Dragoman Digest.

30.07.2021

Stronger supervision of Chinese companies using grey area investment vehicles likely

New rules target Chinese private education companies using variable interest entity (VIE) structures

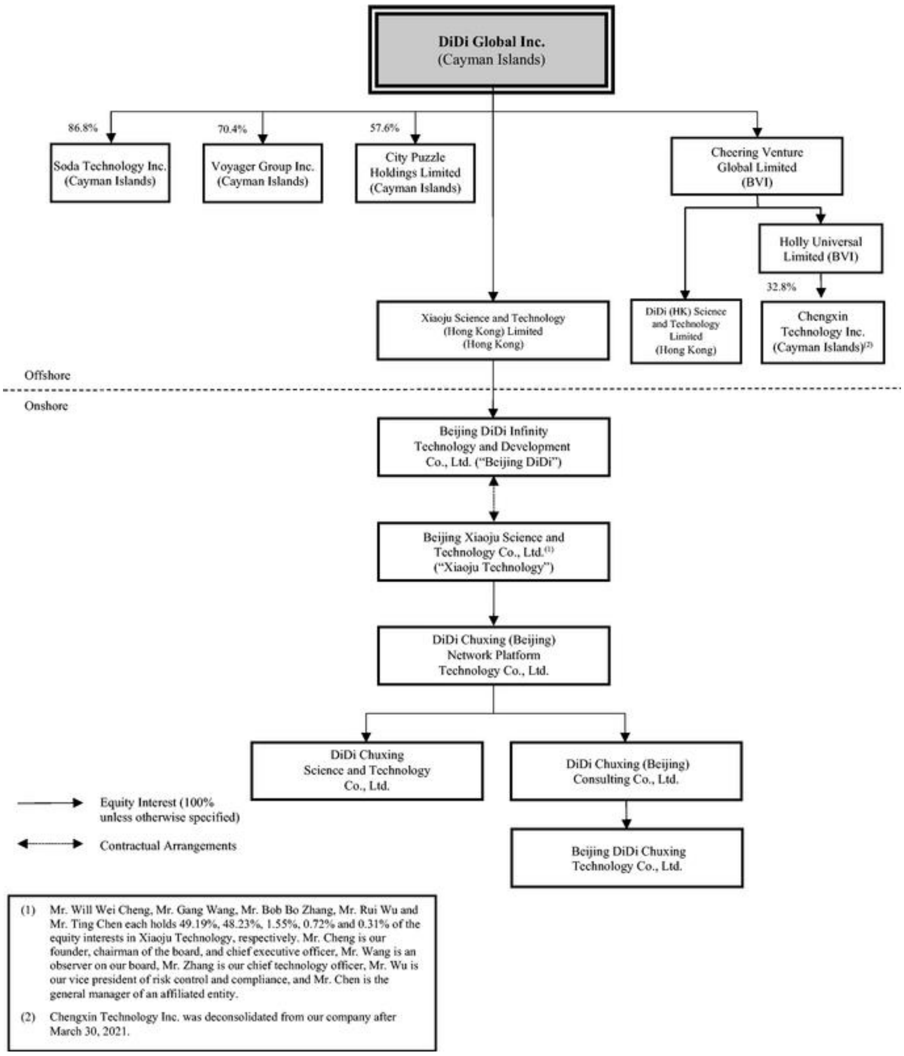
China's crackdown on the education sector may portend greater oversight of listed Chinese companies using VIE arrangements, with the potential to weaken a key means by which foreign capital has invested across many Chinese industries. The new reforms include explicit restrictions on companies in the education sector from using a VIE structure. VIEs have been used to skirt regulations prohibiting foreign ownership of Chinese companies in telecommunications, education, and other sensitive sectors, enabling Chinese companies to access foreign capital. As of June 30 this year, as many as 36 Chinese companies had raised a total of US$12.59 billion in **US** markets.

The legality of VIEs is tenuous as the structure appears to blatantly breach laws prohibiting foreign investment. Investors could face substantial financial risk if Chinese regulatory bodies ruled that VIEs were illegal or the relevant contractual agreements invalid. VIEs mimic direct ownership through a series of contracts (see Didi Global Inc. corporate structure below). The listed company, a shell company with no operations, only holds value because of the contractual obligation of the actual, physical Chinese company to pay returns to it. Investors typically have no recourse to enforce these contracts in the Chinese legal system because VIEs are a legal grey-zone.

American shareholders – particularly public pension funds that have committed substantial amounts of capital to US-listed Chinese companies – would be heavily affected by any clampdown. Most companies listed in the US use the VIE structure, as well as many listed on the Toronto Stock Exchange, the London Stock Exchange and even the Hong Kong Stock Exchange. There are nearly 250 Chinese companies listed on US stock exchanges with a total market capitalisation of US$2.1 trillion. Whilst a complete ban on VIEs seems unlikely, ongoing strategic competition between China and the US makes greater oversight probable and places the structures at risk. This would dovetail with paramount leader **Xi Xinping**'s efforts to increase control over the private sector, as evidenced by recent crackdowns on enterprises such as Alibaba, Meituan and Tencent.

Corporate Structure, Prospectus for Didi Global Inc. for Initial Public Offering on New York Stock Exchange

Didi Global Inc. has contractual relationships with Beijing Xiaoju Science and Technology Co. Ltd. (known as Didi Chuxing)



Source: Didi Global Inc., Registration, US Securities and Exchange Commission (June 2021)

Beijing considering implementing unprecedently harsh measures against Didi

Crackdown on big tech is far from over

The decision of **Chinese** regulators to remove Didi from app stores after its public listing in the **US** is likely just the beginning of a larger broadside against the ridesharing company. Chinese policymakers were initially supportive of Didi's offshore listing plans, but concern grew in April over perceived deficits in the company's data security practices. Specifically, there were concerns that, with regulators demanding enhanced scrutiny of Chinese companies listing in the US, sensitive data collected by Didi could end up in the wrong hands.

Didi's decision to go ahead with the IPO despite clear pushback from the Cyberspace Administration of China was seen as an intolerable challenge to Beijing's authority. According to Bloomberg, regulators are now considering a fine larger than the US$2.8 billion figure imposed on Alibaba, forced delisting or suspension of certain operations. Another option on the table is to forcibly introduce a state-owned investor.

Other tech companies are at risk from the fallout of the Didi saga. New draft regulations released on July 10 will, in essence, require all Chinese companies to undergo a mandatory cybersecurity review before listing overseas. This week has seen the biggest two day fall in the value of US-listed Chinese stocks since 2008, as China's crackdown has spread to the private education sector. Demographic, social and ideological motivations seem to be at play. Competitive and costly private education raises the costs of having children, whilst many Chinese private education providers have foreign capital backing. All in all, it is highly uncertain whether Beijing will be able to thread the needle, enhancing political control over the private sector whilst continuing to promote growth and innovation.

US mulls attempt to get back into the Asian trade game

Digital trade liberalisation is seen as more politically palatable in Washington

Various reports suggest that **US** President Joe **Biden**'s Administration is actively discussing proposals for an Indo-Pacific wide digital trade agreement. The pact would likely include countries such as **Canada**, **Australia**, **Chile**, **Japan**, **Malaysia**, **Singapore,** and **New Zealand**. China would explicitly be excluded. The deal would set standards across the digital economy with an explicit focus on avoiding restrictions on the flows of data across borders. Other proposed areas of focus include paperless customs and synchronising e-invoicing and e-payment frameworks.

A digital trade agreement makes sense on many levels. In the US, such an agreement would not antagonise unions, blue-collar workers, and farmers. This contrasts with the CPTPP (formerly the TPP), which covers many traded goods – agriculture, manufacturing and the like – the US is unlikely to re-join anytime soon. An Indo-Pacific digital trade pact would also play to the US' strengths, as the US remains highly competitive if not dominant in many areas of the digital economy. Crucially, a digital trade agreement wouldn't need Congressional approval. From a foreign policy perspective, a digital trade deal would signal a renewed US commitment to trade liberalisation (albeit of a slightly different kind), standard setting and multilateralism. This would help the US contrast itself favourably to China, which is an ardent proponent of data localisation.

Yet, realising a regional digital trade deal will not be without potential pitfalls. Portraying the deal as a kind of anti-China bloc could make many countries in the region wary of joining. China is also far from the only country in the region embracing aspects of data localisation and protection for its own digital services champions. Within the Biden administration there are also reportedly tensions between Trade Representative Katherine Tai who advocates a "worker centred approach", and those such as Kurt Campbell who are more supportive of a digital agreement.

Water shortages in the Middle East trigger protests

Severe water shortages raises the prospect of regional unrest

Large swathes of the Middle East are facing severe water stress. According to the World Resources Institute's Water Risk Atlas, **Iran**, **Iraq**, **Syria**, **Afghanistan**, **Lebanon,** and **Jordan** will face acute water stress by 2030. Already, severe water shortages have triggered a wave of protests over the last few months in **Sudan** and **Yemen**. More recently, protests have occurred in **Algeria**, **Iran,** and **Iraq** against water cuts amidst temperatures that exceeded 50 degrees Celsius. Over 10 protesters have been killed in Iran.

Whilst rainfall in the region is down by as much as 85 percent this year, mismanagement of water – including a slew of subsidies in the region that encourage wasteful water use in agriculture – and chronic corruption are core underlying issues. **Turkey**'s dam construction programme along the Tigris and Euphrates River is also placing **Syria**, Iraq and Iran's water supplies under pressure. The vulnerability of the region to extreme weather events due to climate change is further aggravating the Middle East's water scarcity.

Left unsolved, this may be a vector for larger-scale unrest, particularly as food security comes under pressure. Countries with limited fiscal wherewithal – including Iraq, Lebanon, and Syria – that are unable to import food to guarantee food security face particular risk. For example, Iraq has a debt-to-GDP ratio of around 80 percent and low foreign exchange reserves of approximately US$60 billion. Its water stress levels are projected to triple by 2030.

US coal shipments to China soar

Despite political and diplomatic support, Australia's loss is China's gain

Late last month, the **US** shipped its largest ever coal load to **China** – a 136,400-ton cargo that departed Virginia for steelmakers in eastern China. **US** miners have benefited from increased demand from China since October last year, after Beijing all but killed Australian coal exports to China. Coalmining is not the only sector benefiting from China's economic coercion against Australia. US exports of wine, wood and cotton have also seen unusually large growth over the last year.

US officials including Trade Representative Katherine Tai and Secretary of State Anthony Blinken have provided strong rhetorical support for Australia. Blinken even went as far as to make an improvement in US-China ties contingent on the normalisation of the Australia-China trading relationship. Nonetheless, according to the trade data, the US is "actually eating Australia's lunch over China trade" – a point that has not been lost on Party attack dog, the Global Times.

Nevertheless, it is not clear what the US could do to support Australia beyond highly unusual market intervention. Calls for an "economic NATO" where economic coercion against one member would induce a collective response, seems to have floundered as Western allies prioritise domestic interests. In the absence of such a mechanism, China will continue to use economic coercion to attempt to wedge allies.