House Committee on Financial Services
Full Committee Hearing: "Member Day"
November 9, 2023 at 9:00 a.m.

Testimony of The Honorable Brad Sherman,
Representative of California's 32nd Congressional District

Thank you, Chairman McHenry and Ranking Member Waters, for the opportunity to testify at this year's Financial Services Member Day hearing. I would like to draw your attention to several pieces of legislation that I have introduced or will introduce in the coming weeks.

China Risk Reporting Act (to be introduced)

I would first like to discuss legislation relevant to the Subcommittee on Capital Markets as its ranking member.

A breakdown of the U.S.-China relationship is a risk facing our corporations and investors. This is particularly the case because China threatens to invade Taiwan, which could lead to a complete rupture in the economic relationship between the United States and China.

Corporations need to evaluate their dependence on China, and should be encouraged to de-risk or decouple. This will protect a major part of our economy should there be an eruption in the economic relationship. Moreover, corporations that have evaluated and minimized their China risk are less likely to make an all-out lobbying effort arguing that we can't respond to a Chinese invasion of Taiwan because our economy is too dependent upon China.

Investors deserve to know the degree to which the companies they invest in are dependent upon China and the risks to their investment posed by a possible Chinese invasion of Taiwan or other disruptive behavior. Publicly traded companies are required to set forth the various risks that their businesses take in annual reports filed with the SEC, but a discussion of the China risk or country-specific risk is not included.

My **China Risk Reporting Act** would require publicly traded companies that filed any reports with the SEC to discuss in their annual reports: (1) The degree to which the company is dependent upon China, and (2) The steps the company has taken to reduce its China risk. I am including draft bill text, subject to minor revisions, alongside my written testimony.

PRC Military and Human Rights Capital Markets Sanctions Act (to be introduced)

I am also working on legislation titled the **PRC Military and Human Rights Capital Markets Sanctions Act of 2023**, which would prohibit the purchase and sale of securities by any American person in companies that appear on various sanctions lists. 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.

Currently, under Executive Order 14032, issued by President Biden in June of 2021, U.S. persons are prohibited from owning securities in companies identified by the U.S. government as being defense or intelligence related. This bill would expand this prohibition to companies on all of the relevant sanctions lists maintained by the U.S. government that touch on China's nefarious activities.

Last Congress, the Capital Markets Subcommittee held hearings addressing the risks posed by Chinese securities in the United States, including potential national security risks. We found that several companies on our sanctions and enhanced export controls lists were selling securities to American investors despite having significant restrictions on their business in or with the U.S. In many cases these firms were doing so perfectly legally – Executive Order 14032 only targets a relative handful of firms, and often fails to capture the affiliates of sanctioned firms.

Last month, the Coalition for a Prosperous America, an organization that has focused on the economic threat posed by China to the United States, found 144 sanctioned companies, or their affiliates, had made their way into a major Vanguard emerging markets fund, as they had been included on the relevant index. 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. My **PRC Military and Human Rights Capital Markets Sanctions Act of 2023** bill would indeed make it illegal.

This bill would also close the affiliates loophole. It would prohibit U.S. persons from buying or selling securities in a firm that appears on a sanctions list, or *that has an affiliate under common ownership or control on a relevant list*. Any member of the corporate family under sanction triggers a ban on the entire family.

Cryptocurrency Taxation Act of 2023 (to be introduced)

Investment policy is squarely in the jurisdiction of the Financial Services Committee, so we ought to pay more attention to how the tax code influences investors. I'd like to draw your attention to two bills I am working on that would amend our tax code to remove capital gains incentives for certain investments. Both of these bills would receive a Financial Services referral

due to provisions directing the SEC to be involved in the bill's implementation since the subjects of these bills are pertaining to the sale of securities.

The sale of cryptocurrencies creates no value for the economy, yet cryptocurrency sales receive a capital gains allowance. That is why I recommend that the Committee take up the **Cryptocurrency Taxation Act of 2023**, a bill which would treat gains from cryptocurrency sales as ordinary income and losses as capital losses. I am including draft bill text, subject to minor revisions, alongside my written testimony.

Historically, capital gains allowances were justified on the basis that such allowances stimulated the financing and start-up of American business, which in turn creates jobs and builds the American economy. However, investments in cryptocurrencies accomplish none of those policy objectives and there is no justification for such investments to be taxed at a rate lower than the income tax rate our staffs pay.

This legislation also incorporates cryptocurrencies into established wash sale rules. A wash sale occurs when an investor closes out an investment position at a loss and immediately buys the same security, in order to claim capital losses on the investor's tax returns. To prevent this, the Internal Revenue Code bars taxpayers from claiming capital losses on wash sales. This legislation clarifies that cryptocurrencies are among the securities subject to wash sale rules.

The bill falls under this Committee's jurisdiction because it directs the SEC to provide to the Secretary of the Treasury for his/her consideration a list of classes of assets that should be subject to the definition of digital assets under Section 6045(g)(3)(D) of the Internal Revenue Code.

No Capital Gains Allowance for American Adversaries Act (to be introduced)

Lower tax rates for capital gains on stocks and other assets are designed to incentivize Americans to make investments that grow our economy. Yet investments made in companies abroad – even in adversarial nations – are still able to receive this preferential tax treatment.

To stop subsidizing investments and boosting the economies of nations undermining American national security interests, I will soon introduce the **No Capital Gains Allowance for American Adversaries Act** which will:

Treat capital gains on all Chinese, Russian, Belarusian, and Iranian stocks as ordinary income. Such investments would then not be eligible for the lower capital gains tax rates, and would be taxed as high as 37%, rather than 15 to 20% for capital gains.

And eliminate the "step-up in basis" for Chinese, Russian, Belarusian, and Iranian assets inherited at death. The "step-up in basis" reduces an heir's tax liability by treating the assets as "costing" its date-of-death value – so increases in value prior to the date-of-death go untaxed.[1]

I am including bill text that I will soon introduce alongside my written testimony.

Amending the Internal Revenue Code so that certain categories of investments do not benefit from preferential tax treatment would be in line with international practices. 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.

Sanctioning Iran's Special Drawing Rights Transactions Act (to be introduced)

I would like to next discuss legislation that I am drafting related to international financial institutions.

Special Drawing Rights (SDRs) are an interest-bearing currency-like reserve asset held in an account at the IMF. The IMF has distributed 660.6 billion SDRs to IMF members since 1970. The Articles of Agreement of the IMF require the IMF to distribute SDRs in proportion to members' quota (the amount each contributes to the IMF each year).

Iran became a member of the IMF back in 1945 before the Iranian Islamic Revolution. As of September 2023, Iran's holdings in International Monetary Fund Special Drawing Rights are nearly 5 billion (equivalent to $6.56 billion U.S.), which includes 3.42 billion SDRs that were allocated to Iran pursuant to the 2021 General Allocation. Before the General Allocation, Iran was increasing its holdings of SDRs in the magnitude of millions.

These SDRs were transacted in secret; there are currently no reporting requirements that make public which nation or nations Iran conducted these transactions with. Unknown third-party countries are trading Monopoly money SDRs for hard currency with Iran – and paying Iran interest in the process – thereby directly contributing to Iran's financing of terrorist groups like Hamas and Hezbollah that were responsible for brutal attacks on Israeli civilians since last month. It is also possible that a trade of goods like oil or even weapons could be part of a deal transacting SDRs with Iran.

My legislation, the **Sanctioning Iran's Special Drawing Rights Transactions Act**, calls for a pause on the U.S. trading SDRs with any other country until the IMF implements common-sense reporting requirements on SDR transactions. I am including draft bill text, subject to minor revisions, alongside my written testimony.

[1] For example, if a descendant sells the stock in 2020, a stock purchased by an individual in 2010 and inherited by their descendant in 2015 is only taxed on the stock's gains between 2015 and 2020.

The U.S. is the largest funder to the IMF, so we should know whether SDRs are being used to support Iran's financing of terrorism – so that we can sanction any country that trades SDRs with Iran, and we surely do not want the United States to be transferring SDRs to some country that will then trade those SDRs with Iran.

Unrealized Losses on Securities & Regulatory Capital: Bank Safety Act (H.R. 4206)

Finally, I would like to turn my attention to two pieces of legislation that I introduced in recent months that would address shortcomings in our system of bank regulation that led to the three major bank failures earlier this year.

The **Bank Safety Act (H.R. 4206)** would prevent large banks over $100 billion in assets from opting out of the requirement to recognize Accumulated Other Comprehensive Income (AOCI) in regulatory capital, which primarily reflects unrealized losses on available-for-sale securities.

Silicon Valley Bank's total assets at the end of 2022 were $212 billion, which includes $26 billion in available-for-sale securities. After interest rates rose, the resale value of these securities declined, leading to $2.5 billion in unrealized losses. Silicon Valley Bank's assets reported to investors on its balance sheet reflected these losses, but its regulatory capital did not reflect these unrealized losses, since it had "opted-out" of doing so.

Europe required banks to include such losses in their regulatory capital following the 2008 banking crisis, but the U.S. didn't follow suit with this Basel III recommendation.
Banks that were neither Category I nor II banks – neither Global Systemically Important Banks nor over $700B in assets, respectively – were given the option of a one-time opt out of Accumulated Other Comprehensive Income (AOCI) regulatory capital requirements in March 2015.[2]

I was pleased to see the July 2023 Basel III endgame proposal to include a requirement that all banks over $100 billion in assets be required to include these unrealized losses on available-for-sale securities in their regulatory capital, and I urge the Committee to take up my **Bank Safety Act** to make this change permanent. This bill would address a problem with SVB's Tier 1 Regulatory Capital Ratio artificially appearing 2% better capitalized than it was when the bank collapsed.

[2] Before the Trump Administration, all banks over $250 billion in assets were required to include AOCI in regulatory capital but after the 2019 "Tailoring Rule" only banks over $700 billion were required to do so. But growing banks the size of SVB were left out under both regulatory regimes.

Improving Bank Stress Testing: Effective Bank Regulation Act (H.R. 3992)

A core problem of the failure of all three banks was that bank executives were unable to properly manage interest rate risk, and bank regulators were unwilling to address and correct this mismanagement. That is why I introduced the **Effective Bank Regulation Act (H.R. 3992)**, which would ensure the Federal Reserve appropriately assesses for interest rate risk in its examination of larger American banks. Importantly, the results of stress tests feed into a bank's capital requirements such that a bank that performs poorly will be required to hold more capital against its assets.

All three of these failed banks invested their money in long-term loans and bonds at low interest rates. When the Federal Reserve increased interest rates, banks were facing a situation where their expenses exceeded their income: Banks began paying out more interest to deposit accounts (like CDs) than they made in income from (1) interest recovered from borrowers or (2) interest yielded from bond holdings.

Yet bank examiners failed to rigorously assess for this type of interest rate risk, including in the Federal Reserve's "stress tests," which determine whether the largest U.S. banks can remain solvent under a set of challenging macroeconomic conditions. As the Fed's Federal Open Market Committee continued to **raise** interest rates in 2022 and 2023, the stress test scenarios Federal Reserve regulators evaluated for only tested for a bank's ability to respond to a recession with rising unemployment and **declining** interest rates.

In 2018, the *Economic Growth, Regulatory Relief, and Consumer Protection Act* (Pub.L. 115-174) amended Dodd-Frank to decrease the minimum number of Federal Reserve supervisory stress test scenarios from three (*baseline*, *adverse*, and *severely adverse*) to only two (*baseline* and *severely adverse*). The **Effective Bank Regulation Act** would restore the "adverse" stress test scenario that existed in the original Dodd-Frank legislation and require two new stress test scenarios: a set of conditions for rising interest rates and a set of conditions for declining interest rates.

Thank you again for the opportunity to testify. I urge the majority to promptly take up these bills for the Committee's consideration.