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Chinese Military Companies Trading Ban: Overview of OFAC's Ongoing Guidance

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On November 12, 2020, the Trump Administration issued an Executive Order prohibiting U.S. persons from trading securities and related derivatives in "Communist Chinese Military Companies" (CCMCs), effective 60 days later on January 11, 2021, and then extended to January 28, 2021. The Order, which was amended on January 13, 2021, prohibits U.S. persons from "any transaction in publicly traded securities, or any securities that are derivative of, or are designed to provide investment exposure to such securities" of a CCMC. Under the Amended Order's terms, a "transaction" is a "purchase for value, or sale, of any publicly traded security." To date, there are 44 companies that the Department of Defense (DOD) has determined to be CCMCs for which trading by U.S. persons is prohibited. The Order contemplates adding other companies to that list.[1]

Over the past few weeks, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) has issued further guidance in the form of Frequently Asked Questions (FAQs) and General Licenses that clarify the terms of the Order and its Chinese Military Sanctions Program. To a large degree, OFAC's guidance confirms that the agency will interpret the Order broadly to prohibit not only direct investments, but also derivatives and any investment that causes "investment exposure" to such securities, such as an investment in a fund that includes CCMCs in its investment portfolio.

I. What Entities Are Designated as CCMCs?

The Executive Order is concerned with civilian Chinese companies that "directly support" China's military, intelligence, and security activities. The Order states that these companies raise capital by selling securities to U.S. investors and thus "constitute[] an unusual and extraordinary threat, which has its source in substantial part outside the United States, to the national security, foreign policy, and economy of the United States."

The Amended Order defines CCMCs as:

- any entity listed by the Secretary of Defense as a CCMC operating directly or indirectly in the United States or in any of its territories or possessions, pursuant to the National Defense Authorization Act for Fiscal Year 1999[2] (the "National Defense Authorization Act") as amended, as of the date of the Order;
- any entity that (i) the Secretary of Defense, in consultation with the Secretary of the Treasury, publicly lists as a CCMC and (ii) operates directly or indirectly in the United States; or
- any entity that the Secretary of the Treasury (i) publicly lists as a CCMC, after such entity has already been listed by the Secretary of Defense, or (ii) determines to be a subsidiary of an entity already determined to be a CCMC.

In turn, CCMCs are defined in the National Defense Authorization Act as (1) any entity already identified in Defense Intelligence Agency publications from September 1990 and October 1995, as well as any updates thereto; and (2) any other entity that is owned or controlled by the People's Liberation Army[3] and engaged in providing commercial services, manufacturing, producing, or exporting.

Pursuant to Section 1237(b) of the National Defense Authorization Act, the DOD has been required to keep a list of CCMCs since 1999, and a subsequent amendment required the DOD to update the list at least annually. Revisions to the list were to be made with input from the Attorney General, Director of National Intelligence, and the Director of the FBI. On June 24, 2020, the DOD publicly released the names of CCMCs for the first time, listing 20 companies in a letter to Senator Tom Cotton. On August 28, 2020, the DOD published the names of 11 additional entities that it determined to be CCMCs. On December 3, 2020, the DOD published the names of four more, and on January 8, 2021, OFAC issued a comprehensive list to date.

II. When do the Trading Prohibitions Take Effect?

The Order's prohibitions on transactions take effect 60 days after a CCMC is designated. Because there were 31 CCMCs listed by the DOD when the Order was issued on November 12, 2020, prohibitions pertaining to those CCMCs were to become effective on January 11, 2021. However, that date was extended to January 28, 2021 in General License No. 1 issued by the Treasury Department on January 8, 2021. Thus, beginning on January 28, 2021, U.S. persons may not take part in "any transaction in publicly traded securities, or any securities that are derivative of, or are designed to provide investment exposure to such securities, of any" of the 31 CCMCs listed here and here. However, investors will have a full year from the issuance of the Order—by 11:59 p.m. on November 11, 2021—to fully divest. Until that time, the Amended Order allows for "any transaction . . . *solely to divest*" on or before November 11, 2021. (Emphasis added).

If new entities are added to the list of CCMCs, investors will have the benefit of the same wind-down period. The prohibition on trading will not take effect until 60 days after the designation of such entities, and investors thereafter will be allowed to transact in securities of such entities for one year as long as it is "solely to divest." Thus, for the four CCMCs that were designated on December 3, 2020, the prohibition on trading will not take effect until February 1, 2021. And investors will have until December 2, 2021 to fully divest, with the ability to transact for purposes of divestiture in the meantime.

This summary chart sets forth the effective dates for the ban on trading and subsequent divestment:

CMC Designation Date	**Transaction Prohibition Date**	**Divestment Deadline**
June 24, 2020	January 28, 2021	November 11, 2021
August 28, 2020	January 28, 2021	November 11, 2021
December 3, 2020	February 1, 2021	December 2, 2021
January 14, 2021	March 14, 2021	January 13, 2022

III. To Whom Does the Executive Order Apply?

The ban on transactions applies to "any United States person," which is defined as "any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction within the United States (including foreign branches), or any person in the United States." That means that hedge funds and fund managers organized in the United States are subject to the Executive Order, as well as U.S. branches of foreign entities. The question of whether an entity is a "U.S. person," is a fact-intensive inquiry that includes an analysis of its touchpoints with the U.S. Accordingly, offshore funds with U.S. managers, or foreign funds where a majority of investment interests are held by U.S. persons, can potentially be deemed "U.S. persons" and subject to OFAC's jurisdiction.

IV. What Counts as a Prohibited Transaction?

The Order applies to publicly traded securities and "any securities that are derivative of, or are designed to provide investment exposure to such securities." The definition of "securities" includes, but is not limited to, the definition provided in Section 3(a)(10) of the Securities Exchange Act of 1934, which means it includes derivatives such as security-based swaps, puts, calls and other options.

The Order is also explicit in prohibiting not just transactions in securities, but any transactions "designed to provide investment exposure to such securities." Subsequent guidance from OFAC emphasizes this point, as it explains that even transactions in ETFs or other mutual funds are prohibited if those funds hold publicly traded securities in CCMCs. This guidance is discussed further below.

The Order also includes a standard provision to prevent circumvention, as it prohibits any transaction that "evades or avoids, has the purpose of evading or avoiding, causes a violation of, or attempts to violate the prohibitions set forth in this order."

Additional OFAC Guidance

Since the Order was issued, OFAC has published several rounds of guidance, in the form of FAQs and General Licenses, that clarify the scope and terms of the Order. This guidance demonstrates OFAC's broad view of the types of securities and investments that are covered by the Order, and identifies certain transactions that are permitted.

I. Affiliates and Subsidiaries of CCMCs

The Executive Order failed, in some instances, to use the formal names of legal entities designated as CCMCs. For example, it lists simply "Huawei," rather than the formal name "Huawei Technologies Co., Ltd."

- FAQ No. 858 clarifies that the Order applies to not only to the exact names of the listed entities but also to entities that "closely match[] the name of any entity identified," and FAQ No. 864[4] likewise provides that the Order's prohibitions apply to CCMC subsidiaries "with a name thatexactly or closely matches the name" of a listed CCMC. This FAQ then goes on to provide several examples.
- FAQ No. 857 similarly clarifies that the Order applies to any publicly listed subsidiary of a CCMC, even though the Order does not address subsidiaries or affiliates of CCMCs. The Treasury Department plans to issue a public list of any CCMC subsidiaries that (i) issue publicly traded securities and (ii) are either at least 50% owned by a CCMC or otherwise determined to be controlled by a CCMC, though the Treasury has not provided a timeline for publication.
- General License 1A, issued on January 26, 2021, allows for all transactions involving publicly traded securities of an entity whose name closely matches, but does not exactly match, that of a CCMC until May 27, 2021. This is also explained in FAQ No. 878.
- FAQ No. 879 notes, however, that General License 1A does not apply to any entities that have been publicly listed by OFAC as a subsidiary of a CCMC. In other words, if OFAC has already affirmatively identified an entity as a CCMC, there is no grace period for complying with the ban on the purchase or sale of its securities.

II. Covered Securities and Derivatives

- FAQ No. 859 clarifies that OFAC will interpret "publicly traded securities" to include securities denominated in any currency that are traded on an exchange or "over the counter." This is consistent with the broad purpose and language of the Order, which specifically addresses transactions "designed to provide exposure to CCMCs" and also has an anti-circumvention provision.
- FAQ No. 860 states that derivatives include futures, options and swaps. Though the term "derivative" is not defined in the Order, this is in line with the definition of "security" from the Securities Exchange Act of 1934.
- FAQ No. 873 confirms the definition of "transaction" as purchase for value, or sale, of any publicly traded security.

III. Effect on Index Funds and ETFs

- FAQ No. 860 explains that financial instruments covered by the Order include exchange-traded funds, index funds, and mutual funds, as well as warrants, American depositary receipts (ADRs), and global depositary receipts. Again, this is consistent with the scope of the Order as described in the prelude, which states the concern that the designated Chinese companies "raise capital by selling securities to United States investors that trade on public exchanges both here and abroad, lobbying United States index providers and funds to include these securities in market offerings, and engaging in other acts to ensure access to United States capital."
- FAQ No. 861 goes on to say that the Order prohibits purchase of ETFs or index funds that hold investments in CCMCs, regardless of the investment level, as the Order is intended to cover "any transaction" that would "provide investment exposure" to CCMCs.
- FAQ No. 865 nonetheless explains that U.S. persons may transact in investment funds that are seeking to divest from CCMCs during the relevant wind-down period.
- General License No. 2 and FAQ No. 871, both issued on January 14, 2021, provide that securities exchanges operated by U.S. persons may continue to conduct transactions that would otherwise be prohibited by the Order until one year after the date that a CCMC has been designated.

IV. Other Permitted Transactions

- FAQ No. 863 provides that U.S. persons may engage in "clearing, execution, settlement, custody, transfer agency, back-end services, as well as other such support services," as long as these services are not provided to U.S. persons in connection with prohibited transactions. In other words, a U.S. broker-dealer could perform these functions as long as the services are not being provided to a U.S. person.
- FAQ No. 865 states that market intermediaries and "other participants" may engage in "ancillary or intermediary" activities that are necessary for a U.S person to divest during the relevant wind-down period.
- FAQ No. 874 confirms that any transactions prior to the divestment deadline are permitted as long as they are made "solely to divest, in whole or in part," from the relevant securities.

V. Timing of Divestiture

- FAQ No. 862 clarifies that divestiture is not required by January 11, 2021 and refers to the terms of the Order. As described above, the earliest deadline for divestment is November 11, 2021.

- FAQ No. 872 reiterates that U.S. persons must be fully divested of publicly traded securities of CCMCs, any derivatives thereof, or any investments designed to provide exposure to CCMCs by the later of November 11, 2021 or one year after such entity was determined to be a CCMC.

Compliance Matters

Though the earliest date for divestment from the CCMC securities is November 11, 2021, the Order raises more immediate compliance challenges. U.S. managers and funds will need to ensure that they do not acquire securities of CCMCs or make investments that otherwise trigger liability under the OFAC's Communist Chinese Military Sanctions Program, and that they have a plan to divest from any such current investments. Those managers and funds should be particularly careful if they in turn invest in other funds, and they should inquire as to whether their underlying funds have investment exposure to CCMCs.

[1] Indeed, the Order originally contemplated 31 banned companies, though four more were added on December 3, 2020 and nine more were added on January 14, 2021.

[2] Public Law 105-261.

[3] The People's Liberation Army is defined in Section 1237(b) as "the land, naval, and air military services, the police, and the intelligence services of the People's Republic of China, and any member of any such service or of such police."

[4] This FAQ likely was issued in response to fluctuating announcements made by the New York Stock Exchange. On December 31, 2020, the NYSE declared that it would delist China Telecom Corporation Limited, China Mobile Limited and China Unicom (Hong Kong) Limited. It then reversed course on January 4, 2021, stating that it would no longer delist the companies after consulting with the Treasury Department. But just two days later, on January 6, 2021, the Treasury Department issued FAQ No. 864. That same day, the NYSE announced that it would in fact delist the aforementioned three companies.

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