ALERTS

White House Revamps Chinese Securities Trading Ban

June 8, 2021

On June 3, 2021, the Biden administration announced significant revisions to the sanctions program directed at Chinese publicly traded securities originally established by President Donald Trump's Executive Order issued on Nov. 12, 2020. These changes take the form of an amended Executive Order[1] and several new and updated Frequently Asked Questions ("FAQs") issued by the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC").[2] Taken together, these actions expand the scope of the China sanctions program in certain respects, ease the restrictions in other respects, clarify certain issues important to private investment funds and other market participants, and create new uncertainties as to other issues. This *Alert* summarizes the key changes made on June 3, 2021; for background on the Chinese securities trading ban, please see our prior *Alerts* dated Nov. 13, 2020, Dec. 31, 2020 and Jan. 19, 2021.[3]

List of Covered Companies: Additions and Subtractions

Executive Order 14032 issued on June 3, 2021 ("New E.O.") "replace[s] and supersede[s]" key provisions of Executive Order 13959 issued on Nov. 12, 2020 ("2020 E.O."). An Annex to the New E.O. lists the names of 59 publicly traded Chinese companies whose securities are subject to the trading restrictions set forth in the New E.O. Under the New E.O., U.S. persons are prohibited from engaging in "the purchase or sale of any publicly traded securities, or any publicly traded securities that are derivative of such securities or are designed to provide investment

exposure to such securities," of these 59 companies effective Aug. 2, 2021 (except for divestment transactions as discussed below).

The list of 59 companies overlaps in part with the 44 companies designated during the Trump administration. A little over half of the 59 companies listed in the Annex were previously designated pursuant to the 2020 E.O. or are linked to previously designated companies. The remaining companies listed in the Annex, however, have been identified for the first time. OFAC has published a list of the companies, including ISIN and equity ticker information, on OFAC's website.[4]

Notably, many of the 44 companies designated during the Trump administration are not included in the Annex to the New E.O. Among the companies omitted from the Annex are all nine companies identified as Tranche 5 published by the U.S. Department of Defense on Jan. 14, 2021. The Defense Department's Tranche 5 included Xiaomi Corp. and Luokung Technology Corp., both of which subsequently obtained preliminary injunctions from the U.S. District Court in the District Columbia preventing the trading ban from taking effect. It thus appears that at least for now, the Biden administration has abandoned any effort to re-impose trading sanctions against Xiaomi or Luokung.

As the New E.O. replaces and supersedes the prohibitions set forth in the 2020 E.O., it appears that U.S. persons are now free to engage in transactions (including purchases) of the publicly traded securities of companies that were previously designated during the Trump administration but do not appear in the Annex to the New E.O.

Timing and Effectiveness

The New E.O.'s prohibitions on trading in the public securities of the 59 listed companies will take effect on 12:01 am ET on Aug. 2, 2021, 2021.[5] This 60-day window period parallels the similar 60-day window provided for in the 2020 E.O. However, the 12:01 am start time is different: the 2020 E.O.'s trading ban took effect at 9:30 am on the 60th day post-designation.

Significantly, it appears that the Aug. 2, 2021 effective date for the trading ban applies to *all* 59 companies named in the New E.O., including the companies previously sanctioned under the Trump administration. The language of the New E.O. indicates that the trading restrictions previously imposed under the 2020 Order have now come to an end and that, to the

extent the same companies are now subject to the trading restrictions in the New E.O., those restrictions do not take effect until Aug. 2, 2021. In other words, the new E.O. appears to create a window between June 3, 2021 and Aug. 2, 2021 in which purchases and sales of these companies' securities is permissible.

Legal Rationale for Imposition of Sanctions

The New E.O. also reformulates the legal basis for this sanctions program. The 2020 E.O. was tied to Section 1237 of the National Defense Authorization Act for Fiscal Year 1999 ("NDAA"), which empowers the Secretary of Defense to designate "Communist Chinese military companies" operating directly or indirectly in the United States in support of People's Liberation Army of China. Under the 2020 E.O., the trading ban applied to publicly traded securities of all Communist Chinese military companies designated by the Secretary of Defense pursuant to Section 1237 of the NDAA, or determined by the Secretary of Treasury to meet the criteria in Section 1237.

Under the New E.O., designation under Section 1237 is no longer a prerequisite to imposition of the trading restrictions, nor can the Secretary of Defense decide which companies are designated. Rather, the sanctions may be imposed against the securities of any company determined by the Secretary of Treasury (in consultation with the Secretary of State and, as appropriate, the Secretary of Defense) either (i) "to operate or have operated in the defense and related materiel sector or the surveillance technology sector of the economy of the PRC"; or (ii) "to own or control, or to be owned or controlled by, directly or indirectly," such a company.

Moreover, the New E.O. finds that, in addition to the threat posed by China's military-industrial complex identified in the 2020 E.O., "the use of Chinese surveillance technology" both outside the PRC and to facilitate human rights abuses within the PRC constitutes a threat to United States interests, and expands the scope of the national emergency declared in the 2020 E.O. to address those threats. Newly issued OFAC FAQ 900 states that OFAC "expects to use its discretion to target" companies whose operations have included or supported "surveillance of persons by Chinese technology companies that occurs outside of the PRC," as well as "the development, marketing, sale, or export of Chinese surveillance technology" that is, was, or can be used for surveillance of religious or

ethnic minorities or otherwise facilitate repression or serious human rights abuses.[6]

By placing the sanctions regime on this different legal footing, it may be easier for the Biden administration to defend against court challenges by Chinese companies that have already been sanctioned or may be sanctioned in the future. In their successful legal challenges, Xiaomi and Luokung were able to persuade the court that the government had failed to establish that the companies met the criteria for a "Communist Chinese military company" as defined in Section 1237 of the NDAA.[7]

Reflecting this change in approach, sanctioned Chinese companies will no longer be referred to as "Communist Chinese Military Companies," or "CCMCs" for short, as was previously the case. Henceforth, sanctioned companies will be referred to as "Chinese Military-Industrial Complex Companies," or "CMICs." OFAC has replaced the list of CCMCs previously published on its website with a "Non-SDN Chinese Military-Industrial Complex Companies List," or "NS-CMIC List."[8]

Divestment of Sanctioned Securities

In parallel to the 2020 E.O., the New E.O. provides an exception that allows U.S. persons ten months from the effective date of the trading prohibitions, or until 12:01 am ET on June 3, 2022, to engage in purchases or sales of sanctioned securities made "solely to effect the divestment, in whole or in part," of positions held in such securities as of Aug. 2, 2021.[9]

But the divestment provisions in the New E.O. differ in another respect. The Trump administration had issued an Executive Order (E.O. 13974) amending the 2020 E.O. and explicitly banning "possession" of sanctioned securities following the expiration of the ten-month divestment period. This amendment made clear, as OFAC explained in FAQ 872, that U.S. persons were not simply permitted to divest sanctioned securities during the divestment period but were in fact *required* to do so. The New E.O., however, revokes E.O. 13974 in its entirety, and FAQ 872 has now also been repealed. Therefore, it appears that U.S. persons now are no longer required to divest any sanctioned securities they hold as of Aug. 2, 2021. However, once the divestment period expires on June 3, 2022, U.S. persons will not be permitted to engage in any further transactions (either purchases or sales) involving these securities.

In addition, it appears that U.S. persons now have additional time to divest themselves of sanctioned securities of entities designated as CCMCs pursuant to the 2020 E.O. and as CMICs pursuant to the New E.O. Under the 2020 E.O., divestment of CCMC securities was required within ten months of when the trading prohibitions went into effect. But the elimination of the divestment provisions contained in the 2020 E.O. appears to mean that, even if the particular CCMC is also named as a CMIC under the New E.O., U.S. persons now have until June 3, 2022 to divest any securities they still hold in the name. In the case of securities of CCMCs that are *not* named as CMICs under the New E.O., it appears that U.S. persons are no longer obligated to divest themselves of such securities.

Definition of 'Publicly Traded Securities'

The 2020 E.O. applied 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. The 2020 E.O. (as amended) also defined the term "transaction" to mean "the purchase for value, or sale, of any publicly traded security." Tracking the language of its predecessor, the New E.O. applies to "the purchase or sale of any publicly traded securities, or any publicly traded securities that are derivative of such securities or are designed to provide investment exposure to such securities," of CMICs.

The 2020 E.O. did not contain a definition of the term "publicly traded securities." It did, however, define the terms "security" and "securities" to include any "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934. The definition also encompassed currency and notes, drafts, bills of exchange and banker's acceptances with a maturity not exceeding nine months. By contrast, the New E.O. instead contains a definition of the term "publicly traded securities," which states that the term includes any "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 "denominated in any currency that trades on a securities exchange or through the method of trading that is commonly referred to as 'over-the-counter,' in any jurisdiction." The New E.O. omits any reference to currency and notes and similar instruments with a maturity not exceeding nine months.

Under the 2020 E.O., OFAC issued FAQ 860, which listed, as examples of financial instruments covered by the trading ban, "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 such instruments also meet the definition of a "security" under the Securities Exchange Act. As part of the updated FAQs issued on June 3, 2021, OFAC has reissued FAQ 860, listing the same financial instruments as examples of those covered by the trading ban in the New E.O., "to the extent such instruments also meet the definition of 'publicly traded security'" in the New E.O.[10]

It thus appears that the scope of transactions in "publicly traded securities" affected by the New E.O. is largely co-extensive with the scope of the 2020 E.O. Fundamentally, the definition remains tied to the Securities Exchange Act's definition of "security." Therefore, to the extent that particular instruments do not meet the Exchange Act definition of a "security" — as is the case with futures and swaps on so-called broad-based market indices — such instruments should remain outside the scope of the New E.O.

'Close Matches' and Subsidiaries

Significant confusion was created by FAQ 858 issued by OFAC under the 2020 E.O. That FAQ stated that the prohibitions in the 2020 E.O. applied with respect to publicly traded securities of a company with a name that either exactly matches or "closely matches" the name of a designated company. Responding to concerns that such a vague standard left market participants uncertain as to what securities were prohibited, OFAC subsequently issued a series of temporary General Licenses, before the "closely matches" standard ever became effective, that authorized transactions with respect to companies whose name "closely matches" that of a designated company, so long as it was not a designated company itself. The last of these General Licenses was due to expire on June 11.

OFAC has now issued FAQ 899, which states: "Only entities whose names exactly match the names of the entities on the NS-CMIC List are subject to the prohibitions in [the New E.O.]."[11] FAQ 858 has been repealed. Accordingly, at least at this juncture, OFAC no longer intends to extend the trading restrictions to companies that have not themselves been designated but whose name "closely matches" that of a designated company.

Similarly, OFAC FAQ 857, issued under the 2020 E.O., stated that OFAC intended to designate as CCMCs any publicly traded subsidiaries of existing CCMCs (i.e., entities that were either owned 50% or more by a CCMC or controlled by a CCMC). In the updated FAQ 857 issued on June 3, 2021, OFAC has eliminated that language and has instead stated that the prohibitions in the New E.O. apply to subsidiaries of CMICs "only if such subsidiary itself is publicly listed on the NS-CMIC List" published by OFAC. [12] New FAQ 857 further notes that OFAC's so-called 50% rule, pursuant to which any entity owned 50% or more by a Specially Designated National ("SDN") is itself considered an SDN even if has not been identified as an SDN, "does not apply to entities listed solely pursuant to [the New E.O.]."[13] CMICs are not SDNs and U.S. persons remain free to engage in other transactions with these companies that are unrelated to their publicly held securities, such as the purchase or sale of goods or services. [14]

Affected Persons

Like the 2020 E.O., the New E.O. only prohibits activities by any "United States person." This term is defined in the same fashion as under the 2020 E.O.: It encompasses "any United States citizen, lawful permanent resident, 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." Therefore, as a general matter, the New E.O. does not restrict the activities of non-U.S. persons.

It should be noted, however, that the New E.O. (like the 2020 E.O.) includes a broad and customary anti-evasion provision prohibiting "any transaction that evades or avoids, has the purpose of evading or avoiding, causes a violation of, or attempts to violate any of the prohibitions set forth in this order[.]" The New E.O. also prohibits "[a]ny conspiracy formed to violate any of the prohibitions set forth in this order[.]" In the context of other sanctions programs, OFAC has taken the position that non-U.S. persons can be deemed to have violated the applicable sanctions by taking actions that "cause" a U.S. person to engage in a prohibited transaction.

Investment Advisory and Management Services to Non-US Funds

Private fund managers organized or operating in the United States will generally be covered by the New E.O., as would funds organized in the

United States. Newly issued OFAC FAQ 902 has, however, clarified that U.S. persons may provide investment advisory, investment management and similar services to non-U.S. persons (such as a foreign fund) in connection with the non-U.S. person's purchase or sale of a sanctioned security, so long as the underlying purchase or sale would not otherwise violate the Order (such as in the case that the purchase or sale is ultimately for the benefit of a U.S. person, or otherwise an attempt to willfully evade the New E.O.).[15]

At the same time, OFAC has reissued FAQ 861 in substantially identical form. FAQ 861 states that the New E.O. "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" CMICs. As with the prior version of FAQ 861, this remains true "regardless of such securities' share of the underlying index fund, ETF or derivative thereof."[16] Therefore, restrictions remain on the ability of U.S. investors to invest in funds that continue to trade sanctioned securities.

OFAC has, however, retained the guidance in FAQ 865 that allows U.S. persons to invest in investment funds that hold sanctioned securities but are "seeking to divest" those securities during the relevant wind-down periods. Specifically, as updated, FAQ 865 states: "Purchase or sales by U.S. persons (including investors and intermediaries) involving investment funds that are seeking to divest during the relevant wind-down periods are permitted."[17]

US Employees of Non-US Companies

The impact of the 2020 E.O. on the activities of U.S. citizens who work for non-U.S. firms was unclear. Caution was warranted because OFAC sanctions often are considered to restrict the activities of U.S. citizens even when they live and work abroad. However, OFAC FAQ 903 now clarifies that U.S. persons employed by non-U.S. firms are not prohibited from being involved in, or otherwise facilitating, purchases or sales related to securities covered by the New E.O. on behalf of their non-U.S. employer, if those activities fall within the ordinary course of their employment and the purchase or sale in question would not otherwise violate the New E.O. (such as being for the ultimate benefit of U.S. persons or as part of a scheme of circumventing the Order).[18]

Market Makers and Market Intermediaries

Newly issued OFAC FAQ 904 clarifies that U.S. market makers, as well as non-U.S. market makers who employ U.S. persons, are permitted to engage in activities necessary to effect divestiture of sanctioned securities during the applicable wind-down period.[19] OFAC has also reissued that portion of FAQ 865 that allows market intermediaries, including market makers, to engage in ancillary or intermediary activities that are necessary to effect divestiture during the relevant wind-down periods.[20]

OFAC FAQ 901 specifies that for purposes of conducting due diligence as to whether a particular purchase or sale is permissible under the New E.O., U.S. persons, including financial institutions, registered broker-dealers, securities exchanges, and other market intermediaries and participants, "may rely upon the information available to them in the ordinary course of business."[21]

As in our previous *Alerts* on this topic, we note that the operation of the Chinese public securities trading ban is complex and questions will inevitably arise involving its impact on both U.S. and non-U.S. fund managers as well as other market participants. The actions taken by the Biden administration on June 3, 2021 demonstrate that, for the foreseeable future, this sanctions program is here to stay and may well be expanded. Firms are advised to carefully consider how the revised sanctions affect their trading and investment activities and to monitor for future developments.

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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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[1] See Executive Order: Addressing The Threat From Securities Investments That Finance Certain Companies Of The People's Republic Of China (June 3, 2021), available here.

[2] For entities subsequently subject to a sanctions determination, the safe harbor will extend to 12:01 am ET on the date that is 365 days after the date of the determination.

[3] See White House Bans Trading in 31 Chinese Companies (Nov. 13, 2020), available here; OFAC Provides Guidance on Trading Ban in

Chinese Companies (Dec. 31, 2020), available here; US Sanctions on Chinese Company Securities: Further Developments (January 19, 2021), available here.

[4] See OFAC, "Non-SDN Chinese Military-Industrial Complex Companies List," available here.

[5] For entities subsequently sanctioned under the New E.O., restrictions on trading will apply beginning at 12:01 am ET on the date that is 60 days after the date of the sanctions determination.

[6] See FAQ No. 900, available here.

[7] See Xiaomi Corp. v. Dep't of Defense, 2021 WL 950144 (D.D.C. Mar. 12, 2021); Luokung Technology Corp. v. Dep't of Defense, 2021 WL 1820265 (D.D.C. May 5, 2021).

[8] See FAQ No. 898, available here; and FAQ No. 899, available here.

[9] For persons subsequently subject to a sanctions determination, the safe harbor will extend to 12:01 am ET on the date that is 365 days after the date of the determination.

[10] See FAQ No. 860 (June 3, 2021), available here.

[11] See FAQ No. 899 (June 3, 2021), available here.

[12] See FAQ No. 857 (June 3, 2021), available here.

[13] See FAQ No. 857 (June 3, 2021), available here.

[14] See FAQ No. 905 (June 3, 2021), available here.

[15] See FAQ No. 902 (June 3, 2021), available here.

[16] See FAQ No. 861 (June 3, 2021), available here.

[17] See FAQ No. 865 (June 3, 2021), available here.

[18] See FAQ No. 903 (June 3, 2021), available here.

[19] See FAQ No. 904 (June 3, 2021), available here.

[20] See FAQ No. 865 (June 3, 2021), available here.

[21] See FAQ No. 901 (June 3, 2021), available here.

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