

New Executive Order Restricts U.S. Persons from Trading in Publicly Traded Securities and Derivatives of Certain “Communist Chinese Military Companies” Effective January 11, 2021

December 30, 2020

Key Points

- On November 12, 2020, President Trump issued a new EO prohibiting U.S. persons from engaging in transactions in publicly traded securities of certain CCMCs, or any securities that are derivative of, or are designed to provide investment exposure to, such securities, effective January 11, 2021, at 9:30 a.m. EST.
- On December 28, 2020, OFAC published [guidance](#) clarifying the breadth of these prohibitions, including (i) a broad interpretation of the covered financial instruments to include, for instance, derivatives (futures, options, swaps), warrants, ADRs, GDRs, ETFs, index funds and mutual funds, to the extent such instruments fall within the definition of “security” under the EO; (ii) confirmation that the prohibition applies to investments in both U.S. and foreign funds that hold publicly traded securities of CCMCs, regardless of the level of such securities’ share of the underlying fund, ETF or derivative, and regardless of where the securities are traded or in which currency the securities are denominated; and (iii) a statement that the Treasury Department intends to list additional entities that are majority-owned or controlled by listed CCMCs.
- The EO provides a limited exemption allowing U.S. persons to divest their holdings in listed CCMCs within one year from the CCMC’s designation.
- For companies designated as CCMCs after November 12, 2020, restrictions imposed by the EO will go into effect 60 days after the designation, with an exemption allowing for divestments made within 365 days of the designation.

Background: China’s Military-Civil Fusion Strategy

As part of a broader series of actions taken over the past year in response to China’s Military-Civil Fusion initiative, President Trump issued a new [Executive Order](#) (EO 13959 or the EO) on November 12, 2020, titled “Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies.” According to the EO, China’s Military-Civil Fusion strategy aims to “increase the size of [China’s]

Contact Information

If you have any questions concerning this alert, please contact:

Christian C. Davis
Partner

chdavis@akingump.com
Washington, D.C.
+1 202.887.4529

Nnedinma C. Ifudu Nweke
Partner

nifudu@akingump.com
Washington, D.C.
+1 202.887.4013

Tatman R. Savio

Registered Foreign Lawyer
tatman.savio@akingump.com
Hong Kong
+852 3694.3015

Wynn H. Segall

Partner
wsegall@akingump.com
Washington, D.C.
+1 202.887.4573

Melissa J. Schwartz

Partne)
mjschwartz@akingump.com
Washington, D.C.
+1 202.887.4539

Robert J. Monjay

Senior Counsel
rmonjay@akingump.com
Washington, D.C.
+1 202.887.4557

military-industrial complex by compelling civilian Chinese companies to support its military and intelligence activities.”

In conjunction with this action the [U.S. State Department](#) stated, “the [Chinese Communist Party] is implementing this strategy, not just through its own research and development efforts, but also by acquiring and diverting the world’s cutting-edge technologies – including through theft – in order to achieve military dominance.” A senior State Department [official](#) said earlier this year that China’s Military-Civil Fusion strategy is “one of the United States’ most pressing national security threats.”

The issuance of EO 13959 also follows calls by a bipartisan group of [members of U.S. Congress](#) in September 2019 for the U.S. executive branch to “reexamine all the statutory authorities at its disposal to confront the CCP’s strategy of Military-Civil Fusion, including powers that have lain dormant for years.” One such authority, Section 1237 of the National Defense Authorization Act (NDAA) of FY1999, as amended (“Section 1237”), required the Secretary of Defense to publish a list of persons “operating directly or indirectly in the United States or any of its territories and possessions that are Communist Chinese military companies.”¹

The Department of Defense (DoD) responded to congressional concerns earlier this year by identifying 31 state-owned enterprises and private companies doing business in various sectors that meet the criteria under Section 1237, see [here](#) and [here](#). Following publication of EO 13959, DoD identified four additional companies (together, “the § 1237 list”), see [here](#).

In a [press statement](#) on December 28, 2020, Secretary of State Mike Pompeo stated that these actions “[ensure] U.S. capital does not contribute to the development and modernization of the People’s Republic of China’s (PRC) military, intelligence, and security services.” Secretary Pompeo emphasized that the Office of Foreign Assets Control’s (OFAC) guidance issued on December 28, 2020, confirming the expansive coverage of the EO, was intended to “allay concerns that U.S. investors might unknowingly support CCMCs via direct, indirect, or other passive investments including those linked to educational, ETFs, venture funds, private equity, Real Estate Investment Trusts, commodities, endowments, pensions, or any other investment funds tracking bonds, loans, lease lines, debt or equity indices that include securities of CCMCs or subsidiaries publicly listed by the U.S. government.”

[Executive Order 13959 and OFAC Guidance](#)

Core Prohibitions. EO 13959 prohibits any transaction² by U.S. persons³ in:

- Publicly traded securities of CCMCs
- Any securities that are derivative of publicly traded securities of CCMCs
- Any securities that are designed to provide investment exposure to publicly traded securities of CCMCs.

Affected Financial Instruments. The affected financial instruments include both debt and equity. Specifically, the EO provides that the term “securities” includes the definition in Section 3(a)(10) of the Securities Exchange Act of 1934 as well as currency or any note, draft, bill of exchange or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Katherine P. Padgett
Counsel
kpadgett@akingump.com
Washington, D.C.
+1 202.887.4079

Dallas Woodrum
Counsel
dwoodrum@akingump.com
Washington, D.C.
+1 202.887.4591

John Bryan Callahan
Associate
jcallahan@akingump.com
Washington, D.C.
+1 202.887.4025

Sina Kimiagar
Associate
skimiagar@akingump.com
Washington, D.C.
+1 202.887.4306

Andrew R. Schlossberg
Associate
aschlossberg@akingump.com
Washington, D.C.
+1 202.887.4314

Alasdair Kan
Law Clerk
alsadair.kan@akingump.com
Hong Kong
+852 3694.3069

On December 28, 2020, OFAC published guidance providing the following examples of financial instruments that “are derivative of, or are designed to provide investment exposure to” publicly traded securities:

- Derivatives (e.g., futures, options, swaps),
- Warrants,
- American depositary receipts (ADRs),
- Global depositary receipts (GDRs),
- Exchange-traded funds (ETFs),
- Index funds, and
- Mutual funds

to the extent they meet the definition of “security” as defined in the EO. (See FAQ [860](#).)

OFAC also stated that the prohibitions apply to any transaction in publicly traded securities, or any securities that are derivative of, or are designed to provide investment exposure to such securities, of CCMCs “**regardless of the securities’ share** of the underlying index fund, ETF, or other derivative.” (Emphasis added.) (See FAQ [861](#).)

Further, OFAC confirmed the global reach of the prohibition by confirming that the prohibitions apply to “publicly traded securities” **denominated in any currency** that trade on a securities exchange or through over-the-counter (OTC) trading **in any jurisdiction**. (Emphasis added.) (See FAQ [859](#).)

Summarizing the breadth of the prohibitions, in his [press statement](#) on December 28, Secretary of State Pompeo stated that the EO “applies to all transactions by U.S. persons, including individuals, institutional investors, pension funds, university endowments, banks, bond issuers, venture capital firms, private equity firms, index firms, and other U.S. entities, including those operating overseas.”

CCMCs Subject to the Prohibitions. CCMCs that are subject to these restrictions currently include the 31 companies listed in the [Annex](#) to EO 13959 (“Annex”) and the § 1237 list as well as the [four additional companies](#) DoD added to the § 1237 list on December 3, 2020.

On December 28, 2020, OFAC published a consolidated [list](#) of all 35 CCMCs listed to date, and clarified that the name of any entity that “exactly or closely matches” a name in the Annex is subject to the prohibitions in the EO.⁴ (See FAQ [858](#).) This list effectively reconciles differences between the § 1237 list and the Annex to the EO by also listing alternate and issuer names.

Further, OFAC confirmed that the prohibitions only apply to subsidiaries of listed entities **after** the subsidiary is publicly listed by the Treasury Department. OFAC explicitly stated that “Treasury intends to publicly list as subsidiaries” any entity that issues publicly traded securities and that is (1) 50 percent or more owned, individually or in the aggregate, directly or indirectly, by one or more of the listed CCMCs (consistent with OFAC’s “[50 Percent Rule](#)”); or (2) “determined to be controlled by one or more” of the listed CCMCs⁵. To date, OFAC has not provided a definition of

“control” for this purpose or indicated the timing of additional listings of the subsidiaries or controlled entities. (See FAQ 857.)⁶

Effective Dates. The prohibitions with respect to the CCMCs identified in the Annex are effective **January 11, 2021 at 9:30 a.m. EST**. The prohibitions with respect to the four additional companies added to the § 1237 list will take effect on **February 1, 2021 at 9:30 a.m. EST**. For CCMCs that may be added to the § 1237 list, or identified by the Treasury Department, in the future (including new listings of CCMC subsidiaries), the prohibitions will take effect 60 days after the listing or identification.

Limited One-Year Exemption. The EO includes a one-year exemption for purchases for value or sales, **solely to divest**, in whole or in part, from securities that any U.S. person held as of the effective date of the prohibition. Accordingly:

- For the 31 CCMCs identified in the EO, this one-year exemption expires at 11:59 p.m. eastern standard time on November 11, 2021.
- For the four additional CCMCs identified on December 3, 2020, the one-year exemption expires at 11:59 p.m. eastern standard time on November 30, 2021.

A similar one-year exemption period will apply to companies designated in the future under the terms of the EO.

Significance of these Sanctions

Limited Sanctions. Significantly, the sanctions imposed by this EO do not impose broad general sanctions on the CCMCs identified by the U.S. government, but rather only limited restrictions. OFAC has not designated these CCMCs on the Specially Designated Nationals and Blocked Persons List (SDN List) subject to comprehensive sanctions, which would broadly prohibit U.S. persons from generally dealing with the SDN, absent OFAC authorization. Rather the sanctions imposed on these entities target publicly traded securities of the listed CCMCs.

Responses of Global Index Providers. Earlier this month, in response to the EO, global index provider **FTSE Russell** announced that it would remove eight Chinese companies from several of its global stock benchmarks, and **S&P Dow Jones Indices** (S&P DJI) followed suit shortly after by stating it would remove mainland-listed A-shares, Hong Kong-listed H shares, and ADRs of 10 Chinese companies from all equity indexes by December 21, 2020 as well as other securities issued by 18 Chinese companies from its fixed income indices by January 1, 2021. Both **NASDAQ** and **MSCI** have since announced they will also remove four and seven Chinese companies from their indices, respectively. In light of the guidance issued on December 28, we would expect others to promptly do the same.

Collateral Consequences. Designation of entities on the § 1237 list may have a number of collateral consequences. For example, while the designations identified under EO 13959 are not directly related to the military end-user (MEU) license requirements also issued by the Commerce Department earlier this year and the recently issued “MEU List,” Commerce has **noted** that inclusion on the § 1237 list may be a red flag that, if unresolved, may trigger the MEU license requirement. (See our previous **client alert** for a summary of these prior MEU restrictions.) Thus, a party supplying certain items subject to the Export Administration Regulations (EAR) to CCMCs may wish to consider undertaking additional due diligence in order to

determine whether it needs to apply for a license from BIS consistent with the MEU license requirements.

Open Questions Regarding the Biden Administration’s Approach to China.

Following the guidance issued by OFAC and the press statement of current Secretary of State Pompeo on December 28, 2020, the position of the Trump administration on its approach to these sanctions against China is clear. However, as 2020 comes to a close it is still unclear how the incoming Biden administration will approach this new sanctions regime. Its approach will doubtlessly be shaped in the context of its broader approach to China, as that evolves, with respect to the current list of designated CCMCs, additional sanctions listings and potential enforcement actions, and in relation to its consideration and use of the broader range of instruments of U.S. foreign and international economic policy, and U.S. international trade law, that the Biden administration will soon inherit in 2021.

¹ Section 1237 defines “Communist Chinese military companies” to include any person that is “owned or controlled by, or affiliated with, the People’s Liberation Army or a ministry of the government of the People’s Republic of China or that is owned or controlled by an entity affiliated with the defense industrial base of the People’s Republic of China” and is engaged in providing commercial services, manufacturing, producing, or exporting.

² “Transaction” means the purchase for value of any publicly traded security.

³ “U.S. persons” means U.S. citizens, permanent resident aliens, entities organized under the law of the United States or any jurisdiction within the United States, (including foreign branches), or any person in the United States.

⁴ OFAC’s list includes equity tickers that cover securities publicly traded on Chinese and Hong Kong exchanges. However, OFAC explains in a footnote to the list that debt and other securities issued by the identified issuers are also subject to the prohibitions in EO 13959.

⁵ Additional companies may be added by either DoD or the Treasury Department. While DoD administers the § 1237 list, the EO also empowers the Treasury Department to list CCMCs meeting the criteria of Section 1237 as well as to list subsidiaries of a person already determined to be a CCMC, a power that the Treasury Department has not exercised to date. The State Department issued a [fact sheet](#) on December 8, 2020 noting that “at least 24 of the 35 parent-level CCMCs had affiliates’ securities included on a major securities index.”

⁶ In his press statement on December 28, 2020, Secretary Pompeo referred to “....debt or equity securities, or any securities that are derivative thereof, regardless of the percentage ownership of CCMCs....” The meaning of the phrase “regardless of the percentage ownership of CCMC” is unclear, and we hope for clarification by OFAC in the future.

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