Sherman, Spartz China Risk Package: Bill Descriptions

China poses a growing risk to American investors and the following four bills guarantee fairness, reasonableness, and robust investor protection in our capital markets.

No Capital Gains Allowance for American Adversaries Act

To stop subsidizing investments and boosting the economies of nations undermining American national security interests, this bill would:

- Treat capital gains on all Chinese, Russian, Belarusian, Iranian, and North Korean stocks as ordinary income. Such investments would then not be eligible for the lower capital gains tax rates.
- Eliminate the "step-up in basis" for Chinese, Russian, Belarusian, Iranian, and North Korean assets inherited at death – which reduces an heir's tax liability by ignoring gains that occurred before inheritance.
- Direct SEC to maintain a public list of securities covered by this Act and require that sellers of covered securities disclosure to customers that sales of those securities will be treated as ordinary income.

The bill defines Chinese, Russian, Belarusian, Iranian, and North Korean company (i.e., "country of concern" company) as any company that, as determined by criteria established by the SEC and the Department of the Treasury:

i. is incorporated or otherwise organized in an aforementioned country of concern;
ii. has a majority of its assets or employees located in a country of concern;
iii. is owned by, controlled by, or subject to the jurisdiction or direction of the government of a country of concern;
iv. where a majority of the company's value depends on the revenues, profits, market capitalization, assets, or the value of a security (including options to purchase or sell) of a company described under subparagraph (i), (ii), or (iii); or
v. where a company described under subparagraph (i), (ii), or (iii) has control, as defined under section 230.405 of title 17, Code of Federal Regulations, of the company.

It is entirely reasonable for the U.S. to provide incentives for domestic investment that are not available on certain foreign investments. According to a comparative analysis of capital gains tax rates by the Law Library of Congress, many countries have investment incentives not applicable to some foreign investments. For instance, China does provide investment incentives through its tax code, but foreign investments are eligible only with the pre-approval of the Chinese government.

China Risk Reporting Act

This bill requires public companies that are required to file an annual report to include in such report:

- A description of the degree to which each supply chain of such public company relies upon or is exposed to China (including Hong Kong and Macau), Taiwan, Japan, Mongolia, North Korea, and South Korea.
- A description of the operations of the public company in the aforementioned markets;
- A narrative description of the public company's China risk;
- If the public company identifies a material China risk, then a narrative description of actions the company has taken or will take to minimize China risk and additional actions the company may take to minimize the China risk if there is a significant disruption in the economic relationship between the U.S. and People's Republic of China as a result of hostile actions by China against Taiwan.

The bill defines China Risk as a public company's exposure to material financial consequences caused by the Government of the People's Republic of China stemming from:

- Disruption in a company's operations caused by disruptions to supply chains;
- Devaluation, seizure, expropriation, denial of access, or nationalization of assets including IP;
- Imperfect rule of law;
- Impediments to exercising full voting rights in a publicly traded firm.

American corporations need to evaluate and minimize their China risk. Investors deserve to know about the China risk before investing in a company.

PRC Military and Human Rights Capital Markets Sanctions Act

The bill directs the President to compile and maintain a single public list of sanctioned companies and its affiliates. Sanctions lists the President must use include:

- OFAC's Specially Designated Nationals and Blocked Persons list.
- OFAC's Non-SDN Chinese Military-Industrial Complex Companies List.
- DoD's list Chinese military companies and military-civil fusion contributors.
- Department of State's Global Magnitsky Sanctions list.
- List of Chinese persons whose goods have been subject of a Withhold Release Order pursuant to the Tariff Act.
- Chinese entity listed on the Entity List in Supplement 4 of the Export Administration Regulations.
- DHS's Uyghur Forced Labor Prevention Act Entity list.
- Department of Commerce's Military End User list.

These lists include those that target human rights violators, including companies that utilize coerced labor in production, companies that proliferate dangerous technologies, and those that have connections to the Chinese military and intelligence services.

The bill prevents U.S. persons from purchasing, selling or holding:

i. a publicly-traded security issued by a sanctioned company or affiliate of the sanctioned company;

ii. a publicly-traded security that is a derivative of a publicly issued security issued by a sanctioned company or affiliate of the sanctioned company; and
iii. security that provides investment exposure to a publicly-traded security issued by a sanctioned company or affiliate of the sanctioned company.

A U.S. person will have 180 days after date of enactment to divest from the prohibited securities. A 180-day divestment period will also be granted if the President identifies subsequent prohibited securities.

Penalties:

i. A U.S. person that violates, attempts to violate, or conspires to violate faces a civil penalty in the amount of $250,000 or amount twice the amount of the prohibited transaction, whichever is greater.
ii. A U.S. person that willfully violates these prohibitions faces a $1,000,000 fine or twenty years in prison or both.

Companies that have their business relations with the United States cut off or strictly restricted should not be allowed to sell securities in the U.S., or to U.S. persons, whether directly or indirectly through a mutual fund or ETF. The *PRC Military and Human Rights Capital Markets Sanctions Act of 2024* bill would indeed make it illegal.

No China in Index Funds Act

The bill defines Chinse company as any company that:

i. is incorporated or otherwise organized in China;
ii. has a majority of its assets or employees located in China;
iii. owned by, controlled by, or subject to the jurisdiction or direction of PRC; or
iv. where a majority of the company's value depends on the revenues, profits, market capitalization, assets, or the value of a security (including options to purchase or sell) of a company described under subparagraph (i), (ii), or (iii), as determined by the Securities and Exchange Commission; or
v. where a company described under subparagraph (i), (ii), or (iii) has control, as defined under section 230.405 of title 17, Code of Federal Regulations, of the company, as determined by the Securities and Exchange Commission.

The *No China in Index Funds Act* would protect investors by putting an end to the paint-by-numbers approach to investing in Chinese companies and prevent investors from being misled regarding the value of an underlying Chinese company.