

ALERTS

US Sanctions on Chinese Company Securities: Further Developments

January 19, 2021

During the first half of January, the Trump Administration continued to expand the ban on trading related to the public securities of designated Communist Chinese military companies (“CCMCs”). Meanwhile, the U.S. Treasury Department’s Office of Foreign Assets Control (“OFAC”) issued additional guidance on how the ban applies to U.S. investors and other market participants. This *Alert* describes these actions, reflected in additional designations of CCMCs, amendments to the original Executive Order issued on Nov. 12, 2020 (“Executive Order”), new Frequently Asked Questions (“FAQs”) published by OFAC, and two OFAC General Licenses.

The sanctions against trading in CCMC securities, as set forth in the original Executive Order, took effect on Jan. 11, 2021. As of that date, U.S. persons are prohibited from engaging in transactions in “publicly traded securities, or any securities that are derivative of, or are designed to provide investment exposure to such securities” (“CCMC securities”), of the CCMCs initially designated on Nov. 12, 2020. For additional CCMCs designated after Nov. 12, 2020, the trading ban takes effect 60 days after the date of the designation. As described in SRZ’s prior *Alerts*, the trading ban encompasses not only the CCMC public securities themselves, but also indices and ETFs that include one or more CCMCs as components, as well as various derivatives and other financial instruments that reference CCMC securities.[1]

The CCMC sanctions present significant compliance challenges for the investment community, compounded by the uncertain contours of the trading ban. While OFAC has clarified some aspects of the sanctions,

many unresolved questions remain and some of the recent actions give rise to new interpretive ambiguities. Firms are advised to carefully monitor developments in this area and take steps to avoid unintentional breaches of this new and unusual U.S. sanctions program.

Expansion of the Trading Ban to Additional CCMCs

On Jan. 14, 2021, the U.S. Department of Defense (“DOD”) named nine additional CCMCs. Transactions in the public securities of each of these entities are permitted through March 14, 2021, at which point only transactions to effectuate divestment are permitted through Jan. 13, 2022.[2] Among other entities, DOD named Xiaomi, the world’s third-largest smartphone maker. According to press reports, Xiaomi is considering action in response to its identification as a CCMC.[3]

The additional designations underscore the multiagency character of the CCMC sanctions program. Under the Executive Order, DOD, as well as OFAC, has the authority to designate CCMCs subject to the trading ban. While OFAC maintains a list of designated CCMCs on its website, entitled “Non-SDN Communist Chinese Military Companies List” (“NS-CCMC List”),[4] as of this writing, OFAC still had not updated this list to reflect the DOD designations made on Jan. 14, 2021. Thus, firms seeking to keep abreast of additional CCMC designations should monitor the DOD website as well as the OFAC website.

When combined with the 31 CCMCs initially designated in the Executive Order, and another 4 CCMCs designated by DOD on Dec. 3, 2020, the 9 designations on Jan. 14, 2021 bring to 44 the total number of CCMCs designated to date.

Mandatory Divestment and Divestment Activities

On Jan. 13, 2021, President Trump issued an Executive Order amending certain provisions of the original Nov. 12, 2020 Executive Order.[5]

Most notably, the amended Executive Order adds a new provision prohibiting “possession” by U.S. persons of CCMC securities as of 11:59 p.m. ET on the date 365 days after the CCMC was named. By contrast, the original Executive Order, while indicating that U.S. persons could no

longer engage in transactions — including divestment transactions — in CCMC securities beginning 365 days after the company was named, did not expressly require divestment.

In the wake of this amendment, OFAC issued FAQ 872 expressly stating that U.S. persons are required to divest their holdings of CCMC securities by the end of the applicable wind-down period and are “prohibited from holding covered securities after the relevant deadline.”[6]

While it is now clear that divestment by U.S. persons is mandatory, the amended Executive Order’s use of the undefined term “possession” will likely engender interpretive difficulties of its own.

FAQ 862, issued on Jan. 4, 2021, makes clear that U.S. persons, including U.S. funds, are not required to divest their holdings in CCMC securities by Jan. 11, 2021, the date the trading ban went into effect.[7] As set forth in the Executive Order, U.S. persons may divest their holdings in the 31 CCMCs initially designated at any time up to Nov. 11, 2021 (and have 365 days from date of designation to divest their holdings in other CCMCs).

FAQ 874 addresses the types of activities by which U.S. persons are permitted to effectuate divestment in accordance with the requirements of the Executive Order.[8] The FAQ reiterates that any transaction (including purchases for value and sales) that is entered into during the wind-down period for the sole purpose of divestment, in whole or in part, is permitted. FAQ 874 refers back to FAQ 865 (discussed below) for the permissibility of market intermediaries and other participants to engage in activities necessary to effect divestment.

Exact or Close Name Matches to CCMCs

There has been considerable confusion concerning the application of the trading ban to subsidiaries and controlled affiliates (“subsidiaries”) of CCMCs. OFAC issued an FAQ on Dec. 28 (FAQ 857) stating that the Executive Order does *not* cover subsidiaries of CCMCs unless and until the subsidiary is itself listed or designated by OFAC or DOD (while adding that OFAC “intends” to list subsidiaries of designated CCMCs in the future).[9] Another FAQ issued at the same time (FAQ 858), however, stated that the Executive Order *does* apply to securities of an entity with a name that “exactly or closely matches” the name of a CCMC.[10]

FAQ 864, issued on Jan. 6, 2021, states that the prohibitions in the Executive Order extend to transactions in securities of subsidiaries of CCMCs, even if those subsidiaries are not expressly listed as subject to the trading ban, if the subsidiary's name "exactly or closely matches" that of a listed CCMC.^[11] FAQ 864 thus clarifies that, in the case of subsidiaries, FAQ 858 in effect trumps FAQ 857 — that is to say, if a publicly traded subsidiary has a name that "exactly or closely matches" the name of a CCMC, it is currently covered by the trading ban even though it has not been expressly listed as a CCMC.

In the absence of a standard for determining when one company's name "closely matches" that of another, market participants could not be sure which CCMC entities would be subject to the trading ban when it took effect on Jan. 11, 2021. As a result, OFAC issued General License No. 1 on Jan. 8, 2021.^[12] General License No. 1 authorizes, until 9:30 a.m. ET on Jan. 28, 2021, all transactions and activities involving the securities of entities whose names closely match the names of CCMCs but which have not been listed on OFAC's NS-CCMC List.

Thus, until Jan. 28, U.S. persons may trade in the securities of CCMC subsidiaries that are not included in the NS-CCMC List without having to make a judgment as to whether the subsidiary's name is a "close match" to that of a listed CCMC. Whether OFAC issues further guidance before Jan. 28 remains to be seen. If it does not do so, and General License No. 1 lapses on that date, firms will have to decide whether to trade in the securities of CCMC subsidiaries based on the guidance provided in FAQ 864.

It should also be noted that on Jan. 8, 2021, OFAC added to the NS-CCMC List the names of, and stock tickers for, four CCMC subsidiaries. Consequently, trading by U.S. persons in the securities of these entities is unaffected by General License No. 1 and is currently prohibited.^[13]

Transactions In Investment Funds Seeking to Divest CCMC Securities

FAQ 865 addresses an issue of particular importance to private investment funds. It states: "Transactions by U.S. persons (including investors and intermediaries) involving investment funds that are seeking to divest during the relevant wind-down periods to ensure compliance with the [Executive Order] are permitted."^[14] In other words, a U.S. person

may continue to invest in a hedge fund, even if that hedge fund is still holding CCMC securities, as long as the fund is seeking to divest its holdings in compliance with the Executive Order.

Intermediary Services Related to Transactions in CCMC Securities

FAQ 863 states that U.S. persons may provide clearing, execution, settlement, custody, transfer agency, back-end services and other such support services related to transactions in CCMC securities, to the extent such services are not provided to U.S. persons in connection with prohibited securities.[15] Thus, such services may be provided in connection with a trade between two non-U.S. persons or a permitted divestment by a U.S. person of CCMC securities.

FAQ 865 confirms that market intermediaries and other participants may facilitate the divestment from CCMC securities (including divestment by investment fund managers).[16] According to this FAQ, participants may engage in ancillary or intermediary activities necessary to effect divestiture during the relevant wind-down periods.

Securities Exchanges

On Jan. 14, 2021, OFAC issued General License No. 2, which authorizes all transactions and activities by securities exchanges operated by U.S. persons involving CCMC securities that are listed after Jan. 14, 2021 for the 365 days following the date the entity is listed as a CCMC.[17]

FAQ 871 was issued in tandem with General License No. 2 and addresses the compliance obligations of securities exchanges operated by U.S. persons. However, other than repeating verbatim the authorizations permitted by General License No. 2, this FAQ does not shed any further light on what those compliance obligations are.[18]

Definition of “Transaction”

The amended Executive Order revises Section 4(e) to include the “sale” of a publicly traded security within the meaning of the term “transaction” as used in the Executive Order.[19] Previously Section 4(e) referred only to the “purchase for value” of a publicly traded security. OFAC FAQ 873 notes that, in light of the amendment, the term “transaction” for purposes

of the Executive Order now includes “the purchase for value, or sale, of any publicly traded security.”[20]

This same definition governs divestments, as Section 1(b) and (c), which address the wind-down periods after a CCMC is identified, have been amended to clarify that any “transaction” solely to divest from CCMC securities is permitted during such period.

FAQ 864 notes that the trading ban was to take effect at 9:30 am ET on Jan. 11, 2021, and clarifies that compliance with it “is measured by trade date, rather than settlement date.”[21]

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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.

[1] SRZ’s prior *Alerts* on the Executive Order, dated Nov. 13, 2020 and Dec. 31, 2020, may be found [here](#) and [here](#), respectively.

[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 5, available [here](#).

[3] See Arjun Kharpal, “Xiaomi Shares Fall 10% As U.S. Adds Smartphone-Marker to ‘Blacklist,’” CNBC (Jan. 14, 2021), available [here](#).

[4] The OFAC list is available [here](#).

[5] Executive Order on Amending Executive Order 13959 (Jan. 13, 2021), available [here](#).

[6] See FAQ No. 872 (Jan. 14, 2021), available [here](#).

[7] See FAQ No. 862 (Jan. 4, 2021), available [here](#).

[8] See FAQ No. 874 (Jan. 14, 2021), available [here](#).

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

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

[11] See FAQ No. 864 (Jan. 6, 2021), available [here](#).

[12] General License No. 1 (Jan. 8, 2021), available [here](#).

[13] OFAC, Non-SDN Communist Chinese Companies List as of Jan. 8, 2021, available [here](#).

[14] *See* FAQ No. 865 (Jan. 6, 2021), available [here](#).

[15] *See* FAQ No. 863 (Jan. 6, 2021), available [here](#).

[16] *See* FAQ No. 865 (Jan. 6, 2021), available [here](#).

[17] General License No. 2 (Jan. 14, 2021), available [here](#).

[18] *See* FAQ No. 871 (Jan. 14, 2021), available [here](#).

[19] The full definition for “transaction” under Executive Order, as amended, is “the purchase for value, or sale, of any publicly traded security.”

[20] *See* FAQ No. 873 (Jan. 14, 2021), available [here](#).

[21] *See* FAQ No. 864 (Jan. 6, 2021), available [here](#).

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