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The CCP Divestment Report

An in-depth analysis on fiduciary duty and the dangers of China-based investments

November 2024

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Fiduciaries, including those managing state pension funds, may violate their duty of care and the prudent investor standard by investing in the stocks or bonds of China-based companies (or related shell companies). In particular, such investments appear to violate the components of the fiduciary duty of care that require monitoring and investigating investments to ensure they are prudent. Many trustees failed to recognize warning signs related to Russian investments prior to Russia's invasion of Ukraine, such as Russian military activities, Russian government objectives, and Russia's designation as a "foreign adversary" by the U.S. government. States have lost billions of dollars as a result, such as California losing over $550 million, Texas losing $250 million, Minnesota losing $235 million, Alaska losing $220 million, Indiana losing $220 million, Florida losing $200 million, Missouri losing $160 million, Georgia losing $150 million, Ohio losing $125 million, Oregon losing $100 million, New York losing $98 million, West Virginia losing $83 million, Pennsylvania losing $53 million, North Carolina losing $50 million, and Kentucky losing $3 million. Fiduciaries must take a different approach with China to avoid a similar result, as noted by twenty state financial officers in a recent letter indicating their intent to divest from China based on material financial risks.

Fiduciaries have a **duty to monitor investments and remove imprudent investments within a reasonable time**. Warning signs indicate that China-based investments are likely to be subject to similar trading restrictions as Russia-based investments were in 2022, leading to similar losses. Those warning signs include: (1) a significant risk that China will invade Taiwan in the near future, leading to U.S. investing restrictions; (2) the incoming Trump administration is likely to impose further restrictions on investing and trade with China even without an invasion, aligning restrictions imposed on China to the other countries on the U.S. government's "foreign adversaries" list—(Cuba, Iran, North Korea, Russia, the Maduro regime in Venezuela); (3) foreign investment in China is rapidly declining, producing net outflows from Chinese markets; and (4) prominent pension funds are divesting from, moving away from, or avoiding China-based investments, including the Federal Thrift Savings Plan, Swedish pension funds, and state systems in Florida, Indiana, Kansas, Missouri, Nebraska, Oklahoma, Pennsylvania, Tennessee, and West Virginia.

Fiduciaries also have a **duty to investigate, using appropriate methods**. Yet it is impossible to conduct a thorough investigation into China-based investment opportunities at this time, given the risks noted above and for other reasons including: (1) the CCP has cracked down on firms providing due diligence, and financial audits have been found to be unreliable; (2) the

CCP interferes with Chinese stock and bond markets; (3) the CCP exerts control over China-based companies; and (4) the CCP keeps most China-based investments in a state of legal uncertainty, as these investments use a high-risk shell-company structure that has few safeguards and relies on the CCP choosing to look the other way on Chinese law.

Based upon these factors, some prominent fiduciaries have prudently recognized that China-based investments are no longer of institutional investment quality, and have taken appropriate action in alignment with their fiduciary duties. Most notably, the Federal Retirement Thrift Investment Board voted unanimously to switch $68 billion in the Federal Thrift Savings Plan portfolio to an index that excludes China and Hong Kong.[1] The board cited an investment consultant's findings, which noted "[t]ensions between the U.S. and China have been building," and suggested that current investment restrictions may be "the beginning of further restrictions."[2] The consultant recommended using the MSCI ACWI IMI ex USA ex China ex Hong Kong index fund (excluding investments from the USA, China, and Hong Kong),[3] and the plan's Office of Investments agreed.[4] The board's minutes note that switching would address the "operational complexity" of the current situation, and also "reduc[e] the risk" of investing in China and "later being forced to sell out of specific markets."[5] Recent reports also indicate that several of Sweden's state pension funds have chosen to divest as well, with a pension fund head stating that the "risk has simply become too great."[6]The West Virginia state treasurer came to a similar conclusion, and excluded Chinese investments from 529 plans after noting the inconsistency between the "fiduciary duty to act in the best financial interests" of the plan participants, and the "potential regulatory and geopolitical risks that come with investing in companies based in China."[7] Based on these risks, twenty state financial officers representing seventeen states recently wrote to public pension fiduciaries recommending divestment from China.[8]

If fiduciaries, including trustees of public pension plans, ignore these risks, they may lose billions while being trapped in an investor stampede for the exits. Fiduciaries can take action to reduce risks related to China-based investments.

I. State Law Contains Strict Fiduciary Duties

Although specific state laws vary, nearly every state requires that fiduciaries, including trustees of public retirement assets, manage assets in a prudent manner.[9] Those prudence requirements are frequently described in terms of two overlapping rules: the duty of care, which is a primary fiduciary duty, and its subsidiary fiduciary principle—the prudent investor rule—which is the centerpiece of trust law.[10]

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[1] https://www.pionline.com/investing/federal-thrift-board-excludes-china-following-years-debate
[2] https://www.frtib.gov/pdf/reading-room/PressRel/PR_2023-11-14_I-Fund-Benchmark-Change.pdf
[3] https://www.frtib.gov/pdf/reading-room/InvBMarks/2023_Nov-Benchmark_Evaluation_Report.pdf
[4] https://www.frtib.gov/meeting_minutes/2023/2023Nov.pdf
[5] https://www.frtib.gov/meeting_minutes/2023/2023Nov.pdf
[6] https://x.com/jojjeols/status/1836230332942815307?s=46&t=YkvkJVNGBoF08O13ZLMhIw; https://www.affarsvarlden.se/artikel/ap-fonderna-dumpar-kinesiska-bolag-risken-har-blivit-for-hog
[7] https://wvrecord.com/stories/657775539-state-treasurer-announces-smart529-board-votes-to-drop-china-investments-from-portfolio
[8] https://sfof.com/wp-content/uploads/2024/11/China-Divestment-Letter11-4.pdf
[9] https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/11/basic-legal-protections-vary-widely-for-participants-in-public-retirement-plans; *see, e.g.*, S.D. Codified Laws § 55-5-7 (prudent investor rule).
[10] *See* Robert H. Sitkoff, Other Fiduciary Duties: Implementing Loyalty and Care, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 419-20.

a. Duty of Care

Under state law, the duty of care is considered a "primary" fiduciary duty "which imposes an objective and relational standard of care."[11] This duty "prescribes the fiduciary's standard of care by establishing a 'reasonableness' or 'prudence' standard that is informed by industry norms and practices."[12]

Although the exact language varies by state, for pension fund fiduciaries, the duty of care under state law typically requires investing and managing assets with "care, skill, prudence, and diligence." Ga. Code Ann. § 47-20-88; *see, e.g.*, Ky. Rev. Stat. Ann. § 61.650; see W. Va. Code Ann. § 44-6C-2(a); see also Del. Code Ann. tit. 29, § 8308. In particular, trustees of state pension plans are subject to the "highest fiduciary dut[ies]." *See, e.g.*, *Dadisman v. Moore*, 384 S.E.2d 816, 822, 831 (W. Va. 1988). Additionally, laws governing public pensions usually elaborate upon the duty of care by specifically mandating that trustees satisfy their duty "under the circumstances then prevailing that a prudent expert acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Ga. Code Ann. § 47-20-88; *see, e.g.*, Ky. Rev. Stat. Ann. § 61.650; *see also* Del. Code Ann. tit. 29, § 8308. This specification, also known as the prudent investor rule,[13] is discussed below. Most states impose a similar duty of care on fiduciaries of private assets as part of the Uniform Prudent Investor Act. *See, e.g.*, Alaska Stat. Ann. § 13.36.230(a) ("A trustee shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.").

b. Prudent Investor Rule

The prudent investor rule, which "is the centerpiece of trust investment law,"[14] "implements the [general or primary] duty of care … by supplying additional detail on what a prudent person would do in the more specific context of investment management—namely, attend to overall risk and return and to diversify, and to do so within a reasonable time."[15] Essentially, the prudent investor rule focuses on risk-and-return and diversification and therefore provides a more precise structure and standard by which the duty of care must be executed.[16] Under the prudent investor rule, fiduciaries must "invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust." *See, e.g.*, Idaho Code Ann. § 68-502(1); W. Va. Code Ann. § 44-6C-2(a) (incorporated in W. Va. Code § 12–6–11) (standard of care for West Virginia Investment Management Board). Being a prudent investor also necessarily includes "reevaluating the trust's investments periodically as conditions change." *Tibble v. Edison International*, 843 F.3d 1187

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[11] *See* Robert H. Sitkoff, Other Fiduciary Duties: Implementing Loyalty and Care, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 419-20.
[12] Robert H. Sitkoff, Other Fiduciary Duties: Implementing Loyalty and Care, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 425.
[13] *See* Robert H. Sitkoff, Other Fiduciary Duties: Implementing Loyalty and Care, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 419-20.
[14] Max M. Schanzenbach & Robert H. Sitkoff, The Prudent Investor Rule and Market Risk: An Empirical Analysis, 14 J. EMP. LEGAL STUD. 129 (2017).
[15] *See* Robert H. Sitkoff, Other Fiduciary Duties: Implementing Loyalty and Care, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 428.
[16] *See* Robert H. Sitkoff, Other Fiduciary Duties: Implementing Loyalty and Care, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 420.

(9th Cir. 2016) (cleaned up) (quoting A. Hess, G. Bogert & G. Bogert, Law of Trusts and Trustees § 684 (3d ed. 2009)).[17]

The prudent investor rule generally requires diversification but contains an exception for situations in which "the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." *See, e.g.*, Tenn. Code Ann. § 35-14-105.[18] And the duty of a prudent investor to diversify investments does not require diversifying across *all* potential investments. For example, in *Bd. of Trustees of Employees' Ret. Sys. of City of Baltimore v. Mayor & City Council of Baltimore City*, 562 A.2d 720 (Md. 1989), the trustees challenged a requirement to divest from South African assets. The court rejected the challenge, reasoning that the "[t]rustees' inability to demonstrate that divestiture will impair the portfolios' equity performance indicates that a diversified S.A.F. [South Africa free] portfolio can be managed consistently with the duty of prudence." *Id.* at 735. The court noted that even after divestment, "economically competitive, substitute investments remain available." *Id.*

The prudent investor rule examines whether a trustee has satisfied his duty of care by looking at whether he acted "with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent expert acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like *character* and with like *aims*."[19] With respect to the "character" and "aims" of a state pension or a private retirement plan, fiduciaries must carefully manage investments in order to ensure that benefits for retirees are not speculative.

The fiduciary duty of care and prudent investor rule also imply specific duties discussed in more detail below: (1) the duty to monitor investments and remove imprudent investments within a reasonable time, and (2) the duty to investigate, using appropriate methods.

II. China-Based Investments Likely Violate the Fiduciary Duty to Monitor Investments and to Remove Imprudent Investments Within a Reasonable Time

Regardless of whether investments in China-based companies were ever prudent, for existing investments, the relevant question now is whether it is prudent to maintain those investments or initiate new ones. Fiduciary duties "apply not only in making investments but also in monitoring and reviewing investments, which is to be done in a manner that is reasonable and appropriate to the particular investments, courses of action, and strategies involved.'" *Tibble*,

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[17] *Tibble* dealt with an ERISA fiduciary and its discussion of the duty to monitor was based on the common law of trusts. *Tibble*, 575 U.S. at 528–29 ("In determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts."); *see Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559, 570 (1985) ("ERISA's fiduciary duty is 'derived from the common law of trusts" (cleaned up)). Many fiduciary duties for state pension trustees are likewise based on the common law of trusts. *See White v. Pub. Emps. Ret. Bd.*, 268 P.3d 600, 606 (Or. 2011) (noting that "common-law trust principles generally apply to the administration of statutory trusts, such as PERS [Oregon's Public Employee Retirement System]," though statutory duties can alter those principles); *see, e.g.*, *New Hampshire Ret. Sys. v. Sununu*, 489 A.2d 615, 619 (N.H. 1985) (basing its decision on the common law of trusts, including the Restatement); *City of Sacramento v. Pub. Emps. Ret. Sys.*, 280 Cal. Rptr. 847, 861 (Ct. App. 1991) (interpreting trustees' duties according to "well-established rules of the law of trusts")

[18] https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=66a6a6aa-f0fd-1340-fe66-690bac023443&forceDialog=0 (Uniform Prudent Investor Act)

[19] *See, e.g.*, Ga. Code Ann. § 47-20-88 (emphases added).

575 U.S. at 529 (quoting Restatement (Third) of Trusts § 90, Comment b, p. 295 (2007)).[20] A "trustee who simply ignores changed circumstances that have increased the risk of loss to the trust's beneficiaries is imprudent.'" *Armstrong v. LaSalle Bank Nat'l Ass'n*, 446 F.3d 728, 734 (7th Cir. 2006).

Even after an investment has been made, "under trust law," a fiduciary has a "continuing duty" to "properly monitor investments and remove imprudent ones." *Tibble v. Edison Int'l*, 575 U.S. 523, 530 (2015). "If the fiduciaries fail to remove an imprudent investment from the plan within a reasonable time, they breach their duty." *Hughes v. Nw. Univ.*, 595 U.S. 170, 176 (2022). Fiduciaries also have a responsibility to remove imprudent investments from the self-directed options available to participants: "Even in a defined-contribution plan where participants choose their investments, *Tibble* instructs that plan fiduciaries must conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options." *Hughes v. Nw. Univ.*, 595 U.S. 170, 176 (2022).

The duty to monitor will sometimes result in fiduciaries identifying investments that are no longer prudent to maintain. For example, investments with a "multi-year record of subpar performance" should be scrutinized for removal. *See Vellali v. Yale Univ.*, 308 F. Supp. 3d 673, 684 (D. Conn. 2018).

Here, several factors indicate that it is no longer prudent to remain invested in China-based companies, including: (1) a significant risk that China will invade Taiwan in the near future; (2) the U.S. government is likely to impose further restrictions on investing and trade with China, even without an invasion; (3) foreign investment in China is rapidly declining, producing net outflows from Chinese markets; and (4) some pension funds are divesting from or avoiding China-based investments, including the Federal Thrift Savings Plan, Swedish state pension plan AP7, and state systems in Florida, Indiana, Kansas, Missouri, Nebraska, Oklahoma, Pennsylvania, Tennessee, and West Virginia.

Ignoring warning signs has resulted in prior litigation against fiduciaries. Litigation can be brought against a fiduciary who fails to account for "numerous 'red flags' that would have invariably provided warnings" about "increasingly serious problems." *See, e.g.*, *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1077 (C.D. Cal. 2008) (allowing lawsuit to move forward for breach of fiduciary duties, including "failure of oversight" claims). And although the decision is unreported, *Louisiana Firefighters' Ret. Sys. v. N. Tr. Invs.*, N.A, No. 09 C 7203, 2011 WL 1770266 (N.D. Ill. May 6, 2011), is instructive. In that case, the plaintiffs alleged that Northern Trust imprudently put assets in high-risk securities, including "unregistered securities, such as structural investment vehicles," and "ignored warning signs, including warnings by its own Chief Economist that a housing bubble and recession would severely impact the United States banking industry." *See id.* at *2–*4. The court allowed the case to move forward to determine whether "defendants had failed to act prudently." *Id.* at *4.

As explained below, the present circumstances indicate that continued investments in China-based companies are imprudent and must be removed within a reasonable time.

[20] As noted above, *Tibble* dealt with ERISA fiduciaries, and its reasoning for this duty is based on the common law of trusts, which would also apply to trustees of state funds.

a. China-Based Investments Are Likely Imprudent Investments Due to the Significant Risk of a Chinese Invasion of Taiwan in the Near Future

U.S. military and intelligence officials have warned that China is preparing to be ready to invade Taiwan by 2027.[21] Last year, the CIA Director revealed that President Xi Jinping has directed the Chinese military to be ready to invade Taiwan by 2027 or sooner.[22]

U.S. military officials have given similar timelines.[23] In 2021, Admiral Davison, who was then the head of the U.S. Indo-Pacific Command, stated that the threat of a Chinese conflict Taiwan would manifest by 2027.[24] Admiral Aquilino, who replaced Davidson as the Commander of U.S. Indo-Pacific command, confirmed in Congressional testimony earlier this year that "All indications point to the [People's Liberation Army] meeting President Xi Jinping's directive to be ready to invade Taiwan by 2027."[25] An analysis posted on the Department of Defense website projects that China will be ready to seize Taiwan by 2027 and "likely" will invade by 2030.[26] The analysis also notes that Taiwan lacks elements of deterrence that Ukraine possessed before it was invaded.[27] The U.S. Navy's Chief of Naval Operations recently released a Navigation Plan for America's Warfighting Navy that calls for "readiness for the possibility of war with the People's Republic of China by 2027," and stated that although President Xi Jinping has called for Chinese forces to be ready for war by that date, the U.S. Navy will be "more ready."[28]

There is also a substantial risk of an invasion occurring before 2027. The head of the U.S. Navy previously stated that China could invade Taiwan before 2024,[29] and though that did not take place, it underscores the imminent threat. A current four-star Air Force general stated earlier last year that he believes China will invade Taiwan in 2025.[30] And earlier this year, Admiral Davidson (now retired), who gave the initial 2027 warning, expressed concern over recent Chinese actions and stated that "[i]t takes action now to prevent war."[31]

China has made clear that it views Taiwan as part of China and will invade Taiwan if necessary to achieve reunification. Just recently, a vice chair of China's Central Military Commission, Gen. Zhang Youxia, stated that reunification is "the mission and responsibility" of

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[21] https://www.defensenews.com/pentagon/2024/05/07/how-dc-became-obsessed-with-a-potential-2027-chinese-invasion-of-taiwan/

[22] https://apnews.com/article/russia-ukraine-taiwan-politics-united-states-government-eaf869eb617c6c356b2708607ed15759

[23] It is possible that China could take some other kind of military action against Taiwan, such as a naval blockade or missile strikes against Taiwan. *See, e.g.*, https://www.csis.org/analysis/how-china-could-quarantine-taiwan-mapping-out-two-possible-scenarios; https://www.reuters.com/world/asia-pacific/china-starts-second-day-war-games-around-taiwan-2024-05-24/. For purposes of simplicity, this memorandum refers to an invasion, but other military actions would have similar results.

[24] https://news.usni.org/2021/03/09/davidson-china-could-try-to-take-control-of-taiwan-in-next-six-years

[25] https://www.newsweek.com/china-ready-invade-taiwan-three-years-aquilino-1881654

[26] https://media.defense.gov/2023/Apr/24/2003205865/-1/-1/1/07-AMONSON%20%26%20EGLI_FEATURE%20IWD.PDF (p. 38, 40)

[27] https://media.defense.gov/2023/Apr/24/2003205865/-1/-1/1/07-AMONSON%20%26%20EGLI_FEATURE%20IWD.PDF (p. 44)

[28] https://news.usni.org/2024/09/18/cno-franchettis-new-navy-navigation-plan

[29] https://taiwannews.com.tw/news/4693479

[30] https://www.nbcnews.com/politics/national-security/us-air-force-general-predicts-war-china-2025-memo-rcna67967

[31] https://www.browndailyherald.com/article/2024/04/retired-admiral-phillip-davidson-warns-of-multidimensional-chinese-threat-to-indo-pacific-stability-in-watson-talk

the Chinese military.[32] President Xi Jinping has repeatedly stated that the CCP has an "unshakeable commitment" to the "reunification" of Taiwan and China, "will never promise to renounce the use of force," and "reserve[s] the option of taking all measures necessary."[33]

Taiwan's election of a pro-independence president brought recriminations from China, and the Chinese defense minister stated that China would "act resolutely and forcefully at all times to curb the independence of Taiwan and to ensure that it never succeeds in its attempts."[34]

Peace is incompatible with China's goals. For example, the United States issued a joint statement with Japan and South Korea in June 2024 calling for peace in the region, only to have China angrily respond by saying the comments "interfere in China's internal affairs and maliciously smear and attack China."[35]

China-based investments are likely imprudent for fiduciaries, including pension fund fiduciaries, at the present time because a Chinese invasion of Taiwan would likely result in several devastating effects for American investors, including: (1) Federal restrictions on investments; (2) State-mandated divestments; (3) Invalidation of the VIE structure; and (4) Massive market selloffs.

i. Effects of Invasion – Federal Restrictions on Investments

A Chinese invasion would trigger federal trading and investment restrictions similar to the prohibitions on Russia after its invasion. After Russia invaded Ukraine, the federal government issued an executive order prohibiting any "new investment in the Russian Federation by a United States person, wherever located."[36] The federal government also has taken action to "fully block" certain assets that are "uniquely important to the Russian Federation economy," such as the Public Joint Stock Company Sberbank of Russia (Sberbank), thus blocking *all* American transactions related to those assets, including divestment.[37]

Similar, and likely more severe, sanctions likely would be imposed if China invades Taiwan. In fact, the restrictions from a Taiwan invasion may be even stronger, given that the United States has repeatedly pledged to protect Taiwan in recent years.[38]

Restrictions like these lead to severe losses for American shareholders. Importantly, those losses are not just limited to individual stocks—they extend to funds that hold these stocks, such as "emerging markets," "world," or "EAFE [Europe, Australasia, and Far East]" stocks, many of which were suspended after the Russian invasion.[39]

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[32] https://apnews.com/article/china-us-sullivan-xi-jinping-military-f309d86175fe4ba4a70dc7792591a5a5
[33] https://www.bloomberg.com/news/articles/2022-10-18/full-text-of-xi-jinping-s-speech-at-china-20th-party-congress-2022
[34] https://www.aljazeera.com/news/2024/6/2/china-ready-to-forcefully-stop-taiwan-independence-defence-minister
[35] https://www.taiwannews.com.tw/news/5883507
[36] https://www.whitehouse.gov/briefing-room/presidential-actions/2022/04/06/prohibiting-new-investment-in-and-certain-services-to-the-russian-federation-in-response-to-continued-russian-federation-aggression/
[37] https://home.treasury.gov/news/press-releases/jy0705
[38] https://thediplomat.com/2024/06/what-to-make-of-bidens-latest-promise-to-defend-taiwan/ (noting that President Biden has pledged a military response on at least six occasions)
[39] *See, e.g.*, https://www.fidelity.co.uk/clients/fund-updates/major-fund-news/#accordion-95818663

Several examples are instructive. After Russia invaded Ukraine, a BlackRock "emerging Europe" fund was suspended, and it remains suspended two and a half years later.[40] BlackRock's Russia ETF was suspended and then liquidated, with holders receiving pennies on the dollar.[41] JP Morgan's Emerging Europe Equity Fund A is still suspended, and its value has dropped to near-zero: [42]

Ironically, the page for JP Morgan's fund still touts that the awards previously won by the fund, including "AsianInvestor Asset Management Awards 2022 - Fund House of the Year Awards - Hong Kong," based on the fund's performance through the end of 2021.[43] These awards demonstrate that funds with these inherent risks may temporarily appear to be good investments—until suddenly, but predictably, they are not, and investors cannot even divest from their near-valueless assets.

ii. Effects of Invasion – State Divestment

A Chinese invasion likely would lead state lawmakers to require divestment by governmental entities, or lead state financial officers to voluntarily divest, even at a potential loss. Although private fiduciaries would not be subject to mandates directed at state officials, these divestments, made at a time when investors are stampeding for the exits, would result in state pension systems obtaining only a tiny fraction of what they invested.

For example, prior to the Russian invasion, states collectively held over $5.7 billion in Russian investments,[44] despite the fact that Russia was already on the U.S. government's foreign adversaries list.[45] After the invasion, "**24** retirement system boards or state investment boards … voluntarily voted to divest; **3** state treasurers or comptrollers … ordered divestment as sole fiduciaries; [and] **6** state legislatures … adopted legislation directing divestment by all state pension funds."[46]

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[40] https://www.blackrock.com/sg/en/literature/shareholder-letters/bgf-emerging-europe-suspension-notice-11-march-sg.pdf; https://www.blackrock.com/hk/en/products/229566/blackrock-emerging-europe-fund-a4-eur#/
[41] https://www.ishares.com/us/literature/forms/erus-historical-premium-discount.pdf; https://www.blackrock.com/americas-offshore/en/products/239677/ishares-msci-russia-capped-etf
[42] https://am.jpmorgan.com/hk/en/asset-management/per/products/jpm-emerging-europe-equity-a-dist-usd-lu0634316300#/historical-price
[43] https://am.jpmorgan.com/hk/en/asset-management/per/products/jpm-emerging-europe-equity-a-dist-usd-lu0634316300#/historical-price
[44] https://equable.org/state-of-pensions-2022/
[45] 15 C.F.R. § 7.4 (effective from March 22, 2021, to July 17, 2024)
[46] https://equable.org/state-of-pensions-2022/ (emphasis in original). For a complete list as of March 2022, see p. 76 here: https://equable.org/wp-content/uploads/2022/07/Equable-Institute_State-of-Pensions-2022_Final.pdf

These divestments have come too late to recover much value, and state losses are in the billions of dollars. For example, Georgia divested its Russian investments at a loss of *99.73%* of the investments' earlier value,[47] losing over $150 million.[48] California lost over $550 million.[49] Alaska lost over $250 million.[50] Minnesota lost over $235 million.[51] Indiana divested based solely on fiduciary considerations,[52] but nevertheless lost over $220 million.[53] Texas lost nearly $250 million.[54] Florida lost over $200 million.[55] Missouri lost over $160 million.[56] Ohio lost over $125 million.[57] Oregon lost over $100 million.[58] New York lost over $98 million.[59] West Virginia lost over $80 million.[60] Pennsylvania lost $53 million.[61] North Carolina lost around $50 million.[62] Kentucky lost $3 million in one Sberbank investment alone.[63] Many other losses have not yet been measured due to restrictions on trading, such as Virginia's Russian investments, which were worth $100 million before the invasion.[64] The loss total has exceeded $2 billion, and final total on losses for states likely will be several billion, given that states collectively held over $5.7 billion in Russian investments before the invasion.[65] Even investments that currently retain a little value may soon lose it, as Russia has threatened to seize billions in remaining U.S. investment assets in retaliation for U.S. actions to help Ukraine.[66]

iii. Effects of Invasion – Invalidation of VIE Structure

A Chinese invasion of Taiwan likely would be accompanied by other actions designed to shore up China against international sanctions like those experienced by Russia. As discussed

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[47] https://stateaffairs.com/georgia/politics/georgia-state-pension-funds-150-million-russia-investment-ukraine-war/
[48] https://stateaffairs.com/georgia/politics/georgia-state-pension-funds-150-million-russia-investment-ukraine-war/
[49] https://www.cnbc.com/2022/08/27/russia-divestment-promises-by-us-states-go-largely-unfulfilled-.html
[50] https://alaskapublic.org/2022/03/09/alaska-sees-a-swift-drop-in-the-value-of-its-russian-investments-and-looks-to-sell/
[51] https://www.minnpost.com/state-government/2023/03/one-year-after-ukraine-war-has-minnesota-fully-divested-from-russia-and-belarus/
[52] https://www.in.gov/inprs/about-us/inprs-newsroom/inprs-russian-related-investments-divestment/
[53] https://indianacapitalchronicle.com/2022/11/29/indiana-pension-system-lost-200-million-plus-in-russia-ukraine-fallout/
[54] https://www.cnhinews.com/cnhi/article_7f22d2b4-c64a-11ec-8292-cff8d98fdb03.html
[55] https://www.wfla.com/news/politics/florida-pension-fund-loses-200m-in-russian-investments-state-rep-says/
[56] https://www.inquirer.com/business/sers-pension-ukraine-divest-russia-board-20220307.html (MOSERS' $18.6 million reduced to essentially zero, PSRS/PEERS with over $138.9 million in exposure); https://www.psrs-peers.org/docs/default-source/board-minutes/march-2022-special-session.pdf?sfvrsn=8856520d_1 (PSRS/PEERS external managers instructing to value Russian holdings at zero)
[57] https://www.toledoblade.com/local/politics/2022/04/14/ohio-pension-holdings-value-in-russia/stories/20220414116
[58] https://www.oregonlive.com/data/2022/04/oregons-government-pension-fund-invested-millions-in-russia-how-much-is-lost.html
[59] https://nypost.com/2022/05/14/ny-pension-money-held-hostage-by-vladimir-putin-russia/
[60] https://wvmetronews.com/2022/03/08/state-investment-committee-moves-toward-divesting-from-russian-assets/
[61] https://www.inquirer.com/business/sers-pension-ukraine-divest-russia-board-20220307.html
[62] https://spectrumlocalnews.com/nc/charlotte/news/2022/03/10/dale-folwell-russian-investments-north-carolina
[63] https://www.nbcnews.com/news/us-news/kentucky-teachers-retirement-fund-lost-3m-selling-investment-russian-b-rcna18781
[64] https://virginiamercury.com/briefs/virginia-retirement-system-estimates-it-had-about-100m-in-russia-linked-investments/ In addition, Maryland likely lost over $100 million, but the report does not specify how much the value was reduced by divestment and how much was reduced by loss of value. https://www.wbaltv.com/article/maryland-retirement-pension-has-dollar7-million-invested-russia/39316153
[65] https://equable.org/state-of-pensions-2022/.
[66] https://www.reuters.com/business/west-stands-lose-least-288-bln-assets-if-russian-assets-seized-ria-2024-01-21/

further below in sections III.d and III.e, most foreign investment in China is in Variable Interest Entity structures (VIEs), which use shell companies that have long appeared to be illegal under Chinese law. If China invaded Taiwan, it could confirm that VIEs are illegal, thus invalidating all VIE contracts and allowing China-based companies with VIEs to legally keep all of the money invested by foreign investors in the shell companies. This action would be similar to threats from Russia to confiscate Western assets in response to Western sanctions and actions,[67] with the notable difference that China can simply argue that VIEs never were legal in the first place.

iv. Effects of Invasion – Massive Selloffs

Even if state pension boards and other fiduciaries have an option on whether to hold their Chinese assets after an invasion and decide to do so, the value of those assets would plummet. A Chinese invasion would trigger a "massive selloff of Chinese assets,"[68] similar to the selloff triggered by the Russian invasion of Ukraine. For example, after Russia invaded Ukraine in 2022, California's Public Employees' Retirement System did not immediately sell any of its Russian assets, but nevertheless saw the value of those assets drop from $765 million to $194 million in less than six months.[69]

b. China-Based Investments Are Likely Imprudent Investments, Because Further Federal Restrictions on Investing and Trade Are Likely Even Without an Invasion

Even prior to a potential Chinese invasion of Taiwan, investments in China face significant risk of U.S. government restrictions that could damage the value of those investments.

i. Risk of General Restrictions

The United States maintains a short list of "foreign adversaries," which are "foreign governments [that] have engaged in a long-term pattern or serious instances of conduct significantly adverse to the national security of the United States or security and safety of United States persons."[70] Notably, before the Russian invasion of Ukraine, it was possible to invest in Russia and China, but it was illegal or nearly impossible for Americans to invest in companies in four of the six foreign adversaries (Cuba, Iran, North Korea, and the Maduro regime in Venezuela).[71] Now, with restrictions imposed on Russian investments, the only remaining exception is China / Hong Kong. Both the Biden Administration and the Trump Administration

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[67] https://www.reuters.com/business/west-stands-lose-least-288-bln-assets-if-russian-assets-seized-ria-2024-01-21/
[68] https://www.csis.org/analysis/reunification-taiwan-through-force-would-be-pyrrhic-victory-china
[69] https://www.cnbc.com/2022/08/27/russia-divestment-promises-by-us-states-go-largely-unfulfilled-.html
[70] 15 C.F.R. § 791.4
[71] *See, e.g.*, https://ofac.treasury.gov/faqs/758 (Cuba); https://www.federalregister.gov/documents/2020/01/14/2020-00534/imposing-sanctions-with-respect-to-additional-sectors-of-iran (Iran); https://www.federalregister.gov/documents/2020/09/23/2020-21160/blocking-property-of-certain-persons-with-respect-to-the-conventional-arms-activities-of-iran (Iran); https://ofac.treasury.gov/media/7676/download?inline (North Korea); https://www.whitehouse.gov/briefing-room/presidential-actions/2022/04/06/prohibiting-new-investment-in-and-certain-services-to-the-russian-federation-in-response-to-continued-russian-federation-aggression/ (Russia); https://home.treasury.gov/news/press-releases/jy0705 (Russia); https://ofac.treasury.gov/media/5516/download?inline (Maduro regime); https://ofac.treasury.gov/media/26786/download?inline (Maduro regime)

issued executive orders limiting some types of investment in China, but others are untouched for the moment.[72]

The inclusion of China on the foreign adversaries list, the current restrictions related to China, and the more severe restrictions placed on other members of that list all raise significant concerns that China may soon be subject to similar restrictions that will damage the value of Chinese investments. Although most of the restrictions on foreign adversaries have come through executive orders, Congress also could act. Several recent bipartisan bills have been introduced to discourage investments in China, including proposals to remove China-based companies from index funds, and removing capital gains tax breaks for investments in adversarial countries.[73] In addition, a newly elected U.S. president could demonstrate strength on national security by taking more aggressive action against Chinese investments next year.

In light of the similar risks, fiduciaries should treat China-based investments the same way they treat investments in other entities on the U.S.'s list of foreign adversaries.

ii. Risk of More Specific Restrictions

In addition to the foreign adversaries list, the federal government maintains several specific lists of China-based companies of concern. However, many of those companies are nonetheless included in various exchange traded funds (ETFs) and MSCI indexes. Fiduciaries investing funds into companies on these lists (whether directly or through ETFs) disregard the clear risk of further government actions related to these federal lists, which would devalue these investments.

In July 2023, the U.S. House Select Committee on the Chinese Communist Party identified over 40 China-based companies that appeared on federal "red-flag" lists and were also listed on one or more MSCI indexes tracked by various ETFs.[74] For example, China State Shipbuilding Corporation Holdings Limited (CSSC Holdings Ltd.), builds aircraft carriers for the Chinese military, and has been flagged as a Communist Chinese Military Company by the U.S. Department of Defense.[75] Yet it is currently included in index funds such as the iShares MSCI Emerging Markets ETF and the iShares MSCI All-Country World Index ETF, and likely in other index funds based on those MSCI indexes.[76]

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[72] https://www.federalregister.gov/documents/2020/11/17/2020-25459/addressing-the-threat-from-securities-investments-that-finance-communist-chinese-military-companies (restricting investments in certain Chinese military companies); https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/ (broadening scope of restrictions); https://www.whitehouse.gov/briefing-room/presidential-actions/2023/08/09/executive-order-on-addressing-united-states-investments-in-certain-national-security-technologies-and-products-in-countries-of-concern/ (issuing additional restrictions related to national security technologies, including semiconductors, quantum computing, and AI)

[73] https://www.ft.com/content/f8c51719-0dcc-4a34-9272-381584d60d6a

[74] https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/2023-07-31-letter-to-msci.pdf

[75] https://media.defense.gov/2024/Jan/31/2003384819/-1/-1/0/1260H-LIST.PDF

[76] https://www.ishares.com/us/products/239637/ishares-msci-emerging-markets-etf/1467271812596.ajax?fileType=csv&fileName=EEM_holdings&dataType=fund; (showing holdings for an example MSCI Emerging Markets fund); https://www.blackrock.com/us/individual/products/239600/ishares-msci-acwi-etf/1464253357814.ajax?fileType=csv&fileName=ACWI_holdings&dataType=fund (showing holdings for an example MSCI ACWI fund)

Similarly, the Hoshine Silicon Industry Co. "has been implicated in the use of Uyghur forced labor and is on the [Uyghur Forced Labor Prevention Act] Entity List," yet is currently listed as a holding in the iShares MSCI Emerging Markets ETF.[77]

Members of Congress have criticized asset managers for allowing investments in companies like these, and issued bipartisan calls to impose further restrictions on investments in Chinese military companies[78] or investments in companies linked to the oppression of Uyghurs.[79] The Uyghur Forced Labor Prevention Act likely will lead to seizures of about $2 billion this year alone.[80] Other China-based lists and targeted restrictions could emerge at any time, such as when the House of Representatives recently passed a bill that would restrict the funding and operations of China-based biotech companies, which caused those stocks to fall.[81]

iii. Risk of Non-Company-Specific Economic Actions

In addition, China-based investments face a significant risk of other economic actions related to China, such as tariffs. President-elect Trump has pledged to apply "new tariffs of anywhere from 60% to 100%" across the board on goods from China.[82] President Biden also recently imposed tariffs on thousands of goods made in China, including a 100% tariff on China's electric vehicles, a 25% tariff on lithium-ion EV batteries, and a 50% tariff on photovoltaic solar cells, with a 50% tariff on semiconductors also set to take effect in 2025.[83] Other countries have recently imposed tariffs as well, including Canada imposing a 100% tariff on China's electric vehicles, and a 25% tariff on steel and aluminum from China;[84] and the European Union imposing tariffs on EVs as well.[85] With both U.S. political parties ratcheting up tariffs on China and other countries doing the same, investors face significant risks of tariffs dramatically reducing the value of China-based investments.

Tariffs also could be a logical response to China's participation in America's fentanyl crisis. Earlier this year, a bipartisan duo of U.S. Senators urged President Biden to close the so-

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[77] https://www.ishares.com/us/products/239637/ishares-msci-emerging-markets-etf/1467271812596.ajax?fileType=csv&fileName=EEM_holdings&dataType=fund; *see* https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/2023-07-31-letter-to-msci.pdf

[78] https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/4.18.24%20How%20Americsan%20Financial%20Institutions%20Provide%20Billions%20of%20Dollars%20to%20PRC%20Companies%20Committing%20Human%20Rights%20Abuses%20and%20Fueling%20the%20PRC's%20Military.pdf (p. 2 – calling for Congress to pass legislation to "restrict investment in companies blacklisted by the U.S. government"); *see* https://thehill.com/opinion/congress-blog/4455214-congress-should-block-us-investment-in-chinas-military-and-human-rights-abuses/ (Democrat ranking member of the House Select Committee on the Strategic Competition Between the U.S. and the Chinese Communist Party)

[79] https://chrissmith.house.gov/news/documentsingle.aspx?DocumentID=412131 (the "Uyghur Genocide Accountability and Sanctions Act"); https://www.congress.gov/bill/118th-congress/senate-bill/1770/text (the "Uyghur Genocide Accountability and Sanctions Act of 2023")

[80] https://www.cbp.gov/newsroom/stats/trade/uyghur-forced-labor-prevention-act-statistics; https://www.cbp.gov/trade/forced-labor/UFLPA

[81] https://www.ft.com/content/c1d2cae9-245b-427f-b821-8905b1dc28d1

[82] https://www.bloomberg.com/features/2024-trump-interview/?sref=VBucTHzi ; *see* https://www.youtube.com/watch?v=WAg99owBB6w (stating that the tariffs may be more than 60%)

[83] https://www.utilitydive.com/news/joe-biden-china-tariff-hikes-ev-battery-semiconductor-final/727014/

[84] https://www.reuters.com/business/autos-transportation/trudeau-says-canada-impose-100-tariff-chinese-evs-2024-08-26/

[85] https://www.csis.org/analysis/unpacking-european-unions-provisional-tariff-hikes-chinese-electric-vehicles

called "de minimis" tariff loophole to protect American businesses and decrease illegal fentanyl smuggling.[86] Recently, a majority of Democratic U.S. House members issued a similar request.[87] Shortly thereafter, the Biden Administration expressed concern that the loophole was allowing fentanyl smuggling.[88] The Administration announced a notice of proposed rulemaking that would stop the loophole from being used for some products, including textiles, and impose new burdens on companies using the loophole.[89] The Administration also called for Congress to "pass comprehensive de minimis reform legislation by the end of the year."[90]

The loophole at issue is one that many Chinese firms depend on in order to ship goods to U.S. consumers without tariffs,[91] with such trade totaling over $23 billion last year alone.[92] Closing the loophole would significantly harm investments in those China-based companies.

In addition, if the loophole or any other U.S. trade law is being abused by a foreign government in order to evade tariffs or to import deadly and illegal fentanyl, a challenge could be brought under Section 301 of the Trade Act of 1974, which allows the imposition of trade sanctions on a foreign country for violating U.S. trade law.[93] Section 301 challenges can be brought by the U.S. or by private citizens, and can result in significant consequences.[94] For example, when a Section 301 challenge was brought against China in 2017 related to IP practices, the result was the imposition of sweeping new tariffs that have cost China-based companies hundreds of billions of dollars.[95] Notably, Section 301 can require mandatory action without any type of *mens rea* requirement, so even an unknowing or unintentional violation by China could still result in significant penalties.[96] The risk of such an action should be factored into fiduciaries' evaluation of China-based investments.

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[86] https://www.brown.senate.gov/newsroom/press/release/sherrod-brown-scott-demand-administration-close-de-minimis-trade-loophole-undermines-american-manufacturers

[87] https://www.reuters.com/world/us/us-lawmakers-urge-biden-close-tariff-loophole-chinese-small-package-imports-2024-09-11/

[88] https://www.whitehouse.gov/briefing-room/statements-releases/2024/09/13/fact-sheet-biden-harris-administration-announces-new-actions-to-protect-american-consumers-workers-and-businesses-by-cracking-down-on-de-minimis-shipments-with-unsafe-unfairly-traded-products/

[89] https://www.whitehouse.gov/briefing-room/statements-releases/2024/09/13/fact-sheet-biden-harris-administration-announces-new-actions-to-protect-american-consumers-workers-and-businesses-by-cracking-down-on-de-minimis-shipments-with-unsafe-unfairly-traded-products/

[90] https://www.whitehouse.gov/briefing-room/statements-releases/2024/09/13/fact-sheet-biden-harris-administration-announces-new-actions-to-protect-american-consumers-workers-and-businesses-by-cracking-down-on-de-minimis-shipments-with-unsafe-unfairly-traded-products/

[91] https://www.reuters.com/business/retail-consumer/key-trade-loophole-keeps-cheap-chinese-products-flowing-us-2023-08-04/

[92] https://www.reuters.com/world/us/us-lawmakers-urge-biden-close-tariff-loophole-chinese-small-package-imports-2024-09-11/

[93] 19 U.S.C. § 2411

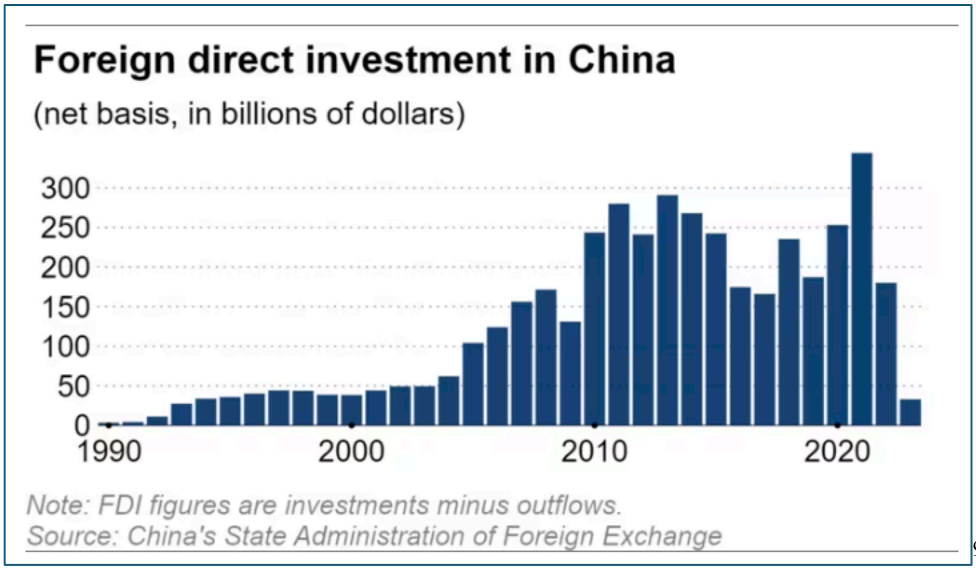
[94] https://crsreports.congress.gov/product/pdf/IF/IF11346

[95] https://crsreports.congress.gov/product/pdf/IF/IF11346 (tariffs imposed on $370 billion of imports from China); https://ustr.gov/sites/default/files/USTR%20Report%20Four%20Year%20Review%20of%20China%20Tech%20Transfer%20Section%20301.pdf ("As of January 2024, CBP had assessed more than $200 billion in section 301 duties under the July 6, 2018 action and the August 23, 2018 action.")

[96] *See* 19 U.S.C. § 2411 (prescribing mandatory action if an "act, policy, or practice of a foreign country--(i) violates, or is inconsistent with, the provisions of, or otherwise denies benefits to the United States under, any trade agreement, or (ii) is unjustifiable and burdens or restricts United States commerce")

c. China-Based Investments Are Likely Imprudent Investments, As Demonstrated by Other Investors Moving Away from All Chinese Investments

Many investors have recognized warning signs and divested from China-based investments. Last year, 75% of foreign money that had been invested into China's market in the first seven months had been divested by November, with investors pulling over $25 billion out of China-based investments.[97] Actions like these dropped China's annual net foreign direct investment to a ***30-year low***:



[98]

As noted above, the slide has continued this year, so much so that China now blocks access to market data showing net daily investment flows.[99] Despite China's attempts to conceal the facts, data indicates that the outflows have accelerated. China suffered a net outflow of nearly $15 billion in the second quarter of this year alone, and China is on pace to have net annual outflows for the first time on record, which would drop the 2024 bar in the above chart below zero.[100] This exodus includes U.S. investors—in just the first *quarter* of this year, 13 US-listed China ETFs closed down, far exceeding the previous record of five closures *in a year*.[101]

China-based investments cannot be justified by a need for diversification. Investors have more options than ever, and even if investing in international funds and/or emerging markets funds is deemed to be an important part of diversifying a portfolio, funds excluding China are readily available. The Federal Thrift Savings Plan has joined many other investors in embracing such funds—last year, mutual funds with "ex China" in their names increased their total net assets *by 65%*.[102] These "ex China" funds outperformed other emerging market funds by 3.5%

[97] https://www.ft.com/content/20c5d5c8-dd64-4c22-a3fc-60d4a8336aeb
[98] https://asia.nikkei.com/Economy/Foreign-direct-investment-in-China-falls-to-30-year-low
[99] https://www.ft.com/content/6e7a4129-d365-4905-8d9b-cc3f5ada5187
[100] https://www.bloomberg.com/news/articles/2024-08-12/foreign-investors-are-pulling-record-amount-of-money-from-china
[101] https://www.ft.com/content/2f988ec0-d2b8-4eb0-8cec-71f25a4aa40b
[102] https://www.investmentweek.co.uk/analysis/4195739/emerging-markets-china-etfs-enjoy-moment-sun-investors-snub-china-2023

last year and also have outperformed other funds over the past five years.[103] The “multi-year record of subpar performance” for China-based investments is another reason these investments should be scrutinized for removal. *See Vellali v. Yale Univ.*, 308 F. Supp. 3d 673, 684 (D. Conn. 2018).

d. Prominent Fiduciaries Have Divested from or Avoided China-Based Investments Already, Pursuant to Their Fiduciary Duties

i. Federal Thrift Savings Plan

The Federal Retirement Thrift Investment Board voted unanimously in late 2023 to switch the benchmark for its $68 billion international fund from the MSCI EAFE Index to the MSCI All Country World ex USA ***ex China ex Hong Kong*** Investable Market Index.[104] The Federal Thrift Savings Plan’s move to an index that expressly excludes China-based and Hong Kong-based companies was precipitated by a hired investment consultant, which noted “[t]ensions between the U.S. and China have been building,” and suggested that current investment restrictions may be “the beginning of further restrictions.”[105] The consultant recommended using an MSCI ACWI IMI ex USA ex China ex Hong Kong index fund,[106] and the plan’s Office of Investments agreed.[107] The board’s minutes note that switching would address the “operational complexity” of the current situation and “reduc[e] the risk” of investing in China and then “later being forced to sell out of specific markets.”[108]

This unanimous decision should give fiduciaries, including state pension boards, serious pause—the Federal Retirement Thrift Investment Board presumably has access to better information related to international relations than any state or private entity, and has decided that the appropriate fiduciary approach at this time is to use a fund that excludes *all* Chinese and Hong Kong investments.

ii. Swedish State Pension Plan

Recent reports also indicate that several of Sweden’s state pension funds have chosen to divest as well, with one pension fund head stating that the “risk has simply become too great.”[109]

iii. State Divestments / Avoidance

Many states already have divested from or avoided China-based investments in recent years. These divestments demonstrate that China-based investments are not institutional investment quality, as is required by some pension boards.[110] It appears, based on the examples

[103] https://www.morningstar.com/funds/avoiding-china-has-been-winning-bet-these-equity-funds
[104] https://www.pionline.com/investing/federal-thrift-board-excludes-china-following-years-debate
[105] https://www.frtib.gov/pdf/reading-room/PressRel/PR_2023-11-14_I-Fund-Benchmark-Change.pdf
[106] https://www.frtib.gov/pdf/reading-room/InvBMarks/2023_Nov-Benchmark_Evaluation_Report.pdf
[107] https://www.frtib.gov/meeting_minutes/2023/2023Nov.pdf
[108] https://www.frtib.gov/meeting_minutes/2023/2023Nov.pdf
[109] https://x.com/jojjeols/status/1836230332942815307?s=46&t=YkvkJVNGBoF08O13ZLMhIw; https://www.affarsvarlden.se/artikel/ap-fonderna-dumpar-kinesiska-bolag-risken-har-blivit-for-hog
[110] *See, e.g.*, https://oklahoma.gov/content/dam/ok/en/trs/documents/investments/Investment-Policy-Statement.pdf (“All assets must be of institutional investment quality. Institutional quality will be determined via a comparative analysis conducted by the System’s Investment Consultant of other prudent institutional investors in terms of sophistication, size, and complexity.”)

below, that China-based investments are no longer "considered acceptable by other prudent institutional investors" such as "public employee retirement systems."[111]

1. Missouri

A 2023 report found that Missouri had about $200 million in Chinese holdings.[112] In 2023, Missouri's employee retirement system used benchmarks including MSCI's ACWI [All Country World Index] Index, which contains China-based investments.[113] However, at the end of last year, the board of trustees voted 9-2 to divest from China-based investments.[114] Missouri State Treasurer Vivek Malek stated that the decision to divest was appropriate based on the level of risk and that the vote "protect[ed] taxpayer money from the risks associated with investing in a nation that has repeatedly proven adversarial."[115] As Treasurer Malek later put it, "[i]nvestments in China simply carry a level of risk that is contrary to the interests of our retirees."[116]

2. West Virginia

An investment consultant reported to a state board that there were significant risks from U.S.-China tensions and China's tendency to unexpectedly change domestic policies, observing that "China's domestic policies can create periods of heightened volatility and it is possible that ongoing tensions could increase and negatively impact Chinese stocks."[117]

In response, West Virginia Treasurer Riley Moore and the state board decided to transition the "emerging markets" option in a 529 plan to an option that excludes China-based companies.[118] Moore noted the inconsistency between the "fiduciary duty to act in the best financial interests" of the plan participants, and the "potential regulatory and geopolitical risks that come with investing in companies based in China."[119] He praised the board for its decision to "reduce exposure to these more risky Chinese investment options."[120]

3. Florida

Florida stopped investing in China as of 2022, and reduced its market exposure to China by $1.3 billion,[121] but in early 2024, still had a quarter billion dollars' worth of Chinese

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[111] https://www.patreasury.gov/pdf/investment/IPS-Commonwealth-Funds-Report.pdf
[112] https://missouriindependent.com/2023/12/12/state-board-votes-to-divest-missouri-pension-fund-from-china/
[113] https://www.mosers.org/docs/default-source/funding/annual-reports/2023-annual-comprehensive-financial-report.pdf?sfvrsn=c4c95900_6
[114] https://missouriindependent.com/2023/12/12/state-board-votes-to-divest-missouri-pension-fund-from-china/
[115] https://missouriindependent.com/2023/12/12/state-board-votes-to-divest-missouri-pension-fund-from-china/
[116] https://treasurer.mo.gov/newsroom/news-and-events-item?pr=396cd819-beec-42e8-905f-4b16cf4fd3d0; *see* https://treasurer.mo.gov/newsroom/news-and-events-item?pr=9571a8a8-9702-42f7-bf45-a81ff08def03 (stating that "for many reasons, China is a bad investment")
[117] https://wvtreasury.com/About-The-Office/Press-Releases/ID/612/Treasurer-Moore-Announces-SMART529-Board-Votes-to-Drop-China-Investments-from-Select-Plan-Emerging-Markets-Portfolio
[118] https://wvrecord.com/stories/657775539-state-treasurer-announces-smart529-board-votes-to-drop-china-investments-from-portfolio
[119] https://wvtreasury.com/About-The-Office/Press-Releases/ID/612/Treasurer-Moore-Announces-SMART529-Board-Votes-to-Drop-China-Investments-from-Select-Plan-Emerging-Markets-Portfolio
[120] https://wvrecord.com/stories/657775539-state-treasurer-announces-smart529-board-votes-to-drop-china-investments-from-portfolio
[121] https://www.flgov.com/2021/12/20/governor-ron-desantis-takes-action-against-communist-china-and-woke-corporations/

holdings.[122] However, under a new state law, Florida now will divest its holdings in China-based companies, similar to restrictions Florida previously imposed on Cuba, Iran, and Venezuela.[123] Florida CFO Jimmy Patronis previously had observed that "limiting our exposure to China … is the financially prudent thing to do for our state."[124]

4. Indiana

A 2023 report found that Indiana had $1.2 billion in Chinese holdings.[125] In 2023, Indiana's retirement system used the MSCI All Country World Investable Market Net Index and the MSCI ACWI ex US IMI [Investable Market Index] as benchmarks.[126] However, since Indiana passed a divestment law, the state has divested 100% of its Chinese investments.[127] The bill's sponsor noted that "As tensions continue to rise between the U.S. and China, removing the possibility of China freezing U.S. assets and harming public employees is simply good policy."[128]

5. Nebraska

Nebraska's benchmarks include the MSCI All Country World IMI.[129] However, Nebraska recently passed legislation requiring a "Pacific Conflict Stress Test," requiring trustees to list investments "at risk of substantially losing value or being frozen, seized, or appropriated by foreign adversaries in the event of a Pacific Conflict," and recommend strategies for "immediate and complete divestment" of such assets.[130] The bill's stated purpose is to "minimize the disruptive impact of a potential conflict precipitated by foreign adversaries."[131]

6. Oklahoma

The Oklahoma state pension system uses a custom non-U.S. equity benchmark that consists entirely of MSCI indexes that include China, and offers a BlackRock MSCI ACWI ex-US Index Fund.[132] However, Oklahoma Governor Kevin Stitt recently issued an executive order calling on all fund managers within his administration to notify State Treasurer Todd Russ regarding "all state assets at risk of substantially losing value or being frozen, seized, or appropriated by foreign adversaries in the event of an Indo-Pacific conflict," and to develop

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122 https://myfloridahouse.gov/Sections/Documents/loaddoc.aspx?FileName=h7071z.SAC.DOCX&DocumentType=Analysis&BillNumber=7071&Session=2024 (p. 4-5)
123 https://floridaphoenix.com/2024/05/16/florida-is-now-one-of-the-few-states-divesting-from-chinese-owned-companies/
124 https://www.flgov.com/2021/12/20/governor-ron-desantis-takes-action-against-communist-china-and-woke-corporations/
125 https://spectrumlocalnews.com/mo/st-louis/news/2024/07/25/missouri-ddivest-chinese-investments
126 https://www.in.gov/inprs/files/INPRSAnnualReportBook_FY23.pdf (p. 109)
127 https://www.indianasenaterepublicans.com/garten-indiana-receives-national-attention-for-divesting-pension-funds-from-china-and-protecting-hoosiers-hard-earned-dollars
128 https://www.indianasenaterepublicans.com/garten-indiana-receives-national-attention-for-divesting-pension-funds-from-china-and-protecting-hoosiers-hard-earned-dollars
129 https://nic.nebraska.gov/sites/default/files/doc/2023%20Annual%20Report.pdf
130 https://www.nebraskalegislature.gov/FloorDocs/108/PDF/Slip/LB1300.pdf
131 https://nebraskalegislature.gov/FloorDocs/108/PDF/Intro/LB1300.pdf
132 https://www.opers.org/pubs-archive/financial/2023-OPERS-Annual-Report.pdf (p. 104, 117)

divestment plans for those assets.[133] The order cited China's presence on the U.S. government's foreign adversaries list.[134]

7. Pennsylvania

In the first half of 2022, Pennsylvania Treasurer Stacy Garrity not only divested the state treasury from its Russian holdings, but divested from nearly $400 million in Chinese holdings as well, based on "serious concerns related to geopolitical risk and human rights abuses."[135] By doing so, Garrity may have helped the state treasury avoid potential losses from the slide in Chinese stocks over the past two years.[136] However, Pennsylvania's pension funds reportedly had over $900 million invested in companies based in China, Hong Kong, or Macau.[137]

8. Kansas

In 2023, Kansas's state public pension system used the MSCI ACWI ex U.S. Index.[138] However, Kansas passed a law this year to divest from companies in countries of concern, which match the countries on the U.S. Foreign Adversaries List.[139] The law passed with over a three-quarters supermajority of legislators.[140]

9. Idaho

Idaho's state pension system uses MSCI indexes that include China.[141] However, the Idaho Legislature unanimously passed a law this year requiring the state treasurer to report on all investments in foreign adversaries,[142] potentially in preparation for divestment.

10. South Dakota, Mississippi, Iowa, and Texas

The governors of these four states sent a letter to Vanguard in May 2023 requesting that the asset manager create an investment fund that excluded China-based investments.[143] The governors cited their commitment to "ensuring that our state investments deliver the highest possible returns while insulating our states from financial risk."[144]

11. Tennessee

Tennessee has long employed a unique system in which it pursues its fiduciary duties by avoiding investments in companies that score poorly on the Economist's Global Democracy Index and Transparency International's Corruption Perceptions Index.[145]

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133 https://oklahoma.gov/content/dam/ok/en/governor/documents/Final%20Draft_China%20Executive%20Order.pdf
134 https://oklahoma.gov/content/dam/ok/en/governor/documents/Final%20Draft_China%20Executive%20Order.pdf
135 https://www.sungazette.com/news/top-news/2023/11/pa-may-consider-divesting-public-funds-from-china/
136 https://finance.yahoo.com/quote/000001.SS/ (Shanghai index, dropping by about 15% since Mar. 2022); https://finance.yahoo.com/quote/399107.SZ/ (Shenzen A-share index, dropping by about 27% since Mar. 2022)
137 https://www.sungazette.com/news/top-news/2023/11/pa-may-consider-divesting-public-funds-from-china/
138 https://www.kpers.org/annualreport2023.pdf
139 https://www.kslegislature.gov/li/b2023_24/measures/documents/hb2711_enrolled.pdf
140 https://www.kslegislature.gov/li/b2023_24/measures/hb2711/
141 https://www.persi.idaho.gov/docs/investments/Fiscal-Year-Investment-Report-2024-0628.pdf
142 https://legislature.idaho.gov/wp-content/uploads/sessioninfo/2024/legislation/H0665.pdf
143 https://governor.sd.gov/doc/Joint-GovernorLetter-to-Vanguard-on-China_5-16-23.pdf
144 https://governor.sd.gov/doc/Joint-GovernorLetter-to-Vanguard-on-China_5-16-23.pdf
145 https://www.marketsgroup.org/news/China-Tennessee%20Consolidated%20Retirement%20System

As a result, unlike other states, Tennessee did not hold Russian stocks before the Ukraine invasion,[146] and thus avoided the significant financial losses that other state pensions have suffered. Tennessee also has long avoided China-based investments for the same reason, and that choice has produced significantly higher returns for Tennessee in recent years.[147] By 2022, Tennessee's decision to avoid China-based stocks had more than erased any historical disadvantage from not investing in those stocks,[148] and since then, China-based stocks have continued to slide,[149] demonstrating the prudence of Tennessee's long-standing approach.

e. Case Study: Russia

Investing in China in 2024 is similar to investing in Russia three years ago. In 2021, Russia was on the federal government's foreign adversaries list,[150] and there were worrying signs of a potential invasion, including Russian leaders "question[ing] the legitimacy of independent Ukraine."[151] A Biden administration official stated that Russia could invade "as soon as early 2022."[152] And the Federal Thrift Savings Plan's international fund was invested in an index that did not include Russia.[153] Yet many fiduciaries,[154] including state pension plans, did not divest, perhaps reassured by a Russian official's statement that Russia would not invade,[155] or analyses reasoning that Russia likely would not invade because of the high resulting cost.[156]

	Russia 2021	**China 2024**
Denying Independence of Target	Russian leaders were "question[ing] the legitimacy of independent Ukraine."[157]	China's defense minister has said China will "act resolutely and forcefully at all times to curb the independence of Taiwan and to ensure that it never succeeds in its attempts."[158]

[146] https://www.pionline.com/pension-funds/tennessee-consolidated-already-screens-out-russia-investments
[147] https://www.marketsgroup.org/news/China-Tennessee%20Consolidated%20Retirement%20System
[148] https://www.marketsgroup.org/news/China-Tennessee%20Consolidated%20Retirement%20System
[149] https://finance.yahoo.com/quote/000001.SS/ (Shanghai index, dropping by about 15% since Mar. 2022); https://finance.yahoo.com/quote/399107.SZ/ (Shenzen A-share index, dropping by about 27% since Mar. 2022)
[150] 15 C.F.R. § 7.4 (effective from March 22, 2021, to July 17, 2024)
[151] https://www.rand.org/pubs/commentary/2021/12/expect-shock-and-awe-if-russia-invades-ukraine.html (Dec. 2021 article laying out warning signs)
[152] https://www.washingtonpost.com/national-security/russia-ukraine-invasion/2021/12/03/98a3760e-546b-11ec-8769-2f4ecdf7a2ad_story.html (Dec. 2021 article)
[153] https://www.govexec.com/pay-benefits/2022/03/no-your-tsp-money-isnt-invested-russia/362670/
[154] *See, e.g.*, https://www.pensionbee.com/uk/blog/2022/may/uk-pensions-as-global-investment-markets-plummet; https://citywire.com/americas/news/blackrock-funds-suffer-17bn-losses-on-russia-exposure/a2382267
[155] https://www.npr.org/2022/01/10/1071766987/u-s-russia-dicuss-ukraine-can-diplomacy-help-avoid-a-military-confrontation (Jan. 2022, after Russia-U.S. talks, Russian official states "There are no plans or intentions to attack Ukraine.")
[156] https://www.americansecurityproject.org/why-putin-shouldnt-invade-ukraine/ ; https://www.chathamhouse.org/2021/12/putin-does-not-need-invade-ukraine-get-his-way
[157] https://www.rand.org/pubs/commentary/2021/12/expect-shock-and-awe-if-russia-invades-ukraine.html (Dec. 2021 article laying out warning signs)
[158] https://www.aljazeera.com/news/2024/6/2/china-ready-to-forcefully-stop-taiwan-independence-defence-minister

U.S. Warnings of Potential Invasion	A Biden administration official stated that Russia could invade "as soon as early 2022."[159]	A current four-star U.S. Air Force general stated earlier last year that he believes China will invade Taiwan in 2025.[160]
Statements about Need for Reunification	President Vladimir Putin stated in 2021 that Russians and Ukrainians were one people, that Russia was "robbed" of Ukraine, and that Ukraine sits on historically Russian territory.[161]	President Xi Jinping has repeatedly stated that the CCP has an "unshakeable commitment" to the "reunification" of Taiwan and China, "will never promise to renounce the use of force," and "reserve[s] the option of taking all measures necessary."[162]
Threatening Military Exercises	Russia conducted military exercises in September 2021 that appeared to be geared towards invading Ukraine.[163]	China has twice this year conducted military exercises called "Joint Sword" that appear to simulate an invasion or blockade of Taiwan,[164] during which it moved military units closer to the island than ever before.[165] China said its most recent exercise in October 2024 was a warning against "separatist acts."[166]

As a result, state investments collectively lost billions of dollars, including California losing over $550 million,[167] Texas losing $250 million,[168] Alaska losing $250 million,[169] Minnesota losing $235 million,[170] Indiana losing $220 million,[171] Florida losing $200 million,[172]

[159] https://www.washingtonpost.com/national-security/russia-ukraine-invasion/2021/12/03/98a3760e-546b-11ec-8769-2f4ecdf7a2ad_story.html (Dec. 2021 article)
[160] https://www.nbcnews.com/politics/national-security/us-air-force-general-predicts-war-china-2025-memo-rcna67967
[161] https://www.atlanticcouncil.org/blogs/ukrainealert/putins-new-ukraine-essay-reflects-imperial-ambitions/
[162] https://www.bloomberg.com/news/articles/2022-10-18/full-text-of-xi-jinping-s-speech-at-china-20th-party-congress-2022
[163] https://www.politico.com/news/magazine/2023/02/24/russia-ukraine-war-oral-history-00083757
[164] https://www.bbc.com/news/articles/cvgd4yn45qlo
[165] https://www.taipeitimes.com/News/taiwan/archives/2024/10/16/2003825381
[166] https://www.reuters.com/world/asia-pacific/takeaways-chinas-latest-war-games-around-taiwan-2024-10-15/
[167] https://www.cnbc.com/2022/08/27/russia-divestment-promises-by-us-states-go-largely-unfulfilled-.html
[168] https://www.cnhinews.com/cnhi/article_7f22d2b4-c64a-11ec-8292-cff8d98fdb03.html
[169] https://alaskapublic.org/2022/03/09/alaska-sees-a-swift-drop-in-the-value-of-its-russian-investments-and-looks-to-sell/
[170] https://www.minnpost.com/state-government/2023/03/one-year-after-ukraine-war-has-minnesota-fully-divested-from-russia-and-belarus/
[171] https://indianacapitalchronicle.com/2022/11/29/indiana-pension-system-lost-200-million-plus-in-russia-ukraine-fallout/
[172] https://www.wfla.com/news/politics/florida-pension-fund-loses-200m-in-russian-investments-state-rep-says/

Missouri losing $150 million,[173] Georgia losing $150 million,[174] Ohio losing $125 million,[175] Oregon losing $100 million,[176] New York losing $98 million,[177] West Virginia losing $83 million,[178] Pennsylvania losing $53 million,[179] and North Carolina losing $50 million.[180] Many other losses have not yet been realized and have not been quantified, such as Virginia's Russian investments, which were worth $100 million before the invasion.[181] The final total on losses likely will be far greater, given that states collectively held over $5.7 billion in Russian investments before the invasion.[182]

A similar scenario presents itself here, and trustees of private funds and state pension plans have a chance to learn lessons from the past.

III. Fiduciaries Cannot Fulfill Their Fiduciary Duty to Investigate the Merits of China-Based Investments

Fiduciaries must investigate investments using the appropriate methods for doing so. For example, a "fiduciary charged with making investment decisions … is required (1) to employ the appropriate methods to investigate the merits of the investment and to structure the investment; (2) to act in a like capacity familiar with such matters; and (3) to conduct an independent investigation of the merits of a particular investment." *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 10 n.9 (1st Cir. 2009) (cleaned up).[183] The SEC is clear that fiduciaries such as investment

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[173] https://www.inquirer.com/business/sers-pension-ukraine-divest-russia-board-20220307.html (MOSERS' $18.6 million reduced to essentially zero, PSRS/PEERS with over $138.9 million in exposure); https://www.psrs-peers.org/docs/default-source/board-minutes/march-2022-special-session.pdf?sfvrsn=8856520d_1 (PSRS/PEERS external managers instructing to value Russian holdings at zero)
[174] https://stateaffairs.com/georgia/politics/georgia-state-pension-funds-150-million-russia-investment-ukraine-war/
[175] https://www.toledoblade.com/local/politics/2022/04/14/ohio-pension-holdings-value-in-russia/stories/20220414116
[176] https://www.oregonlive.com/data/2022/04/oregons-government-pension-fund-invested-millions-in-russia-how-much-is-lost.html
[177] https://nypost.com/2022/05/14/ny-pension-money-held-hostage-by-vladimir-putin-russia/
[178] https://wvmetronews.com/2022/03/08/state-investment-committee-moves-toward-divesting-from-russian-assets/
[179] https://www.inquirer.com/business/sers-pension-ukraine-divest-russia-board-20220307.html
[180] https://spectrumlocalnews.com/nc/charlotte/news/2022/03/10/dale-folwell-russian-investments-north-carolina
[181] https://virginiamercury.com/briefs/virginia-retirement-system-estimates-it-had-about-100m-in-russia-linked-investments/
[182] https://equable.org/state-of-pensions-2022/.
[183] The *Bunch* case interpreted fiduciary standards for ERISA trustees, and cited to *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir. 1984) for authority. *Katsaros* makes clear that the duty to investigate is simply based on the standard of prudence, which is "measured according to the objective 'prudent person' standard developed in the common law of trusts," and as discussed above, state fiduciary duties typically are based on the common law of trusts.
In addition, although ERISA standards do not directly apply to state pension plans, state courts may look to ERISA and applicable case law for guidance. *See, e.g.*, *Bd. of Trustees of Vill. of Barrington Police Pension Fund v. Dep't of Ins.*, 570 N.E.2d 622, 626 (Ill. Ct. App. 1991); *cf. MacKenzie v. Reg'l Principals Ass'n*, 377 N.J. Super. 252, 265, 872 A.2d 150, 158 (Ch. Div. 2004) ("Trustees [of a church plan] should be permitted to obtain guidance from decisions under ERISA, even though ERISA's disclosure requirements do not apply to a 'church plan.'").
State cases also discuss the duty to investigate, though the issue has typically arisen in the context of pension funds suing those who sold securities. *See In re Bear Stearns Mortg. Pass-Through Certificates Litig.*, 851 F. Supp. 2d 746, 762-63 (S.D.N.Y. 2012) (potential retirement system plaintiffs have a "duty to investigate" when they have information sufficient to plead securities fraud violations with enough "'detail and particularity to survive a 12(b)(6) motion to dismiss'" (quoting *City of Pontiac Gen. Emps. Ret. Sys. v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011)). *See also Krolikowski v. San Diego City Employees' Ret. Sys.*, 24 Cal. App. 5th 537, 562 (2018) (when a party becomes

advisors must "conduct a reasonable investigation into the investment sufficient not to base its advice on materially inaccurate or incomplete information," or risk an SEC enforcement action.[184]

As explained below, fiduciaries cannot fully carry out their duty to investigate with regard to China-based companies, due to the uncertainties regarding the risks above and four other primary reasons: (1) the CCP has cracked down on firms providing due diligence, and financial audits have been found to be unreliable; (2) the CCP interferes with Chinese stock and bond markets; (3) the CCP exerts control over China-based companies; and (4) the CCP keeps most China-based investments in a state of legal uncertainty, as these investments use a high-risk shell-company structure that has few safeguards and relies on the CCP choosing to look the other way on Chinese law.

a. Fiduciaries Cannot Properly Investigate China-Based Investments, Because the CCP Has Punished Companies for Engaging in Due Diligence, and Audits Are Unreliable

Financial reports from China-based companies cannot be verified according to accepted financial standards. China punishes firms for engaging in due diligence on Chinese companies, and available evidence indicates China-based companies' accounting standards are severely deficient.

China attempts to prevent firms from performing due diligence on China-based companies, and has made examples of those who violate this principle.[185] In 2023, China took action against several firms attempting to perform due diligence on China-based companies, including shutting down one firm's Beijing office and detaining all of its Chinese employees.[186] China subsequently fined that firm $1.5 million for conducting "foreign-related statistical investigations" without approval from the CCP.[187] This year, China increased the fine to $2.2 million.[188] China also has frozen assets of an offshore firm that specializes in identifying the risk of Chinese companies being penalized for forced labor violations, and prohibited Chinese

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"aware of facts which would make a reasonably prudent person suspicious" it is under "'a duty to investigate further, and [is] charged with knowledge of matters which would have been revealed by such an investigation'" (quoting *Miller v. Bechtel Corp*. 33 Cal.3d 868, 875 (1983))).

184 https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf Although this guidance applies to investment advisers, it also has applicability to public and private fiduciaries who are not simply recommending investments, but are actually deciding how trustees' money will be invested and, in doing so, must comply with applicable laws and regulations. *See, e.g.*, Restatement (Third) of Trusts Vol. 3, § 76 (2007) (describing the fiduciary duty of obedience as a part of the duty of care and loyalty that requires trustees to "administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law");
Chavis v. Plumbers & Steamfitters Loc. 486 Pension Plan, 612 F. Supp. 3d 516, 558 (D. Md. 2020) (ERISA plan fiduciary must "administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law") (quoting Restatement (Third) Trusts § 76(A)).

185 https://harris-sliwoski.com/chinalawblog/due-diligence-in-china-just-got-a-lot-harder-now-what/; https://www.nytimes.com/2023/03/24/business/china-business-company-raid.html; https://www.wsj.com/articles/chinese-authorities-question-bain-staff-in-shanghai-e0bbf2fb?mod=article_inline

186 https://harris-sliwoski.com/chinalawblog/due-diligence-in-china-just-got-a-lot-harder-now-what/; https://www.nytimes.com/2023/03/24/business/china-business-company-raid.html; https://www.wsj.com/articles/chinese-authorities-question-bain-staff-in-shanghai-e0bbf2fb?mod=article_inline

187 https://www.cnn.com/2023/08/22/economy/china-mintz-consulting-fine-intl-hnk/index.html

188 https://www.wsj.com/world/china/china-raises-fines-on-mintz-due-diligence-firm-c7486aeb

companies from interacting with the firm.[189] The crackdowns have led other research firms to reduce their presence in China or exit completely.[190]

On-the-ground due diligence previously has helped uncover false financial information from Chinese companies, such as when a Shanghai-based due diligence firm found discrepancies between Luckin Coffee's reported figures and its actual customer traffic and sales, and Luckin Coffee later admitted that over $300 million in reported sales had been faked.[191] As one analysis noted, Luckin's fraud may have been aided by the VIE structure, which "increases the opaqueness of financial reporting."[192] In this light, the CCP's crackdown on due diligence firms suggests that the CCP may be trying to shape foreign perception and stem the tide of foreign outflows either by concealing inflated financial numbers or creating an environment for China-based companies to inflate those numbers. Indeed, business executives who have had discussion with Chinese authorities reported earlier this year that the CCP is trying to "limit the information collected by foreign companies such as auditors, management consultants and law firms that could influence how the outside world views China."[193]

Fiduciaries cannot properly investigate Chinese investments when the CCP is actively working to stifle the flow of information and intimidate companies trying to assess the actual risks of an investment.

The lack of due diligence also is especially damaging in light of the lack of reliable audited financials of China-based companies. Initial investigations by the U.S. Public Company Accounting Oversight Board (PCAOB) revealed rampant errors in the audits of Chinese companies that it reviewed, finding "unacceptable" levels of deficiencies in *seven out of eight* audits by major accounting firms in China,[194] resulting in millions of dollars in penalties.[195] Those errors have serious consequences, as evidenced by the fact that PwC China now is facing a potential six-month ban for its auditing of Evergrande.[196] Before it resigned as auditor in January 2023, PwC China approved Evergrande's financials for 15 years[197]—only for the company to default under the weight of $300 billion in debt, raising serious accounting questions.[198] These data points demonstrate that auditing within the Chinese market is woefully insufficient.

Fiduciaries cannot fulfill their duty to investigate China-based companies when the audits supporting those companies' financials appear to be inaccurate and unreliable. Investment decisions should be based on accurate financials, not on guesswork based on manipulated financials. Investments based on the latter do not meet the fiduciary duty to "employ the

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[189] https://harris-sliwoski.com/chinalawblog/due-diligence-in-china-just-got-a-lot-harder-now-what/
[190] https://www.ft.com/content/dff10673-f3e3-4117-8a71-cb57a9cc4ccb
[191] https://www.wsj.com/articles/coffees-for-closers-how-a-short-sellers-warning-helped-take-down-luckin-coffee-11593423002
[192] https://ai-analytics.wharton.upenn.edu/wp-content/uploads/2022/02/Luckin_Case_Study.pdf (p. 5-6)
[193] https://www.wsj.com/world/china/china-raises-fines-on-mintz-due-diligence-firm-c7486aeb
[194] https://www.wsj.com/articles/audits-of-chinese-companies-are-highly-deficient-u-s-regulator-says-2da99766
[195] https://pcaobus.org/news-events/news-releases/news-release-detail/fact-sheet-pcaob-imposes-historic-sanctions-on-china-based-audit-firms
[196] https://www.dmnews.com/potential-business-ban-for-pwc-china-amidst-evergrande-audit-controversy/
[197] https://www.wsj.com/finance/regulation/china-has-another-firm-in-its-crosshairs-over-its-epic-property-bust-pwc-f0516f47
[198] https://www.nytimes.com/2023/12/05/business/china-evergrande-default-debt.html

appropriate methods to investigate the merits of the investment." *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 10 n.9 (1st Cir. 2009).

Although the PCAOB finally obtained the ability to investigate certain auditors in 2022, after it had threatened to de-list companies, its authority only extends to auditors who audited *U.S.-listed* China-based companies.[199] Indeed, shortly after the PCAOB deal was announced, reports emerged that the CCP was "urg[ing] state-owned firms to phase out using the four biggest international accounting firms," and instead switch to "local Chinese or Hong Kong accountants when contracts come up" with the "Big Four auditing firms."[200]

b. Fiduciaries Cannot Properly Investigate China-Based Investments, Because the CCP Interferes with Its Stock and Bond Markets

The CCP has frequently interfered with its stock markets, and those efforts have intensified recently in an apparent attempt to staunch the severe outflow of foreign capital.

In 2015, when stocks slid, Chinese authorities took similar actions to bar shareholders from selling, but also suspended trading on many stocks, banned short selling, and instructed state-owned enterprises to buy stocks to prop up the market.[201] Actions like these worried foreign investors and likely helped keep MSCI from including China-based stocks traded on Chinese stock markets (also known as A-shares) in its indexes for years, despite CCP pressure.[202] Concerns included "widespread voluntary stock suspensions" and "pre-approval restrictions on launching financial products."[203] In 2018, however, "after considerable arm-twisting from Beijing," MSCI added A-shares and continued to expand the number of A-shares for several years.[204] MSCI justified this expansion by continued Chinese reforms and the CCP "addressing investor concerns."[205]

However, faced with foreign investors fleeing China-based investments and a sustained slide in stocks, the CCP has returned to its patterns of stock market manipulation. Late last year, the Beijing Stock Exchange reportedly once again prevented major shareholders from selling stock, in order to bump up prices of stocks on the exchange.[206] The CCP also has recently concealed market trading data from investors and reportedly has privately ordered "some domestic financial institutions not to be net sellers of stocks on certain days."[207] These resemble the activities that previously helped prevent China-based investments from being included in MSCI indexes, and should lead a prudent fiduciary to avoid such indexes.

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[199] *See* https://pcaobus.org/oversight/international ("PCAOB oversight extends to non-U.S. firms *that audit or play a substantial role in the audit of U.S. issuers and broker-dealers*." (emphasis added))
[200] https://www.insurancejournal.com/news/international/2023/02/23/709183.htm
[201] https://www.frbsf.org/research-and-insights/blog/sf-fed-blog/2017/06/23/china-msci-emerging-market-stock-index/
[202] https://www.frbsf.org/research-and-insights/blog/sf-fed-blog/2017/06/23/china-msci-emerging-market-stock-index/
[203] https://www.msci.com/www/blog-posts/the-world-comes-to-china/01002067599
[204] https://democrats-financialservices.house.gov/uploadedfiles/hhrg-117-ba16-wstate-chuc-20211026.pdf
[205] https://www.msci.com/www/blog-posts/china-a-shares-what-have-we/02164045217 ; https://www.msci.com/www/blog-posts/the-world-comes-to-china/01002067599
[206] https://www.reuters.com/world/china/beijing-stock-exchange-tells-major-shareholders-refrain-selling-sources-2023-11-27/
[207] https://www.ft.com/content/6e7a4129-d365-4905-8d9b-cc3f5ada5187

The CCP's steps appear to be designed to conceal and stem the massive outflows of capital from Chinese markets, as China suffered a net outflow of nearly $15 billion in the second quarter of this year alone, and China is on pace to have net annual outflows for the first time on record.[208] It remains to be seen what additional actions the CCP may take as the situation worsens.

Bonds face similar issues—China's state-owned credit rating agencies provide glowing ratings of nearly all China-based bonds.[209]

Indeed, the Chinese government's level of interference in the economy means the country does not have a market economy. In 2017, the U.S. Department of Commerce concluded that China was a "non-market economy" because the CCP's "role in the economy and its relationship with markets and the private sector results in fundamental distortions" that "permeate throughout China's financial sector" and China's economy.[210] These fundamental distortions make it difficult, if not impossible, for an American fiduciary to assess the true financial state of affairs, which likely differs substantially from what is shown in stock and bond markets.

Fiduciaries cannot fulfill their duty to investigate the value of China-based stocks when the CCP manipulates those values and the markets on which those stocks trade. Fiduciaries must invest based on financial risk and return, but fiduciaries cannot tell whether a China-based company's cash flow is generated based upon financial performance or based upon the usefulness of the company for the government to achieve military objectives. This makes it essentially impossible for fiduciaries to accurately assess the risk-return profile of the investment.

c. Fiduciaries Cannot Properly Investigate China-Based Investments, Because the CCP Exerts Control over China-Based Companies

Under Chinese law, large companies must have CCP cells embedded in their company, raising further concerns about CCP interference.[211] In addition, all China-based companies are subject to Article 7 of China's National Intelligence Law of 2017, which states that "any organization … shall support, assist, and cooperate with state intelligence work according to law."[212] There is also a recent trend of the CCP establishing People's Armed Forces Department militia units in corporations, embedding the Chinese military within those companies and increasing the CCP's ability to exert corporate control.[213]

The CCP also has increasingly flexed its muscles to force China-based companies to make significant changes, costing foreign investors billions. For example, ride-hailing app Didi completed a $4.4 billion NYSE IPO in 2021, only for the CCP to announce a "cybersecurity review" of the company days later,[214] based on the company's apparent failure to get the CCP's

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[208] https://www.bloomberg.com/news/articles/2024-08-12/foreign-investors-are-pulling-record-amount-of-money-from-china
[209] https://www.reuters.com/business/autos-transportation/eu-report-details-widespread-chinese-interference-economy-2024-07-03/
[210] https://enforcement.trade.gov/download/prc-nme-status/prc-nme-review-final-103017.pdf (p. 4, 7)
[211] https://www.cnbc.com/2023/07/12/communist-cells-influence-companies-in-china-fbi-director.html; https://www.pamirlaw.com/articles/preparing-for-new-requirements-for-communist-party-of-china-cells-inside-your-private-company/
[212] https://thediplomat.com/2019/02/the-real-danger-of-chinas-national-intelligence-law/
[213] https://jamestown.org/program/chinas-peoples-armed-forces-departments-developments-under-xi-jinping
[214] https://www.cnbc.com/2021/07/02/didi-shares-fall-after-china-announces-cybersecurity-review.html

blessing before conducting the IPO.[215] The company's app was removed from Chinese app stores, and later in the year, the company delisted from the NYSE.[216] By May 2022, the SEC had also announced an investigation and Didi's stock had lost 85% of its value.[217] In 2024, a U.S. district court judge allowed a lawsuit to advance that alleged that Didi had known about an impending crackdown by the CCP, and had concealed that information from investors.[218]

China has meddled with other companies as well. In recent years, China has "mandated that several publicly traded education companies change their status to nonprofit organizations."[219] And in 2023 alone, "at least 11 listed Chinese companies have been forced to put out disclosures … alerting investors to the disappearance of executives or board members," some of whom the government later confirmed to have detained and others whose disappearances remain unexplained.[220] China's interfering actions have led to an increase in lawsuits, such as a series of 2023 securities class actions related to companies that allegedly failed to describe risks of CCP crackdowns on their companies or industries.[221]

Fiduciaries cannot fulfill their duty to investigate China-based companies when the CCP is actively manipulating companies, embedding its political, intelligence, and military agents within companies, shutting down major companies, and making company executives abruptly disappear.

d. Fiduciaries Cannot Properly Investigate China-Based Investments, Because the CCP Keeps the Primary Method of Investment for American Investors in a State of Legal Uncertainty

Most China-based investments use a high-risk shell-company structure that has few safeguards and relies on the CCP not enforcing Chinese law. Investors in these shell companies also do not own any equity in the underlying company, and thus lack even basic legal protections of shareholders.

Under Chinese law, foreign ownership of China-based companies is prohibited for over 100 industries.[222] In contrast, even Russia has laws generally giving foreign investors rights equal to Russian investors.[223] To work around these clear prohibitions, China-based companies have created VIE structures, in which a shell company incorporates outside of China (typically in the Cayman Islands),[224] enters into contracts with a Chinese VIE company allowing the shell

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[215] *See* https://www.npr.org/2021/12/03/1061219965/a-top-chinese-tech-company-delists-from-the-nyse-just-months-after-its-ipo
[216] https://www.npr.org/2021/12/03/1061219965/a-top-chinese-tech-company-delists-from-the-nyse-just-months-after-its-ipo
[217] https://www.cnbc.com/2022/05/04/chinese-ride-hailing-giant-didi-investigated-by-sec-after-us-ipo.html
[218] *In re Didi Glob. Inc. Sec. Litig.*, No. 21-CV-05807 (LAK), 2024 WL 1119483 (S.D.N.Y. Mar. 14, 2024).
[219] https://www.morningstar.com/funds/chinas-market-risks-are-nothing-new
[220] https://www.economist.com/business/2023/12/07/the-case-of-chinas-vanishing-chairmen
[221] https://www.dandodiary.com/2023/06/articles/securities-litigation/chinese-regulators-crack-down-securities-suits-follow/
[222] *See, e.g.*, https://www.state.gov/reports/2023-investment-climate-statements/china/
[223] https://www.state.gov/reports/2020-investment-climate-statements/russia (note that "some industries have limits on foreign ownership")
[224] *See, e.g.*, https://globalcapitalallocation.s3.us-east-2.amazonaws.com/CCDMS_Draft.pdf

company to receive profits, and then sells shares of equity in the shell company to American investors.[225]

As the SEC has stressed to investors, "***The Chinese government has never approved these structures.***"[226] In fact, under Chinese law, a contract is invalid if "there is an attempt to conceal illegal goals under the disguise of legitimate forms."[227] This provision was relied on by the Supreme People's Court (China's top legal body) in 2013 to invalidate contracts that a Hong Kong company had used to indirectly get a holding in a new bank that would have been impossible to obtain directly. The Hong Kong company had paid $11 million for the shares, and the shares were worth $700 million, but the court ruled that the contracts to purchase the shares were invalid because they were "concealing illegal intentions with a lawful form."[228] Shanghai's arbitration board has issued similar rulings, finding that VIEs or similar structures were "concealing illegal intentions with a lawful form."[229]

However, the CCP has deliberately refused to confirm that VIE structures are illegal. Scholars have observed that this policy of ambiguity may be intentional, as it allows the CCP to "reap the economic benefits of foreign investment without bearing the downsides of sacrificing sovereignty in return."[230] The ambiguity also puts pressure on companies using VIE structures, as a study found that companies with VIEs were more responsive to CCP whims, suggesting that the ability of the "Chinese government to dissolve VIEs at will … helps to ensure that managerial behavior conforms to government priorities."[231]

Although the Chinese government benefits from this arrangement, VIEs "have always entailed massive regulatory, legal, and tax risks for their foreign investors,"[232] in three primary forms.

First, investors face risk from **legal uncertainty**. Given that China has laws on the books that appear to prevent VIE structures, as the SEC bluntly put it, the CCP "***could determine at any time and without notice that the underlying contractual arrangements on which control of the VIE is based violate Chinese law.***"[233] In other words, the CCP "preserve[s] the force to dissolve certain VIE usage at will."[234] If VIE structures are invalidated, "there is little likelihood that

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[225] https://www.sec.gov/newsroom/speeches-statements/gensler-2021-07-30
[226] https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/investor-bulletin-us-listed-companies-operating-chinese-businesses-through-vie-structure (emphasis in original)
[227] Contract Law of the People's Republic of China, Chapter III, Article 52, Section 3, http://www.npc.gov.cn/zgrdw/englishnpc/Law/2007-12/11/content_1383564.htm
[228] https://archive.nytimes.com/dealbook.nytimes.com/2013/06/02/in-china-concern-of-a-chill-on-foreign-investments/ Notably, the ruling came over a decade after the case was first appealed to the court. *Id.*
[229] https://archive.nytimes.com/dealbook.nytimes.com/2013/06/02/in-china-concern-of-a-chill-on-foreign-investments/
[230] https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229
[231] Justin Hopkins, Mark Lang and Donny Zhao, 'The Rise of US-Listed VIEs from China: Balancing State Control and Access to Foreign Capital' (2018) Darden Business School Working Paper No 3119912, 9–10 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3119912
[232] https://www.econstor.eu/bitstream/10419/264203/1/1800375948.pdf; https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229 (noting that the "legal uncertainties of the VIE structure may cause huge risks to foreign investors")
[233] https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/investor-bulletin-us-listed-companies-operating-chinese-businesses-through-vie-structure
[234] https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229

Chinese authorities would grant reasonable compensation," and it is "unlikely" that investors could get any recourse.[235]

Second, investors face risks from **company executives**. Investors own shares of the shell company, *not* any equity interest in the actual company. If the shell company folds, investors could be left with nothing while the company persists. China-based companies also have shown little willingness to actually pay dividends to the VIE.[236] Investors have little to no recourse to enforce VIE contracts, given that most VIEs incorporate in the Cayman Islands—the Cayman Islands give "investors much less protection than Delaware," and "[n]either U.S. nor Cayman court judgments can be enforced in China."[237] For example, when American shareholders took over the board of ChinaCast's U.S. shell company, the company's executives withdrew cash and transferred the company's interests to a third party, leaving U.S. holders with nothing.[238] The SEC has expressed its concern over these issues and demanded detailed disclosures to investors, noting that if VIE company executives breach contracts, "***U.S. investors may suffer significant losses with little or no recourse available***."[239]

Third, investors face risks from the **VIE structure**. Investors like Yahoo that invest in shell companies related to Alibaba do not own a share of Alibaba. They merely own a share of a shell company that has contracts with Alibaba, and do not have basic legal protections that typically accompany ownership of a company's shares. This makes these investments inherently imprudent. Stocks typically carry a risk of loss that corresponds with the companies' risk—if a company collapses, the stocks do as well. But a holding company only holds contracts with the actual company, and if the VIE structure collapses, the company can keep all of its assets, adding a unique risk to these investments.

Despite these known risks, the vast majority of foreign investment related to China-based companies exists under a VIE structure. Over 90% of the total market capitalization of China-based firms on the U.S. market is in companies using VIE structures.[240] Investors have pumped hundreds of billions into VIE-structured companies,[241] despite the fact that these stocks are only shares in shell companies with massive risks. Fiduciaries cannot fulfill their duty to investigate these investments when the CCP deliberately maintains a legal ambiguity that allows it to completely devalue VIE investments at any time.

e. VIE Case Study: Alipay

One case study illustrating the risks inherent in Chinese VIEs and China-based investments, both from company executives and from the Chinese government, is Alipay.

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235 https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229

236 https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229#abstract (noting that "foreign capital is injected into the operating entity, but the reverse capital flow is rarely conducted," and citing China's third-largest e-commerce company declaring that it did not intend to provide dividends to investors "in the foreseeable future")

237 https://corpgov.law.harvard.edu/2020/06/09/delisting-chinese-firms-a-cure-likely-worse-than-the-disease/

238 https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229#d1e744 ; https://archive.nytimes.com/dealbook.nytimes.com/2014/05/06/i-p-o-revives-debate-over-a-chinese-structure/ ; https://ww3.lawschool.cornell.edu/research/ILJ/upload/Guo-final.pdf

239 https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229#abstract

240 https://www.uscc.gov/sites/default/files/2024-01/Chinese_Companies_Listed_on_US_Stock_Exchanges_01_2024.pdf

241 https://www.uscc.gov/sites/default/files/2024-01/Chinese_Companies_Listed_on_US_Stock_Exchanges_01_2024.pdf

In 2005, Yahoo paid $1 billion for a 40% stake in a VIE for shopping marketplace Alibaba (a stake often incorrectly described as a 40% stake of Alibaba itself).[242] A key piece of the valuation was Alibaba's "Alipay" payment system.[243] After Yahoo's purchase, the value of Alipay continued to grow. In 2011, Alibaba and VIE executive Jack Ma (without Yahoo's knowledge or consent) "unilaterally transferred 100% ownership of Alipay into a different company controlled solely by himself," without even informing Yahoo or Softbank, which collectively held 70% of the Alibaba VIE structure.[244] After Yahoo protested, Ma brazenly defended the move as "100 percent legal and 100 percent transparent."[245]

With little legal recourse, Yahoo ultimately settled for a conditional payment of up to $6 billion if Alipay goes public.[246] This was immediately recognized as Yahoo getting "the short end of the stick."[247] Indeed, though Alipay (now Ant Group) has had fluctuating valuations, it tends to be valued in the hundreds of billions of dollars, meaning Yahoo was given pennies on the dollar for its investment.[248]

In October 2020, Ant Group attempted to launch an IPO on the NYSE to raise over $34 billion at a valuation of over $313 billion, which would have been the biggest IPO of all time.[249] The IPO would have resulted in Yahoo receiving $6 billion, despite the fact that a 40% share of Ant Group would be worth over $125 billion. However, the CCP intervened, and reports state that Chinese President Xi Jinping personally halted the IPO after hearing that Ma had criticized the government.[250] After a meeting with the CCP about the issue, Ma disappeared for several months,[251] and subsequently was rarely seen for several years.[252]

In 2023, Ant Group announced that Ma's share of the company would change from over 50% to under 7%.[253] After this maneuver was completed, there was speculation that the company could attempt to move forward with an IPO once again.[254] Instead, Ant Group attempted a stock buyback under which it was revalued at $79 billion, hundreds of billions less than it had been at the time of the IPO.[255] Ant Group also had to pay a penalty of nearly $1 billion in fines from the

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[242] https://www.gsb.stanford.edu/insights/jack-ma-chinas-alibaba-wants-acquire-yahoo ; https://hbr.org/2014/08/an-insiders-account-of-the-yahoo-alibaba-deal; https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229#d1e744

[243] https://hbr.org/2014/08/an-insiders-account-of-the-yahoo-alibaba-deal (When Yahoo purchased its stake in Alibaba, "More than half the value of the venture — more than $2 billion — was attributed to Taobao [a consumer-to-consumer marketplace] and Alipay.")

[244] https://gci-investors.com/chinese-vie-structure-wall-street-continues-to-ignore-the-risks/ ; https://www.bloomberg.com/news/articles/2011-05-12/yahoo-notified-by-alibaba-of-alipay-reorganization-on-march-31 ; https://www.tandfonline.com/doi/full/10.1080/10192557.2021.1995229#d1e744

[245] *See* https://www.forbes.com/sites/gadyepstein/2011/05/16/yahoo-alibaba-spat-over-alipay-jack-ma-needs-to-say-more/

[246] https://www.ft.com/content/40a66dd2-b9ec-11e0-8171-00144feabdc0

[247] https://www.reuters.com/article/technology/yahoo-gets-short-end-of-stick-in-alibaba-deal-idUSTRE76S2QN/

[248] https://gci-investors.com/chinese-vie-structure-wall-street-continues-to-ignore-the-risks/

[249] https://www.cnbc.com/2020/10/26/ant-group-to-raise-tktk-billion-in-biggest-ipo-of-all-time.html

[250] https://www.wsj.com/articles/china-president-xi-jinping-halted-jack-ma-ant-ipo-11605203556

[251] https://www.bbc.com/news/technology-56448688

[252] https://www.bbc.com/news/world-asia-china-65084344

[253] https://www.cnn.com/2023/01/07/intl_business/jack-ma-ant-group-restructuring-intl-hnk/index.html

[254] https://www.scmp.com/tech/big-tech/article/3246806/chinese-fintech-giant-ant-group-gets-approval-no-controller-status-ending-jack-mas-reign-seeking-ipo

[255] https://www.bloomberg.com/news/articles/2024-02-07/jack-ma-backed-ant-s-profit-fell-more-than-90

CCP, and earlier this year reported that its quarterly profit had fallen 92%.[256] One commentator observed that the CCP viewed Ant Group as "too big to fail in the eyes of the party-state, but not too big to be cut down to size."[257]

Alipay thus illustrates the inability of fiduciaries to properly investigate an investment. Yahoo invested a billion dollars into an Alibaba VIE structure based in large part on its valuation of Alipay. When Alipay increased in value, Jack Ma spun the asset off without notice and without recourse, ultimately forcing Yahoo to accept a lowball offer that would trigger in the event of an IPO. But just when that IPO was about to take place, the CCP halted the IPO without notice and without recourse. Despite Yahoo's best attempts to investigate the investment, the investment was devalued and manipulated on two separate occasions, and Yahoo lacked recourse. Even the biggest investors simply do not have basic legal protections when it comes to China-based investments.

IV. All Types of China-Based Securities and Bonds Possess These Risks

China-based investments come in a variety of forms and are included in a variety of ETFs, as discussed below. Regardless of their form, all types of China-based investments are subject to the risks noted above and a similar analysis should occur regarding divestment. Several types of China-based investments are discussed below, though this list is not exhaustive.[258]

a. A-shares

Chinese A-shares are actual shares of China-incorporated companies that are denominated in Chinese currency (renminbi) and traded only on Chinese exchanges.[259] Chinese A-shares **cannot** be purchased directly by foreign investors, except for specified licensed institutional investors.

As noted above, MSCI included A-shares in its indexes for the first time in 2018, after "arm-twisting" by the CCP.[260] But MSCI recently announced it was removing many Chinese stocks from its emerging market indexes, and dropped over 50 Chinese stocks from its indexes for the third time this year.[261] These removals likely are driven in part by Chinese market manipulation and in part the massive losses in value in Chinese securities over the past several years. To take one example, the MSCI China index has lost about half of its value since its peak in early 2021.[262]

Due to MSCI's inclusion of Chinese A-shares in its indexes, state pension funds and other fiduciaries with investments mapped onto these MSCI benchmarks (such as ETFs that use

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[256] https://www.bloomberg.com/news/articles/2024-02-07/jack-ma-backed-ant-s-profit-fell-more-than-90
[257] https://jamestown.org/program/ant-group-expands-overseas-but-still-hampered-by-the-state/
[258] Other types of China-related investments include P-chips, red chips, S-chips, and N-shares, but each of these relate to companies that are not incorporated in China. https://www.lseg.com/content/dam/ftse-russell/en_us/documents/policy-documents/guide-to-chinese-share-classes.pdf VIEs also are not incorporated in China but are discussed below.
[259] https://www.lseg.com/content/dam/ftse-russell/en_us/documents/policy-documents/guide-to-chinese-share-classes.pdf (guide to various types of shares)
[260] https://democrats-financialservices.house.gov/uploadedfiles/hhrg-117-ba16-wstate-chuc-20211026.pdf
[261] https://www.bloomberg.com/news/articles/2024-08-13/msci-trims-china-s-index-presence-by-removing-dozens-of-stocks
[262] https://www.investing.com/indices/msci-china

MSCI's emerging market or world indexes) are holding Chinese A-shares.[263] For example, the iShares MSCI ACWI ex U.S. ETF includes "Kweichow Moutai Ltd A" shares that are listed on the Shanghai stock exchange, as well as dozens of other A-share holdings.[264]

Other ETFs are exclusively focused on A-shares. In fact, Florida's FY 2022-23 annual report listed nearly $200 million invested in a "BlackRock China A Shares" fund.[265]

For ETF holdings using an MSCI index that includes A-shares, state pensions and other fiduciaries can simply switch to the "ex China" or "ex China ex Hong Kong" version of those funds, where available, such as the MSCI ACWI IMI ex USA ex China ex Hong Kong index, which the Federal Thrift Savings Plan recently began to use.[266]

b. B-shares

B-shares are similar to A-shares, as they are shares of China-incorporated companies listed on Chinese markets, but with two differences: (1) B-shares are traded in U.S. or Hong Kong dollars, and (2) B-shares can be purchased directly by foreign investors (not just qualified institutions). However, because B-shares are traded only on Chinese markets subject to manipulation and are of companies that have no U.S. oversight of their auditors, B-shares share the same structural issues as A-shares.

Some MSCI indexes include China B-shares, as do corresponding ETFs.[267] For example, the BlackRock's iShares MSCI ACWI ETF includes "Inner Mongolia Yitai Coal Ltd B" and "Shanghai Baosight Software Ltd B" shares, which are listed on the Shanghai stock exchange.[268] South Carolina's largest global public equity ETF holdings in FY 2022-23 were in BlackRock and State Street MSCI ACWI funds including B-shares like these.[269]

For ETF holdings using an MSCI index that includes B-shares, state pensions and other fiduciaries can simply switch to the "ex China" or "ex China ex Hong Kong" version of those funds.

c. H-shares

H-shares of China-based companies are traded in Hong Kong dollars, and traded on Hong Kong exchanges. Given China's increasing assertion of control over Hong Kong,[270] the Hong Kong markets may be subject to CCP manipulation as well. Indeed, the Hong Kong market has

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263 Full MSCI indexes are not publicly available, but index funds that follow the MSCI indexes do have publicly available holdings. This memo relies on the latter.
264 https://www.ishares.com/us/products/239594/ishares-msci-acwi-ex-us-etf/1467271812596.ajax?fileType=csv&fileName=ACWX_holdings&dataType=fund (showing holdings for an example MSCI ACWI ex-U.S. fund)
265 https://frs.fl.gov/forms/2022-23_ACFR.pdf#page=128
266 https://www.pionline.com/investing/federal-thrift-board-excludes-china-following-years-debate
267 https://www.msci.com/documents/10199/aa99c3a4-d48b-44ac-8caa-49522caa9021 (noting that the MSCI China index "captures China A shares, H shares, B shares" and others); https://www.blackrock.com/us/individual/products/239600/ishares-msci-acwi-etf/1464253357814.ajax?fileType=csv&fileName=ACWI_holdings&dataType=fund (showing holdings for an example MSCI ACWI fund)
268 https://www.blackrock.com/us/individual/products/239600/ishares-msci-acwi-etf/1464253357814.ajax?fileType=csv&fileName=ACWI_holdings&dataType=fund (showing holdings for an example MSCI ACWI fund)
269 https://www.peba.sc.gov/sites/default/files/acfr_2023.pdf#page=119
270 *See, e.g.*, https://www.bbc.com/news/world-asia-china-52765838

experienced similar declines to Chinese exchanges over the last several years, with all three markets showing significant declines since 2021.[271]

Some MSCI indexes include China H-shares, as do corresponding ETFs. For example, the iShares MSCI Emerging Markets ETF includes "China Construction Bank Corp H" shares as a top-10 holding.[272] As of FY 2022-23, North Dakota had tens of millions of dollars invested in a State Street MSCI Emerging Markets China fund.[273]

Fiduciaries can switch to the "ex China" or "ex China ex Hong Kong" version of ETFs, much like the Federal Thrift Savings Plan recently did.[274] For example, North Dakota holds both an "ex China" emerging markets fund, and an emerging markets fund that includes China, so it could shift its assets solely to the "ex China" fund.[275]

d. Variable Interest Entity Structures (VIEs)

The extensive issues with VIE structures are discussed above in sections III.d and III.e. The fiduciary duties to investigate investments, and to monitor and divest from imprudent investments, indicate fiduciaries should divest from Chinese VIEs within a reasonable time, such as by using an "ex China" fund.

Some fiduciaries, including states, hold VIE-structured shares directly—for example, Wisconsin owns shares in Alibaba's holding companies.[276] Other fiduciaries own ETFs that contain shares in shell companies connected to VIE structures, such as Kentucky, which as of FY 2022-23, had heavily invested in shares in BlackRock ACWI ex-U.S.,[277] and that fund has shares of the Alibaba and TenCent holding companies as some of its largest holdings.[278]

e. China-Based Bonds

China-based bonds do not have the same level of transparency as bonds located elsewhere. China's credit rating agencies are state-owned, and as a result, "By the end of 2020, 96% of Chinese bonds were rated 'AA' or better, with 38% of credit bonds carrying an 'AAA' rating," in contrast to the U.S. market, where less than 10% of firms receive the coveted 'AAA' rating.[279] Yet China-based bonds are nonetheless included on major bond indexes, such as the FTSE World Government Bond Index, JP Morgan Global Aggregate Bond Index, and the

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[271] https://finance.yahoo.com/quote/%5EHSI/ (Hong Kong index, falling by about 40% since Feb. 2021); https://finance.yahoo.com/quote/000001.SS/ (Shanghai index, falling by about 25% since Feb. 2021); https://finance.yahoo.com/quote/399107.SZ/ (Shenzen A-share index, falling by about 37% since Feb. 2021)

[272] https://www.ishares.com/us/products/239637/ishares-msci-emerging-markets-etf/1467271812596.ajax?fileType=csv&fileName=EEM_holdings&dataType=fund (showing holdings for an example MSCI Emerging Markets fund)

[273] https://www.rio.nd.gov/sites/www/files/documents/PDFs/SIB/Reports/callanpension202403.pdf#page=41 Although not the same as MSCI Emerging Markets, an MSCI Emerging Markets China fund presumably is even more invested in China.

[274] https://www.pionline.com/investing/federal-thrift-board-excludes-china-following-years-debate

[275] https://www.rio.nd.gov/sites/www/files/documents/PDFs/SIB/Reports/callanpension202403.pdf#page=41

[276] https://www.swib.state.wi.us/_files/ugd/69fc6d_58c13061587e4bb7b89144d058dcfb26.pdf (p. 5)

[277] https://www.kyret.ky.gov/Publications/Books/2023%20Annual%20Report.pdf#page=135

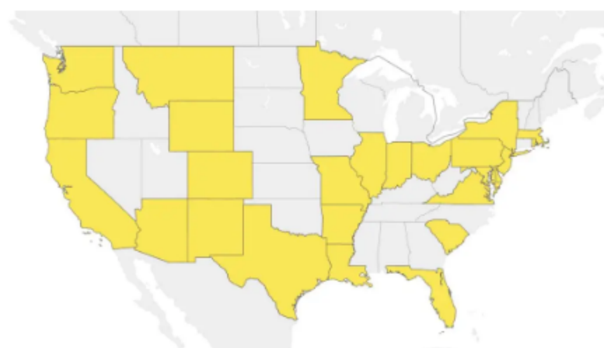
[278] https://www.blackrock.com/us/individual/products/239594/ishares-msci-acwi-ex-us-etf/1464253357814.ajax?fileType=csv&fileName=ACWX_holdings&dataType=fund

[279] https://www.reuters.com/business/autos-transportation/eu-report-details-widespread-chinese-interference-economy-2024-07-03/

Bloomberg Barclays Global Aggregate Index.[280] China-based bonds also are included in various bond ETFs—for example, Chinese government bonds make up the second-largest category of bonds in BlackRock's iShares Core International Aggregate Bond ETF, and bonds from the China Development Bank make up the seventh-largest category.[281]

V. Fiduciaries, Including Those Managing State Pensions, Continue to Hold Chinese Investments at Great Financial Risk

Fiduciaries that continue to hold Chinese investments are exposed to great financial risk. The risk to state pension systems is particularly acute as a report from Future Union indicates that U.S. public pensions have invested more than $68 billion in China and Hong Kong over the last three years.[282] Even that report acknowledges it "significantly underreports the scope and scale of the issue," due to a lack of requirements for public pensions to divulge specific information.[283] The report included the following chart, indicating that most states had at least one public pension fund investing in China as of June 2023 (and as noted below, the chart appears to be underinclusive):



*This map depicts the states with public pension responsible for investing US retirees' money that have invested in China and Hong Kong.

A January 2024 report indicated that New York and Illinois' primary retirement funds had committed a combined $5 billion to China-based investments.[284] The same report indicated that California's primary retirement systems invested over $3 *billion* in China-based or China-focused companies or funds in the prior 36 months alone.[285]

Although helpful, the chart above does not appear to incorporate at least some investments from index funds. One of the primary ways in which public pensions have become invested in China is through major asset managers' inclusion of China-based companies in index funds. The most prominent example of this issue is BlackRock, which was investigated by the

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280 https://docs.house.gov/meetings/ZS/ZS00/20230517/115974/HHRG-118-ZS00-Wstate-RobinsonR-20230517.pdf
281 https://www.ishares.com/us/products/279626/ishares-international-aggregate-bond-etf
282 https://futureunion.co/pensions/
283 https://futureunion.co/pensions/
284 https://nypost.com/wp-content/uploads/sites/2/2024/02/Future-Union_The-Rubicon-Report_Conflict-Capital-Full-Report-1-2.pdf (p. 46)
285 https://nypost.com/wp-content/uploads/sites/2/2024/02/Future-Union_The-Rubicon-Report_Conflict-Capital-Full-Report-1-2.pdf (p. 43)

U.S. House Select Committee on the Strategic Competition Between the United States and the Chinese Communist Party.[286] The report found that BlackRock invested over $1.9 billion into China-based companies "that the U.S. government had blacklisted or otherwise red-flagged because they advance the PRC's military capabilities or support the CCP's human rights abuses."[287] Other asset managers with funds based on MSCI indexes have similar issues—the same report found that MSCI indexes had channeled $3.7 billion to blacklisted or red-flagged China-based companies.[288]

These indexes have led states to hold questionable investments in China-based companies. For example, over 50% of North Carolina's long-term policy benchmark is based on the MSCI All Country World Investable Market Index.[289] That index has included multiple bad actors on U.S. government red-flag lists: Hoshine, Daqo, and GCL are implicated in the use of forced labor, and Dahua, Inspur, ZTE, and IflyTek are implicated in Uyghur surveillance.[290] North Carolina's biggest international holding appears to be a BlackRock fund that mirrors the index.[291] Similarly, Illinois is invested in multiple index funds that include China-based companies on federal government lists.[292] Wisconsin holds direct investments in many Chinese companies, including Petrochina, which is 80% owned by the CCP.[293]

VI. Potential Action by Fiduciaries

Fiduciaries, including state treasurers, could take a variety of actions to deal with this risk, including actions that some state treasurers already have taken:

1) **Divest Funds Under Control.** Fiduciaries, including state treasurers, that control investments can act to move funds away from China-based stocks and bonds. Pennsylvania Treasurer Stacy Garrity did so in 2022, thus potentially avoiding the losses in the Chinese stock markets over the past two years.

2) **Remove Imprudent Options from Investment Plans Offered to Citizens.** Fiduciaries, including state treasurers, can also remove China-based investment opportunities from investment plans offered to customers and/or state citizens. For

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[286] https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/4.18.24%20How%20Americsan%20Financial%20Institutions%20Provide%20Billions%20of%20Dollars%20to%20PRC%20Companies%20Committing%20Human%20Rights%20Abuses%20and%20Fueling%20the%20PRC's%20Military.pdf
[287] https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/4.18.24%20How%20Americsan%20Financial%20Institutions%20Provide%20Billions%20of%20Dollars%20to%20PRC%20Companies%20Committing%20Human%20Rights%20Abuses%20and%20Fueling%20the%20PRC's%20Military.pdf (p. 1)
[288] https://selectcommitteeontheccp.house.gov/sites/evo-subsites/selectcommitteeontheccp.house.gov/files/evo-media-document/4.18.24%20How%20Americsan%20Financial%20Institutions%20Provide%20Billions%20of%20Dollars%20to%20PRC%20Companies%20Committing%20Human%20Rights%20Abuses%20and%20Fueling%20the%20PRC's%20Military.pdf (p. 1)
[289] https://www.nctreasurer.com/documents/files/imdiac/investment-policy-statement-nc-retirement-systems/open
[290] https://prosperousamerica.org/explainer-preventing-state-pension-funds-and-endowments-from-funding-china/
[291] https://www.nctreasurer.com/documents/files/imdinvestmentreports/performance-and-fee-report-fiscal-year-2022-2023/open
[292] https://prosperousamerica.org/explainer-preventing-state-pension-funds-and-endowments-from-funding-china/
[293] https://www.swib.state.wi.us/_files/ugd/69fc6d_58c13061587e4bb7b89144d058dcfb26.pdf

example, 529 savings plans are designed to ensure money is available for prospective college students, and should not contain China-based investments that carry the risks above. West Virginia Treasurer Riley Moore recently moved a 529 college savings plan away from China-based investments.

3) **Educate State Pension Boards.** For state pensions managed by a board, state treasurers and others can explain the risks listed above and reasons for divestment of these high-risk assets, as Missouri State Treasurer Vivek Malek did last year.
4) **Engage with Asset Managers.** If asset managers do not offer "ex China" versions of their international funds, state treasurers and other fiduciaries could ask asset managers to offer such options, as the governors of Iowa, Mississippi, South Dakota, and Texas did last year.
5) **Obtain a Legal Opinion**. State treasurers and other fiduciaries could consider seeking a legal opinion on these issues from their respective attorneys general.

Fiduciaries that take action can avoid the risk of a catastrophic loss of value in their China-based investments similar to that which occurred for Russia-based investments just two years ago.