.g., PetroChina, Sinopec, etc.) -- is in the range of 40-60 percent.[316] What is clear is that the U.S. represents a substantial percentage of global demand for Chinese securities.

Capital Markets Sanctions

Given the global stature of the U.S. demand market, there is a strong argument to be made that the ability to access American capital represents a potentially effective source of leverage. Not only could this type of influence be exercised to discourage foreign firms from undertaking potentially harmful global activities (e.g., proliferation of weapons of mass destruction, etc.), but if properly employed, foreign governments could likewise be dissuaded from policy initiatives that conflict fundamentally with U.S. foreign policy objectives. As the Casey Institute observed in April of this year,

"The question is no longer whether "bad actors" are attempting to take advantage of access

312. Ibid.

313. Ibid.

314. Ibid.

315. Ibid.

316. There is surprisingly little information available regarding the "demand markets" for global securities. Despite extensive research, including a number of appropriate web-sites (i.e., the Federal Reserve, World Bank, etc.) and interviews with noted economists and financial consultants, many of the statistics required to provide a clear indication of global investing patterns remained elusive. This may be due, at least in part, to the voluntary reporting requirements for institutional investors and, until now, the absence of a substantive reason to conduct such a survey.

> to this country's capital markets. Policy-makers have correctly concluded this is the case. Increasingly, they are wrestling with how effective capital markets sanctions or leverage would prove to be in impeding such activity, if not actually halting it -- and the malevolent behavior it is making possible -- and, thereby, advancing the vital security interests of this nation."[317]

The potential use of this financial policy tool could offer important advantages over traditional sanctions. Unlike trade sanctions, for example, "collateral damage" to U.S. interests could be minimized. Specifically, denying U.S. market access to a particular foreign firm or government would most likely not impact on American jobs or exports. Similarly, there is little, if any, people-to-people contact and retaliation concerns are more manageable than in the trade arena.[318] Admittedly, some Wall Street firms might have to forego fees associated with these foreign offerings, but in most cases their earnings would likely not be diminished significantly. Put simply, there is no shortage of U.S. or foreign firms seeking to offer securities that could replace those few foreign firms deemed unacceptable due to, for example, overriding national security or human rights concerns.

In addition to the above-stated advantages, the rationale for the use of capital markets leverage revolves around the goal of protecting vital U.S. security interests. The key question is whether the denial of U.S. market access would achieve the desired objective -- namely, applying sufficient pressure on the targeted foreign firm or government to encourage that entity to reconsider its problematic activities or policies.

Irrespective of whether a foreign company or government incurs a significant financial penalty upon the implementation of capital markets sanctions, there will likely be occasion when principled U.S. leadership requires action in our markets. For example, while some have argued that capital markets sanctions against Talisman and PetroChina would not appreciably alter the situation on the ground in Sudan, the case has rarely been made that Americans should be underwriting the activities of foreign companies that are closely tied to the horrific plight of Christians and animists in the South of that country.

The argument for capital markets-related action may be made on two grounds. First, many observers believe that if American companies are prohibited from doing business with certain countries engaged in morally reprehensible and/or harmful security-related activities, then U.S. investors should not be providing the wherewithal for those foreign companies that decide to fill the gap. For example, were a foreign oil firm to violate the U.N. sanctions regime and begin to develop Iraqi energy resources, a strong case could be made that U.S. investors should be barred from funding that company were it to come to market or seek U.S. investor funds through offshore exemptions.[319] Second, it is increasingly argued that the U.S. should not be underwriting the

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317. The William J. Casey Institute, "*Newsroom Online* Sets Parameters for Global Debate on Efficacy of Capital Markets Sanctions," April 13, 2001.

318. Roger W. Robinson Jr., "Financial Sanctions: How Might They Be Used Against Proliferators?" (Prepared for the Nonproliferation Policy Education Center, 1997).

319. The PetroChina precedent is troubling in this connection. Treasury's Office of Foreign Asset Control ruled that

governments of potential -- or actual -- adversaries. Indeed, just as it would have been imprudent to allow the former Soviet Union to access the U.S. debt and equity markets, it would be hard to find those who believe that Iraq or Iran should be permitted to float a sovereign bond in New York.

Detractors have argued that the cavalier use of such sanctions would compromise the free flow of capital into and out of the United States. This is a legitimate issue of concern. In addition to upholding the tenets of open markets, however, the U.S. has the burden of taking a leadership stand against those global entities whose activities and policies genuinely threaten the security interests of this nation and those of our allies. An analogy may be constructive. While most Americans favor free trade, this country maintains export controls on militarily-relevant technologies.

The case for the potential use of capital markets sanctions against China in some future scenario is more challenging and selective. The American people may be surprised to learn how much capital China has already raised in the U.S. markets. They may be likewise surprised to learn the extent to which the U.S. financial community is invested in mainland Chinese securities, including those issued via Hong Kong. Given some of China's more troubling internal and external policies, it is perhaps understandable that some have called for the denial of market access to, at least, those companies directly connected to that country's military-industrial complex and troubling human rights activities. As long as China continues to engage in an array of abuses (e.g., a robust military modernization program, mock war games directed against Taiwan, proliferation activities, religious persecution, human rights violations, partnering with terrorist and genocidal regimes such as that of Sudan, etc.), it is likely that capital markets-related policy responses will be called for on principled grounds by outraged Members of Congress and NGO's. Again, the question is: would such sanctions be effective?

Potential Effectiveness of Capital Markets Sanctions

A debate regarding the efficacy of capital markets leverage has surfaced in reaction to the elevated visibility of this policy issue in Washington. In the latter half of 2000, a national dialogue on this matter was initiated by President Bill Clinton and Federal Reserve Chairman Alan Greenspan. It was the first time that those opposed to the use of this type of leverage outlined their concerns publically. In so doing, the parameters for the debate were, at least in part, established.

While testifying before the Senate Banking Committee, Chairman Greenspan provided a lengthy, skeptical assessment of capital markets sanctions in response to the "China Nonproliferation Act," co-sponsored by Senators Thompson and Torricelli. According to the Chairman,

"In addition to questioning the value of [the Thompson legislation], there's a very serious

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if there were U.S. investor proceeds diverted to the activities of PetroChina's parent company in Sudan, a violation of U.S. law could be cited. Put another way, irrespective of the fungibility of money, as long as a foreign firm *claims* that U.S. investor proceeds would not be used in U.S.-sanctioned countries, the firm could raise funds in the U.S. markets.

question as to whether it will produce, indeed, what is suggested it will produce...It is a mistake to believe that the rest of the world is without dissimilar resources. Indeed, there [are] huge dollar markets all over the world to lend dollars. And because of the arbitrage that exists on a very sophisticated level throughout the world, the interest rates and the availability of funds are not materially different abroad than here. We do have certain advantages, certain techniques which probably give us a competitive advantage, but they are relatively minor. But most importantly, to the extent that we block foreigners from investing -- for raising funds in the United States, we probably undercut the viability of our own system.

> But far more important is, I'm not even sure how such a law would be effectively implemented, because there is a huge amount of transfer of funds around the world. For example, if we were to block China, or anybody else, from borrowing in the United States, they could very readily borrow in London and be financed by American investors. Or if not in London -- if London weren't financed by American investors, London could be financed, for example, by Paris investors, and we finance the Paris investors. In other words, there are all sorts of mechanisms that are involved here, and so the presumption that somehow we can block the capability of China or anybody else borrowing at essentially identical terms abroad as here, in my judgment, is a mistake. So my most fundamental concern about this particular amendment is it doesn't have any capacity, of which I am aware, to work."[320]

Making similar arguments later that year in response to a query from the USCIRF regarding the President's authority to bar the PRC government access to the U.S. bond market, President Clinton stated:

> "Barring China's access to U.S. capital markets, however, in my judgement will not advance respect for religious freedom in China. It will have little impact on China's access to capital in an age of global capital markets, but it will have seriously damaging effect on our ability to engage China on issues of human rights and religious freedom. It could also have a negative impact on the American people, as our commitment to the free flow of capital would be undermined, with adverse consequences for our economy."[321]

Both President Clinton and Chairman Greenspan articulated a basic proposition: Due to the fact that foreign entities can "go elsewhere" to raise funds "on essentially identical terms," these measures would fail to achieve their objectives. Notwithstanding these cautious -- and even negative -- comments by the former President and Federal Reserve Chairman, a strong case can be made that such measures would not only be effective, but could exact a high price on those foreign entities targeted. To illustrate the potential impact of financial sanctions, this issue must be addressed both in the context of specific foreign companies as well as governments and their state-owned enterprises.

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320. The William J. Casey Institute, "Fed Chairman Greenspan Takes Aim at Use of Capital Markets Leverage to Protect U.S. Security Interests -- *and Misses*," July 20, 2000.

321. Correspondence from President William Clinton to USCIRF Chairman Elliott Abrams, December 19, 2000.

Most evidence indicates that selective capital markets sanctions imposed against companies doing material business with countries under U.S. sanctions regimes would have a deleterious effect on those firms. This is especially true regarding those companies already listed on -- and actively traded in -- our markets. For example, a law that suspended the trading of a NYSE-listed foreign firm and prohibited Americans from holding the stock of that entity would presumably result in the immediate divestiture of shares in that company by U.S. funds. Such an increase in the global supply of the shares in question would likely apply downward pressure on the value of the stock and, by extension, the company's market capitalization. This pressure may be intensified by a contraction of the aggregate global demand market.

A hypothetical example may be useful. Assume that some 40 percent of a foreign firm's total outstanding shares are held by U.S. investors. For the purposes of this example, the firm has ten million actively-traded shares. Following the sanction, some four million shares would become available in the market, thereby creating a buyer's market and likely reducing substantially the firm's share price. Given the fact that the target's total asset value would remain constant, the depressed share value could make the firm an attractive takeover candidate. Whether such a scenario would lead the foreign company to discontinue its offensive activities would likely depend on the degree of financial pressure applied (i.e., what percentage of the target's stock is currently held by U.S. entities).

In addition to the potential financial implications, such capital markets sanctions would likely send a powerful signal to other firms actively considering ties to the problematic government involved. If foreign firms reconsider strategies related to the country in question -- or if the government of concern discontinues those actions deemed to conflict with vital U.S. security interests -- the policy might be viewed as having met its objectives.

It is further envisioned that a decision to bar foreign firms not already in the U.S. markets could damage the target's fundraising objectives globally, even if the company were to access successfully non-U.S. markets. For example, the stigma attached to such a rebuke would likely be perceived by the markets as elevating the risk of the firm's securities, which in turn may negatively impact on the value of its shares. In the case of an initial public offering, a lower share value (resulting from increased risk) equates to reduced proceeds. A similar financial cost could be exacted in the debt markets where perceived risks could increase the cost of funds and, possibly, result in shortened maturities. When considering multi-billion dollar sums, even a slight increase in the cost of borrowing can prove material.

Returning briefly to the PetroChina example may be useful. Although that firm was granted access to the U.S. markets, demand for the IPO was sufficiently depressed to force the company to scale back its price/earnings ratio and downsize the offering. A decision to bar a firm's access to the U.S. capital markets would likely result in a similar fate. Indeed, it is difficult to imagine U.S. investors flocking to the stock of a targeted firm in the event that company lists overseas. The connectivity of the markets leads to the conclusion that institutional demand might likewise suffer in foreign markets (due to the perception of higher risk). Moreover, a less robust aggregate demand market may lead some investors to conclude that the future sale of that holding could prove difficult. PetroChina was unable to raise the level of funding originally sought due to demand shortfalls. There is little reason to expect a significantly different outcome for foreign firms denied the U.S. markets.

The question of whether capital markets sanctions would be effective becomes more nuanced when considering a government or its state-owned firms. President Clinton and Chairman Greenspan are likely correct in stating that the Chinese government and its SOE's could raise funds overseas if barred from the U.S. debt and equity markets. This "foreign availability" argument, however, seemingly fails to recognize the basic tenets of supply and demand.

The form of capital markets sanctions likely envisioned by President Clinton and Chairman Greenspan would entail proscribing foreign firms and/or governments from offering their securities in the U.S. debt or equity markets (i.e., listing a firm on a U.S. exchange and/or offering debt in the U.S. bond market). They may not have considered that such sanctions could be crafted to preclude the investment participation of the U.S. demand side. As stated above, simply impeding a firm's ability to issue securities in the U.S. would likely reduce U.S. demand and attach a risk "stigma" to the firm. These effects would likely increase the cost of borrowing in foreign markets and, perhaps, reduce the aggregate proceeds raised in an equity offering. The firm would, however, still be able to attract funds overseas -- especially given the fact that in the Clinton/Greenspan scenario the targeted company or government would not be proscribed from marketing its securities to U.S. investors through offshore exemptions and sales.[322] The central issue, therefore, becomes the relative "depth" of the markets and foreign access to U.S. institutional and other investors.

For the purposes of this report, how "deep" or "thin" a market is refers to its prospective investor base. As referenced above, although capital flows have become globalized, it remains an established practice that debt or equity issued in a market is primarily sold to investors in that market. By offering securities in the United States, foreign firms are informally imbued with a degree of legitimacy by traditionally conservative U.S. banks, insurance companies, pension funds and mutual funds. While U.S. institutional investors purchase ADR's and utilize offshore exemptions, offering securities directly in the U.S. markets remains the most effective and efficient means of accessing the massive U.S. demand market.

Unlike the sanctions envisioned by President Clinton and Chairman Greenspan, those referenced in this report refer not only to the denial of access to our markets, but also to the sanctioning of all U.S. entities and persons from holding -- and/or trading in -- the securities of the

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322. Although the denial of the U.S. debt and equity markets would presumably dampen U.S. demand, the depth of the American financial system makes it likely that the foreign firm could still attract U.S. investors through an overseas exchange. For example, despite substantial public opposition to PetroChina, there are still a number of U.S. entities that hold this company in portfolio. For the most part those are private funds that, unlike the more politically-sensitive public pension systems, are less vulnerable to public pressure.

foreign firm or government.[323] As such a prohibition has never been implemented, the impact of such sanctions can only be estimated. To do so, China can serve as a useful example.

The PRC hopes to partially privatize as many as 300 state-owned enterprises in the coming years. Recalling that the U.S. demand market would include those U.S. firms and subsidiaries domiciled overseas, the denial of this market to Chinese SOE's would force those entities to rely upon the non-U.S. demand market to underwrite their offerings.[324] This scenario assumes that the EU and Japan would not follow the U.S. lead in blocking the demand side for China's SOE's. As these markets are "thinner" than that of the U.S., the risk of "booking up" foreign markets with Chinese securities would increase over time. Put another way, without the U.S. demand side, there is ultimately a limited global market for these securities. Moreover, financial prudence dictates that institutional investors limit their exposure to any one country.

It is the cumulative effects of denying U.S. capital markets access and the American investor base that are important to understand. First, any significant contraction in the global demand market for the securities of Chinese SOE's and sovereign debt would likely force China to slow its convoy of market entrants. As referenced earlier, if these firms chose to list on foreign exchanges, they would likely have to offer their stock at a discounted price to account for demand shortfalls. The unknown variable, however, is the reaction of the global financial community to U.S. sanctions. Markets seek to avoid the unknown and such unprecedented, unilateral U.S. measures could catalyze a global reduction in demand for Chinese state-owned enterprises that could make it less financially attractive for the PRC to continue its surge of fundraising activities.

By way of review, the denial of the U.S. market access and the demand market would likely have five primary effects: 1) an increase in perceived material risk; 2) the dampening of individual institutional demand in foreign markets, thereby reducing, to some degree, share or debt value; 3) a higher cost of those funds raised; 4) the prospect that thinner volume foreign markets could, over time, "book up" with respect to Chinese risk exposure; and 5) the slowing of China's rate of market activity and likely reduction of its total amount of funds raised.

Perhaps the best evidence regarding the efficacy of capital markets sanctions, however, was provided by those cases in which such sanctions have been threatened, but not implemented. Talisman's reported difficulty in finding prospective buyers for its stake in Sudan is one illustration that even the threatened use of U.S. capital markets leverage may dissuade foreign companies from engaging in proscribed or problematic activities. (See page 34.)

Talisman CEO James Buckee's response to the recent Sudan Peace Act amendment that would, if enacted, impact on Talisman's standing in the U.S. capital markets is likewise instructive. As Canada's *Globe and Mail* reported,

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323. This would include those U.S.-owned financial firms and subsidiaries that operate overseas. For example, if Lehman Brothers Asia were majority owned by its U.S. parent, it would be unable to hold the stock of the targeted foreign firm, even were that firm to list on an Asian exchange.

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> "Talisman Energy Inc. chief executive officer Jim Buckee said yesterday that the company would dump its controversial stake in Sudan's oil fields rather than lose its coveted New York Stock Exchange listing and access to deep U.S. capital markets."[325]

Mr. Buckee reportedly went on to state, "I don't think anybody could afford not to have access to the U.S. capital markets. No asset is worth more than that."[326]

A second instructive case involves China's attempt to issue a sovereign bond offering in late 2000. According to reports in September of that year, the offering was estimated to be worth at least $1 billion -- a figure that could be expected to rise depending on the level of interest in the offering. Almost immediately, members of the PetroChina Coalition catalyzed media reports warning of broad political opposition to the transaction. Moreover, the USCIRF began studying China's presence in the U.S. capital markets vis a vis that country's recent designation by the State Department as a so-called "country of concern" with respect to religious persecution.[327]

In a twist on the use of capital markets leverage, the USCIRF sent a letter to then-President Clinton seeking his acknowledgment that under the International Religious Freedom Act of 1998 (IRFA), the President was provided the authority to bar religious persecuting nations from accessing the U.S. capital markets. (See Appendix 8.) According to the letter:

> "The Commission is considering whether to recommend that you immediately bar any such [bond] offering until China meets two conditions: (1) it makes substantial improvements in respect for religious freedom; and (2) it provides sufficient assurances that the proceeds are never used to support religious persecution...
>
> We therefore respectfully ask (1) whether you agree that IRFA vests your office with power to bar U.S. financial institutions from purchasing China bonds and 2) if so, whether you plan to exercise that power so as to prevent China from offering bonds on the U.S. market until it meets the two conditions listed above."[328]

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325. Lily Nguyen, "Talisman CEO Says He'll Take NYSE Over Sudan," *The Globe and Mail*, June 18, 2001.

326. Ibid.

327. The William J. Casey Institute, "Senate' Approval of PNTR Sets Stage for China to Renew Its Penetrations of the U.S. Bond Market," September 20, 2000.

328. Correspondence from USCIRF Chairman Elliott Abrams to President William Clinton, November 1, 2000: In its attachment to the President, the USCIRF went on to state, "Moreover, it is troubling that the proceeds of such an offering might end up supporting further religious persecution – for example, in the purchase of police supplies or surveillance equipment or payment of security force salaries. The sale of sovereign bonds is starkly different from the trading of goods or even the sale of debt or equity securities by a Chinese corporation. It results in the direct transfer of cash into the hands of the government, without any constraints on the use of that cash whatsoever. Also, the value of the sale to China lies not only in the cash received, but also in collateral benefits, most particularly: 'benchmarking.' That is, the sale provides empirical information about market conditions to set the terms for and otherwise facilitate future offerings, not only by the government but also by Chinese corporations generally. Indeed, the sale may be serving in the mind of the Chinese government as the vanguard of a much larger post-PNTR campaign to raise capital for economic expansion and modernization. China's need for capital is massive, particularly

The Commission's letter was significant for a number of reasons. In addition to making clear that a government body had concluded that the President was legally authorized to deny a foreign government access to the U.S. debt market, the correspondence offered the prospect of at least one new condition for China's sovereign offerings in this country. Presently, China's disclosure has been limited to stating that a bond offering would be used to support "infrastructure" projects and other such general purposes. Under the Commission's interpretation, China could be forced to certify in its SEC filings that funds would not be used to support religious persecution in any way.

Most importantly, however, were the repercussions of the letter -- in conjunction with the burgeoning NGO opposition to the offering -- for the Chinese government. With the release of this letter, China's sovereign bond was on the verge of becoming a highly-charged political issue in the United States. It was not the type of attention China was seeking to attract. Quietly, the offering was withdrawn some weeks after the Commission's letter was received by the President. According to a short comment in the Dow Jones Wire, the offering was reportedly withdrawn due to "unfavorable market conditions."[329] This account differed significantly, however, from that provided to the William J. Casey Institute by a senior Chinese embassy official familiar with the offering. According to an "E-Mail Analysis" prepared by the Casey Institute,

> "According to the official, the offering was withdrawn due to 'political concerns.' Notably, 'the opposition of non-governmental organizations and a letter to the President' [from the USCIRF]."[330]

These two examples indicate that certain foreign companies and governments seem to be persuaded that the prospect of U.S. government action in the capital markets is sufficiently onerous to merit reconsideration of specific funding objectives and/or business strategies. Given this reaction, it is likely safe to argue that capital markets leverage, if properly constructed, could serve as a significant source of pressure on targeted companies and governments should an urgent need arise to do so.

Finally, there remain a number of arguments that have been put forth in opposition to the use of capital markets leverage that merit attention. Some have pointed out that the implementation of such sanctions could lead to a "slippery slope" of market-disruptive policies. This argument holds that sanctions would be utilized with such frequency as to "cast a pall" over America's markets and unduly "politicize" them.[331] It should be noted, however, that a number

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as measured against its goal of doubling the GDP in ten years. Thus, the significance of the upcoming offering goes far beyond that of a single transaction."

329. *Dow Jones Wire,* November 6, 2000.

330. Roger Robinson, "Casey Institute E-mail Analysis," November 27, 2000.

331. It should be noted that in order to impose capital markets sanctions, both the authority of the U.S. Congress and the President would be required (barring an Executive Order). It is, therefore, difficult to envision the frequent use of such sanctions.

of policy tools, if effective, run the risk of being emulated or overused. Such a risk does not, however, diminish the potential effectiveness of the prudent, rare use of capital markets leverage. Similarly, the possibility of a "slippery slope" should not render this policy option inappropriate, especially if utilized in a highly discriminating manner (i.e., only in cases of egregious harm to U.S. security and other vital interests).

The possibility of a slippery slope also can be viewed as validating the need for an Executive Branch interagency working group to review potentially problematic foreign registrants. Indeed, were questionable firms given a "green light" by such an interagency committee, it would probably prove more challenging for NGO's and those on Capitol Hill to mobilize support for sanctions.

It is more difficult to determine when and if capital markets sanctions might "cast a pall" over the free flow of capital into and out of the United States. If targeted and limited in scope, the markets will presumably factor these new variables into their calculations and proceed largely unaffected. In policy terms, it would likely be deemed a success were global "bad actors" to eschew U.S. investors or alter their behavior prior to an effort to enter the U.S. markets. Moreover, it is unlikely that foreign firms not impacted by new U.S. policies would forego America's capital markets. Similarly, retaliatory efforts by China or other governments of targeted companies would likely prove difficult if confined to the financial arena due to the size and depth of the U.S. capital markets. After all, how many U.S. firms seek to list in, for example, Shanghai? Nonetheless, this possibility should be considered by policy-makers.

Finally, while our capital markets are a pillar of American global competitiveness, so too is principled leadership on matters of national security, human rights and religious freedom. Striking a proper balance between these two national assets is the challenge for U.S. policy practitioners.

Conclusion

Selective action in the U.S. capital markets represents a potentially significant source of leverage for policy-makers seeking non-military solutions to complex national security and foreign policy issues. Increasingly, this new policy measure is being tested by those on Capitol Hill and in the NGO community. It will be the task of the U.S.-China Commission and those in government to study this matter in greater detail in the period ahead and recommend prudent and sound policy prescriptions.

Next Steps

The field of capital markets security has only recently been introduced to America's policy-making community. The funding patterns of global "bad actors" and those governments that may be judged to be potential adversaries of the United States are not sufficiently understood. Similarly, the functioning of America's capital markets has never before been viewed through a national security lens. These shortcomings must be rapidly redressed.

While official Washington struggles to get a handle on the complexities of this 21st century issue area, NGO's, some Members of Congress and other activists will likely continue to oppose certain foreign offerings that do not reflect their fundamental values and perceptions of U.S. national interests. At the same time, the fundraising activities of global "bad actors" continue to escalate, especially as the markets grow more receptive to higher yield emerging market securities.

There remain a number of immediate steps that could be undertaken by the federal government to strengthen transparency and disclosure requirements and evaluate capital markets security. Additionally, the U.S.-China Commission can play an important role in raising Congressional and national awareness regarding the PRC's fundraising activities and offering non-disruptive policy prescriptions to relevant legislative committees and government agencies. Recommendations regarding possible actions by the federal government and the Commission have been provided to the Commission for its internal consideration.