PSSI PERSPECTIVES — 35

EUROPE MUST MATCH AMERICAN LEGISLATIVE MOMENTUM IN SAFEGUARDING INVESTORS, HUMAN RIGHTS AND INTERNATIONAL SECURITY

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A CHANGING FINANCIAL LANDSCAPE

With a decades-long peace in Europe thoroughly shattered, the continent has been forced to reconsider its long-held assumptions regarding the nature of war, the risk of conflict, and the role of financial markets within these domains. The EU is currently focused on deepening and developing its capital markets, through facilitating cross-border investment, increasing transparency and access to information for investors, and ensuring that European investment products are "underpinned by a robust retail investor protection framework that bolsters trust in capital markets." While attracting investment into the bloc is necessary for the Union, doing so without addressing the unique and asymmetric security risks posed by companies from authoritarian nations, such as China and Russia, exposes the continent and its investors to significant vulnerabilities. PSSI has previously illuminated Europe's disengaged stance towards "China Risk" in the EU's capital markets, including the financial dimensions of legislative proposals on forced labor, and 5G infrastructure projects.

Meanwhile, across the Atlantic, dozens of legislative proposals have been introduced in the U.S. Congress to counter the various military, economic, ideological, and technological threats posed by the Chinese Communist Party. With some already having been voted upon and passed, and many others pending, the momentum and direction of the U.S. Government is clear. Representative John Moolenaar (R-MI), Chairman of the House Select Committee on the CCP, highlighted this bipartisan approach: "This week, we will draw a line in the sand. With one voice, the US Congress will tell Xi Jinping, this far, and no further."

PSSI seeks to highlight ten of these proposals in particular, aimed at bolstering national security and human rights through risk management in the capital markets. Considering Europe's ongoing efforts to establish a common Capital Markets Union while pursuing a policy of de-risking from China, PSSI urges the Union to consider these legislative proposals introduced in the U.S. Congress. This would significantly advance our common security interests, strengthen the integrity of our human rights policies and contribute to the development of safer, more sustainable capital markets.

These current legislative measures in the U.S. Congress can be divided into four groups:

- *Those seeking to reduce U.S. investor risk and exposure in high-risk Chinese companies;*
- *Those aimed at imposing sanctions and removing tax benefits associated with investing in the companies of foreign adversaries;*
- *Those aimed at increasing U.S. Government understanding and control of the strategic risks posed by large-scale foreign penetration of the U.S. capital markets and private equity flows;*
- *Those insisting on greater transparency, material risk disclosure, corporate governance, shareholder rights and other standard market practices and requirements.*

1) Reduction of U.S. Financial Exposure to Risky Chinese Securities

- No China in Index Funds Act (H.R. 7758)
- Stop Funding the CCP through A-Shares Act (S. 4586)
  - Introduced as Sections 107 and 108 of the Countering Communist China Act (H.R. 7476)
  - TRADE SAFE Act (S. 4590)

These measures seek to sever financial ties with Chinese entities, especially those linked to security issues and human rights violations. These proposals are based on the recognition that the CCP ultimately controls all firms operating in China. Due to a range of reasons, including concerns over national security, data privacy, human rights, limited financial transparency and disclosure, and rising geopolitical and military belligerence, many countries have begun to decouple and/or de-risk from China. However, the adoption of these prudent measures has varied greatly by sector and region. These types of legislation seek to redress the relative failure of the United States to acknowledge that its capital markets are a conduit for funding the CCP and PLA. Given the EU's ambitions to establish a common capital markets union, PSSI urges the EU to likewise acknowledge, and act upon, the strategic significance of capital markets funding of adversary nations and their state-controlled companies.

2) Impose Sanctions and Tax Penalties on Foreign Adversaries

- No Capital Gains Allowance for American Adversaries Act (H.R. 7760)
- Sanctions with Respect to Communist Chinese Military and Surveillance Companies
  - Introduced as Section 102 of the Countering Communist China Act (H.R. 7476)

The bills in this category aim to exert financial pressure on foreign adversaries through a combination of sanctions and tax policy adjustments, specifically targeting those nations deemed to be undermining American national security interests, such as China, Russia, Belarus, and Iran. This is accomplished through disincentivizing high-risk investments in these nations, and, in the case of the latter bill, financially disrupting and deterring the activities of those entities identified as contributing to China's military and surveillance capabilities.

3) Increased Government Understanding and Control

- PRC Military and Human Rights Capital Markets Sanctions Act (H.R. 7759)
- The Protecting Americans' Retirement Savings Act
  - Introduced as Section 105 of the Countering Communist China Act (H.R. 7476)
- Preventing Adversaries from Developing Critical Capabilities Act (H.R. 6349)

These bills seek to mitigate at least some of the prominent risks posed by certain publicly listed Chinese companies, through equipping the government with clear, actionable intelligence and the tools to act on it. This is accomplished by identifying adversary nations, curtailing the transfer of certain categories of technology which pose acute security concerns, and calling on the Executive Branch to establish and maintain a "Masterlist" of Chinese companies based on official sanctions and export control lists - subsequently prohibiting the purchase, sale, or holding of any securities affiliated with these companies.

Whereas centralization of power is more challenging in the EU, PSSI nonetheless urges the EU to match American efforts to establish and maintain a Masterlist of entities of concern. The EU must strive to scrutinize those entities which pose strategic threats to Europe, or which act in direct contravention of European values, such as through corporate trafficking in forced labor or other human rights abuses. Mechanisms should be put in place to enact capital markets sanctions against such corporate abusers -- such as delisting and legal investment prohibitions -- on any entities placed on such a list.

4) Encourage Transparency and Informational Symmetry

- Disclosing Investments in Foreign Adversaries Act of 2024 (S. 3286)[1]
  - Introduced as Section 106 of the Countering Communist China Act (H.R. 7476)
- China Risk Reporting Act (H.R. 7757)

These two proposals function as legislative recommendations to require full transparency among investors, private firms, and the government through increased disclosure and information sharing. The fist bill requires private equity fund advisors to annually report to the SEC the total private fund assets in 'countries of concern' -- such as China, North Korea, and Iran. The latter proposal requires public companies to file an annual report to include their exposure to "China Risk" -- defined as material financial consequences stemming from CCP activity, such as supply chain disruptions, nationalizations of assets, or expropriation.

Notably, risk disclosure is hampered by Chapter 5 of the CCP Constitution, the "Military-Civil Fusion" policy, and other such government policies designed to offer Chinese companies preferential treatment from a regulatory perspective. These legal structures grant the Chinese government final authority over all companies in China, requiring firms to align with government interests, including technology transfers to, and information sharing with, the military.

1 Although the senate bill S. 3286 was introduced as the *Disclosing Investments in Foreign Adversaries Act of* 2023, rather than 2024, the content of the bill remains practically identical to the act as introduced in Section 106 of the Countering Communist China Act (H.R. 7476).

The Path Forward for Europe's Outbound Investment Strategy

The United States continues to lead the way in establishing and fostering viable non-kinetic policy tools underpinned by its global financial dominance. The U.S. holds over 60% of the world's investible equity - with Japan in second place at 6.2% -- and possesses the world's reserve currency.

The EU's project of a common capital markets union would undoubtedly raise its share of global equity and strengthen the EU's relative power and influence in this domain, spurring positive growth and investment into the bloc. However, without adequate mechanisms to monitor, maintain, and, when necessary, interdict certain capital flows, the EU risks positioning itself as a passive actor in a rapidly evolving geoeconomic landscape. This could enable undisciplined investor support of authoritarian regimes, ultimately undermining the EU's long-term strategic interests and global influence. The above highlighted legislative proposals in the U.S. Congress illuminate a path where, if applied appropriately, the EU can be a model of responsible outbound investment that safeguards our collective security, upholds fundamental values, and protects the interests of tens of millions of European retail investors.

Europe has been painfully reminded that every cent going to Russia fuels its war machine, leading to further bloodshed in Ukraine. In light of China's strategic alignment with Moscow and its destabilizing actions in the Pacific and beyond, Europe must recognize the broader implications of its financial markets and investments - every cent directed to the CCP strengthens its undemocratic practices and exacerbates economic imbalances. As the EU builds and consolidates its capital markets, it must recognize their political power and ensure they're designed not only to enable sanctions but also to enforce them in staunch defense of democratic values and human rights -- an issue that Europe can no longer afford to overlook.

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