

Alert

OFAC Provides Guidance on Trading Ban in Chinese Companies

December 31, 2020

On Dec. 28, 2020, the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") issued guidance clarifying the scope of the Trump Administration's recent Executive Order banning trading in the public securities of certain companies deemed to be supporting the People's Liberation Army of China (each, a "Covered Company"). The guidance takes the form of five Frequently Asked Questions ("FAQs") available on OFAC's website.

OFAC's guidance focuses on three issues of particular importance to U.S. investors and to private investment fund managers in the United States and abroad: (1) whether subsidiaries of the Covered Companies are included in the trading ban; (2) what types of securities and financial instruments are covered by the ban; and (3) how the ban affects U.S. investors who invest in funds that hold prohibited securities.

Background

On Nov. 12, 2020, President Trump signed Executive Order No. 13959 ("Executive Order"), which, effective Jan. 11, 2021, will impose restrictions on trading by U.S. persons in the securities (and derivatives thereof) of 31 Covered Companies.¹ On Dec. 3, 2020, four other entities were added to the list, bringing the total to 35.²

In general, the Executive Order applies to transactions in "publicly traded securities [of Covered Companies], or any securities that are derivative of, or are designed to provide investment exposure to such securities."³ Beginning on Jan. 11, 2021, U.S. persons are prohibited from engaging in "transactions"⁴ in the affected securities of the 31 companies, except that U.S. persons may, up until Nov. 11, 2021, engage in transactions "solely to divest" from securities held as of Jan. 11.⁵ The Executive Order's trading ban is described more fully in a prior *SRZ Client Alert*.⁶

The effect of the Executive Order as drafted was unclear in a number of respects. As a result, it had been expected that OFAC, which is responsible for administering and enforcing most U.S. economic sanctions

¹ Executive Order (Nov. 12, 2020), available [here](#).

² See Qualifying Entities Prepared in Response to Section 1237 of the National Defense Authorization Act for Fiscal Year 1999 (PUBLIC LAW 105-261), Tranche 4, available [here](#).

³ Executive Order, *supra* note 1.

⁴ The term "transaction" for purposes of the Executive Order is defined as "the purchase for value of any publicly traded security." *Id.*

⁵ With respect to the four entities that were added to the list on Dec. 3, 2020, U.S. persons are prohibited from transacting in affected securities beginning on Feb. 1, 2021, except that U.S. persons may, up until Dec. 2, 2021, engage in transactions "solely to divest" from securities held as of Dec. 3, 2020.

⁶ See "White House Bans Trading in 31 Chinese Companies," *SRZ Alert*, Nov. 13, 2020, available [here](#).

programs, would provide clarification as to the scope of the Executive Order. The guidance issued by OFAC yesterday represents at least a first step in that direction.

Subsidiaries of Covered Companies

FAQ 857 addresses a question that, according to press reports,⁷ had caused some tension between OFAC and the Department of Defense: Does the trading ban apply to subsidiaries of Covered Companies? A number of the Covered Companies have subsidiaries that are themselves publicly traded.

OFAC confirms in FAQ 857 that the Executive Order does not cover subsidiaries of Covered Companies unless and until the subsidiary is itself publicly listed by OFAC (pursuant to section 4(a)(iii) of the Executive Order) or designated by the Defense Department under Section 1237 of the National Defense Authorization Act (pursuant to section 4(a)(ii) of the Executive Order).⁸

However, the FAQ announces that OFAC “intends to publicly list as subsidiaries” subject to the Executive Order any entity that issues publicly traded securities and that is (1) 50% or more owned by one or more Covered Companies or (2) determined to be controlled by one or more Covered Companies.⁹ It is not clear when OFAC will publicly list these subsidiaries. The prohibitions on trading in the publicly traded securities of the subsidiaries (or in securities derivative of, or intended to provide investment exposure to, such securities) will take effect 60 days after the subsidiaries are listed by OFAC.

Securities Encompassed by the Executive Order

FAQ 858 notes that in some cases, the names of the Covered Companies, as identified pursuant to the Executive Order, do not “match” the names of issuers of publicly traded securities.¹⁰ The FAQ clarifies that the Executive Order’s trading ban applies to entities “with a name that exactly or closely matches” the name of an identified Covered Company.¹¹

To assist investors, OFAC has published a list on its website containing the names of the 35 Covered Companies along with additional identifying information including “a/k/a” names for the entities, issuer names and equity ticker symbols.¹²

FAQ 859 provides guidance on how OFAC will interpret the term “publicly traded securities” as used in the Executive Order.¹³ It explains that OFAC “intends to interpret the term ‘publicly traded securities’ to include securities (as defined in section 4(d) of [the Executive Order]) denominated in any currency that trade on a securities exchange or through the method of trading that is commonly referred to as ‘over-the-counter,’ in any jurisdiction.”¹⁴ The Executive Order does not contain any definition of the term

⁷ Demetri Sevastopulo, “US Treasury Seeks to Water Down Trump’s Chinese Securities Ban,” Financial Times (Dec. 17, 2020), available [here](#).

⁸ See FAQ No. 857 (Dec. 28, 2020), available [here](#).

⁹ *Id.*

¹⁰ See FAQ No. 858 (Dec. 28, 2020), available [here](#).

¹¹ *Id.*

¹² See OFAC, “Non-SDN Communist Chinese Military Companies List” (Dec. 22, 2020), available [here](#).

¹³ See FAQ No. 859 (Dec. 28, 2020), available [here](#).

¹⁴ *Id.*

“publicly traded securities,” and merely defines (in section 4(d)) the term “securities” to include the definition found in the Securities Exchange Act of 1934.¹⁵

FAQ 860 provides “examples” of financial instruments covered by the other parts of the trading ban — “securities that are derivative of, or are designed to provide investment exposure to,” publicly traded securities of Covered Companies.¹⁶ According to the FAQ, such financial instruments include — “but are not limited to” — the following instruments, “to the extent such instruments also meet the definition of “security” as defined in section 4(d)” of the Executive Order:

- Derivatives (e.g., futures, options, swaps)
- Warrants
- ADRs
- GDRs
- ETFs
- Index funds
- Mutual funds¹⁷

Application to Investments by US Persons in Funds Holding Prohibited Securities

OFAC FAQ 861 gives a broad sweep to the Executive Order’s impact on U.S. investors.¹⁸ It provides, in full:

861. Does Executive Order (E.O.) 13959 prohibit U.S. persons from investing in U.S. or foreign funds, such as exchange-traded funds (ETFs) or other mutual funds, that hold publicly traded securities of a Communist Chinese military company?

Yes. Under E.O. 13959, 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 Communist Chinese military company is prohibited regardless of such securities’ share of the underlying index fund, ETF, or derivative thereof.¹⁹

Under this FAQ, a U.S. person (beginning on Jan. 11, 2020) cannot make an investment in any “U.S. or foreign fund,” including a foreign fund that is not itself subject to the Executive Order’s trading ban, if the fund holds securities of one (or more) of the Covered Companies. There is no *de minimis* exception to this ban, as it applies “regardless of” how small a percentage those securities comprise of the fund’s overall portfolio.

¹⁵ It also includes “currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.” Executive Order, *supra* note 1.

¹⁶ See FAQ No. 860 (Dec. 28, 2020), available [here](#).

¹⁷ *Id.*

¹⁸ See FAQ No. 861 (Dec. 28, 2020), available [here](#).

¹⁹ *Id.*

Shortly after OFAC's publication of the FAQs, U.S. Secretary of State Michael R. Pompeo issued a statement, entitled "Protecting U.S. Investors from Financing Communist Chinese Military Companies," highlighting the impact of the Executive Order on U.S. investors:

The Executive Order 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. This should 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.²⁰

How the FAQ and the Executive Order would apply to hedge funds and private equity funds that are domiciled outside the U.S. and managed by a non-U.S. manager, but that receive investments from U.S. investors, merits careful consideration by both investors and fund managers.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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²⁰ Dep't of State, Press Statement, "Protecting U.S. Investors from Financing Communist Chinese Military Companies," available [here](#).