Statement for the U.S.-China Economic & Security Review Commission

Hearing: U.S. Investment in China's Capital Markets and Military-Industrial Complex
Panel: U.S. Government Restrictions on Investment in China
Date: March 19, 2021

Panelist: Perth Tolle
Title and Organization: Founder, Life + Liberty Indexes

How do you view the respective roles of the government and the market in ensuring U.S. investment does not fund Chinese companies which pose a threat to U.S. national security and values?

The prevailing mindset within the investment community is that issues like national security and values are not our concern. Instead, our concern is creating shareholder value through higher profit. Publicly traded fund companies (e.g. iShares) and their respective index providers (e.g. MSCI) report their earnings and outlook quarterly. So, the concern of dominant market participants is typically not what is best for the world on a long-term basis, but what is best for earnings on a quarterly basis. Any responsibility for national security or values is therefore typically left to the government. The ESG movement does not change this. If anything, it's another manifestation of this mentality. We'll discuss further below.

While there is growing awareness among investors that they have an outsized China allocation in their passive funds, there is little they can do to change benchmarks. And the large index providers are limited to standard methodologies which I will discuss in more detail in further testimony. Due to the nature of these indexing standards, it would be very difficult for the large indexers to change their trajectory without policy intervention. MSCI's CEO has stated that they would restrict China investments only if regulations made it a requirement.

As a freedom indexer, I don't typically advocate for government intervention. And my company is here with the private market solution for investors who care about these issues. But we are a very small drop in a very large, very deep ocean. And I can say with a high degree of confidence that policy solutions are needed if investments in Chinese companies are to be restricted in any meaningful way. In fact, without policy solutions, investments in Chinese companies would probably accelerate, because it is a Chinese government policy priority, and the finance and investment industries are, generally speaking, willingly myopic to the risks and consequences of such investments.

Please discuss investment index providers' rationale and methodology for including Chinese securities. What role can the U.S. government play in ensuring investment index providers consider the unique risks posed by investing in Chinese securities?

The most standard index weighting methodology is market capitalization weighting, meaning the largest companies (by market capitalization), and in turn, the largest markets, receive the largest allocations, or weights, in the index. Index providers classify countries as either "Developed Markets," "Emerging Markets," or "Frontier Markets." Most asset managers will have a separate allocation to each of these of these categories. The largest index providers (MSCI and FTSE) serve as benchmarks for the world's institutions and set the country classification standards, and all of them classify China as an emerging market. The emerging markets country universe typically contains around 26 countries, China having the biggest market capitalization by far as a result of its huge size and the fact that it is classified as an emerging market. Most emerging markets indices have about 40% direct allocation to China. The MSCI Emerging Markets Index has around 38% and the FTSE Emerging Markets Index has around 43% China allocation currently. The biggest US ETFs tracking these indices are as follows:

VWO – $78B in assets under management (AUM), 44% allocation to China

IEMG - $76B AUM, 37% allocation to China

EEM – $29B AUM, 39% allocation to China

(AUM data as of March 5, 2021)

In the week of February 22, 2021, $2B in U.S. investments flowed to emerging markets ETFs (Source: Bloomberg), $1.5B of that went to IEMG, and China was the biggest country level beneficiary, due to its huge allocation in the index and consequently, the funds tracking them.

Even more impactful to ETF flows is the fact that these indexers provide the benchmarks for the world's investment institutions – pensions, endowments, sovereign funds, etc. By investment policy, these institutions cannot deviate from their benchmarks, so they, too, must have about 40% allocation to China in their EM allocations.

In short, the large index providers (MSCI, FTSE, S&P) set the standards for the investment industry by providing the benchmarks by which the asset allocators for the world's institutions are measured and mandated to track. But, like the rest of Wall Street, they are primarily sales people, and want to be everyone's best friend, especially that of foreign powers doling out VIP perks and promises of market access.

I see the U.S. government's role as the regulator who can't be swayed by state narratives, and who sets the rules for market participants in a country with rule of law and investor protections. In a good cop/bad cop scenario, we need policy makers to be the bad cop.

Please discuss the relationship between investment index providers and asset managers with respect to inclusion of Chinese securities in major investment indices. What incentives drive these parties' investment decisions vis-à-vis Chinese securities?

Index providers license their indexes to be used as the basis for investment products like index mutual funds and ETFs, and the big fund issuers are their clients. They also license to institutions (like the TSP, or CalPERS) to be tracked by separately managed accounts (SMAs). In this case, the institutions are their clients. The fund companies, in turn, sell their funds to institutions and retail clients (the investing public). Lastly, as previously mentioned, the index providers, as standard bearers, set the benchmarks for the world's institutions.

The passive investment industry is dominated by three big fund issuers and their index providers, iShares ($1.8 Trillion AUM as of September 2020) mostly benchmarking to MSCI indices, Vanguard ($1.3 Trillion AUM as of September 2020) mostly benchmarking to FTSE indices, and State Street Global Advisors (SSGA, $772 Billion AUM as of September 2020) mostly benchmarking to S&P indices. Together these three issuers represent about 70% of the market share of ETF issuers globally (Source: Statista).

Index providers and fund issuers are driven by profit incentives and market access. For the promise of market access (thus far unfulfilled) and with the threat of curtailed business, they willingly buy in to the China growth narrative, turning a blind eye to the obvious national security issues, human rights atrocities, opaque ownership structures, high level of state interference, inefficiency, fraud, and total lack of investor protections and rule of law.

Index providers will do what their biggest clients request. When the investment ban on military linked companies was announced, they surveyed their clients and asked them what course of action they should take. Their clients, the fund issuers and asset managers, responded with their preference that the banned companies be dropped out of indices. And that's when all the index companies made announcements of the drops.

What are the limitations of investment filtering methods that attempt to consider social and governance factors, like ESG? Are these effective screens against state influence and links to authoritarian governments?

Industry standard ESG parameters are company level and not country level, and thus are completely useless screens against state influence and links to authoritarian governments which are country level metrics.

In addition, ESG funds, based on methodology, cannot deviate much from their parent index country allocations. Here is the result – the largest emerging markets ESG funds and their China allocations:

ESGE, iShares ESG Aware MSCI EM ETF – 37% China

NUEM – Nuveen ESG EM Equity ETF – 39% China

No alcohol, tobacco, gambling or guns, but 1M+ people in prison camps is totally fine? And does it make sense to exclude companies like Lockheed Martin when they are providing weapons to Taiwan to help them defend their own democracy? Are we woke, or are we blind? Basic freedoms, democratic institutions, and rule of law on the country level are the basis of all ESG on the company level, and in emerging markets, to ignore the former is to render the latter a joke, at best.

It's deceptive for ESG fund issuers to claim they are acting in interest of the public when they are acting against it by using investor money to fund autocracies and spreading the narratives of foreign governments ("China as world leader in ESG" despite being the world's worst polluter and among the worst human rights offenders) without disclosing their own interests for doing so – to justify higher fees, and to gain market access in said autocracies.

Firms that hold themselves out to be objective should not act in favor of foreign state actors under threat of curtailed business or for the (false) promise of market access. And firms that hold themselves out to be the arbiters of ESG should hold themselves to an even higher standard of disclosure and transparency, especially about concentration risk of autocrat exposures in passive funds.

There are information asymmetries between developed capital markets and those in emerging markets, particularly China. How can retail investors who increasingly invest in passively managed funds navigate these asymmetries?

Without investor protections and rule of law around transparency and disclosures, emerging markets, particularly China and other autocracies, often withhold and manipulate necessary information/data and narratives.

Investors in passively managed funds can navigate these asymmetries by using a strategy that accounts for country level metrics in emerging and frontier markets. Our solution is freedom-weighting, where autocratic EMs like China, Russia, and Saudi Arabia are naturally excluded, and the higher weights go to freer countries. We think this makes more sense than excluding China arbitrarily, but ex-China EM is an additional solution that exists in the ETF space.

The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. What recommendations for legislative action would you make based on the topic of your testimony?

More specifically to capital markets:

1. Enforce our policies – our exchanges have allowed Chinese companies to use a loophole to get around audit requirements that every other listing from anywhere else has to follow. We should continue enforcing the policy to delist companies that do not comply with these standards and universally applied listing requirements.

2. Indexes and funds can get around delisting by owning the foreign listed shares, i.e. H-shares of Alibaba instead of the ADR. The US government could ban investments in any shares of Chinese companies that don't meet listing requirements, regardless of listing venue.

3. We could also require full disclosure of ownership as a listing or investment requirement. If a company refuses to disclose 100% of company ownership, they can't prove that they are not owned by shell companies benefitting Chinese government actors.

4. We could ban investments in companies that provide mass surveillance and data collection capabilities to the Chinese government. How many times has Tencent's WeChat been used to surveil and prosecute or disappear political dissidents or intimidate people into silence, for example, Dr Li Wen Liang?

5. We could incentivize allocators, especially federal and state pensions and retirement plans, to use indexers and asset managers who consider these risks for federal and state plans, like we do for ESG or women/minority owned businesses.

6. We could require disclosures of country concentrations over a certain percentage, for example, anything over 30%, in broad based funds such as diversified emerging markets funds.

More broadly:

1. Work with our allies to build coalitions around this issue.

2. Support our own market and keep it competitive.

3. Support Taiwan and other freer developing nations.

I'll leave further creative legislative solutions up to you and leave you with this. We are the leaders of the free world, there's immense power and responsibility in that. In the investment community, many of us don't realize that we hold the keys to power, we are in position to direct assets, and we can use that power for good. How we direct assets has consequences for ourselves, others, and the world we live in. Instead of making decisions based on fear (of deviating from the benchmark), we should make decisions based on what we hope to see and the impact we hope to have. That's why my company exists, to provide investors who believe in the long term benefits of human rights and economic freedoms a way to express that in their emerging markets allocations. But the reason we can exist is because we have the protection of the rule of law of the United States of America. Otherwise, based on Hong Kong's new National Security Law, I would be labeled a criminal for even promoting these ideas. So I would ask you, advisors to the legislators of the United States of America, to use your powers for good. May you not act out of fear of a tyrant's response, because as long as we stand for our values, it is the tyrants who fear us. May you lead with boldness, unity, courage, and conviction, out of hope for what you'd like to see in the world and in defense of our values and security. Let's strengthen our own markets, work with our allies to develop coalitions to keep tyrants in check, and no longer allow our capital markets to be used as fundraising venues for foreign governments. Let's use our positions of privilege to fight for those living under oppression. Thank you for including me in your great work. Keep fighting, and God speed.