
OFAC Issues Guidance on Sanctioned Chinese Military Companies

December 31, 2020

On December 28, 2020, the Department of the Treasury Office of Foreign Assets Control (OFAC) published awaited guidance on the implementation of Executive Order (EO) 13959, “[Executive Order on Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies](#),” which President Trump issued on November 12, 2020. EO 13959 will prohibit, as of January 11, 2021, purchases by U.S. persons of certain securities issued by so-called Communist Chinese military companies. OFAC’s guidance comes in the form of Frequently Asked Questions (FAQs) [857](#), [858](#), [859](#), [860](#), and [861](#). The State Department also issued a [press release](#) the same day addressing OFAC’s guidance.

The new FAQs, discussed below, address some—but not all—key questions asked by industry groups regarding the EO’s scope. While OFAC is working on additional guidance that it may publish prior to January 11, 2021, fund managers, broker-dealers, investment advisors, banks and many others are now making challenging compliance and commercial decisions with limited information about this novel sanctions program.

Background

EO 13959 continues recent Trump Administration efforts to confront “the [Chinese] national strategy of Military-Civil Fusion” through which commercial Chinese companies allegedly support Chinese military and intelligence activities. While past administration efforts have focused on the risks of technology transfers to China that might support Military-Civil Fusion (MCF), both the administration and some members of Congress had been considering [measures to restrict investments in blacklisted Chinese firms](#) for at least several months prior to EO 13959’s issuance.

The EO establishes January 11, 2021, as the date on which “transactions” by U.S. persons in securities of certain Chinese issuers must cease. However, it also affords a 10-month wind-down period for U.S. persons to make purchases or sales “solely to divest, in whole or in part,” from securities held as of that date. President-elect Joe Biden will face a range of challenges as he and

his administration assess whether this and other Trump Administration sanctions measures advance its foreign policy and national security objectives.

Under Sec. 1(a)(i) of the EO, U.S. persons are prohibited, as of January 11, 2021, 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 any Communist Chinese military company,” as defined.

That term, “Chinese Communist military company,” draws from Sec. 1237 of the National Defense Authorization Act for FY 1999, pursuant to which the Department of Defense was required to publish a list of such companies in the *Federal Register* within 90 days. While that did not occur, the Department of Defense purported to revive the provision this summer: it published two lists—[one in June, one in August](#)—“in accordance with the statutory requirements of” Sec. 1237. Under the terms of the EO, any of those Communist Chinese military companies (CCMCs) and any CCMCs subsequently identified by the Department of Defense, in consultation with the Department of the Treasury, are CCMCs for the purposes of the EO.¹ In addition, a CCMC may be a company identified by the Department of the Treasury alone based on its independent assessment of the Sec. 1237 criteria: any person that is owned or controlled by the People’s Liberation Army and is engaged in providing commercial services, manufacturing, producing or exporting.² The Treasury Department may also designate subsidiaries of previously designated CCMCs.

Sec. 1(a)(ii) of the EO addresses situations where the Treasury or Defense Departments subsequently make CCMC designations. In those cases, the prohibition on transactions in publicly traded securities of those CCMCs (or derivatives of securities designed to provide investment exposure to such securities) would be effective 60 days after the designation.

Sec. 1(b) provides for a wind-down period of 10 months—from January 11, 2021, to November 11, 2021—authorizing U.S. persons to make “purchases for value or sales ... solely to divest, in whole or in part, from” securities held as of January 11, 2021, in the CCMCs that the Department of Defense has already designated. Sec. 1(c) provides a comparable wind-down period for securities of subsequently designated CCMCs.

These wind-down periods by now are a familiar feature of U.S. sanctions programs, which increasingly target certain types of securities. The U.S. sanctions targeting Venezuelan sovereign debt and other Venezuelan securities were accompanied by general licenses authorizing U.S.

¹ The Department of Defense has since identified additional companies. See Department of Defense, *DOD Releases List of Additional Companies, In Accordance With Section 1237 of FY99 NDAA* (Dec. 3, 2020), <https://www.defense.gov/Newsroom/Releases/Release/Article/2434513/dod-releases-list-of-additional-companies-in-accordance-with-section-1237-of-fy/>.

² Sec. 1237 also authorized the President to exercise authorities under the International Emergency Economic Powers Act (IEEPA) to target the “commercial activity in the United States” of CCMCs. The EO, however, does not rely explicitly on that authority and instead relies exclusively on IEEPA (and the complementary National Emergencies Act).

persons to divest their holdings that were targeted by the sanctions measures. Notably, however, EO 13959 prohibits only “transactions,” which means “the purchase for value of any publicly traded security,” but does not—by its terms—prohibit holding the CCMC securities or selling them.

Implications of OFAC Guidance

OFAC’s new FAQs offer some initial clarity regarding the agency’s interpretation of certain aspects of EO 13959, but they leave several important questions unanswered. We expect that OFAC will issue additional FAQs in the coming weeks.

Subsidiaries of CCMCs

FAQ 857 clarifies that the prohibitions in EO 13959 apply to the securities of subsidiaries of designated CCMCs, but only “after such subsidiary is publicly listed by Treasury.” In other words, U.S. investors do not need to refrain from purchasing the CCMC subsidiaries’ securities until the Treasury Department (or the Department of Defense) has specifically identified the relevant subsidiary—thus far, no subsidiaries of previously identified CCMCs have been publicly listed. Whether to extend the sanctions to CCMC subsidiaries reportedly had been a source of contention between the Treasury Department, on the one hand, and the State and Defense Departments, on the other, with the latter pushing to extend sanctions to subsidiaries.³

Screening CCMCs

In FAQ 858, OFAC has stated that the prohibitions apply with respect to the publicly traded securities “of an entity with a name that exactly or closely matches the name of” a designated entity. OFAC has also published a [new list](#) on its website that contains the names of the designated entities along with some additional identifying information. For example, for “Huawei,” the new list identifies “Huawei Investment & Holding Co Ltd” as the relevant issuer and identifies “KMCACZ CH” as the equity ticker. But FAQ 858 does not provide any guidance concerning what a “close” match means in this context, and does not provide any safe harbor for U.S. persons that purchase securities issued by entities whose names are not an exact match with the designated CCMCs.

“Publicly Traded Securities”

Sec. 4(d) defines the terms “security” and “securities” to include not only “the definition of ‘security’ in section 3(a)(10) of the Securities Exchange Act of 1934, Public Law 73-291, as codified as amended at 15 U.S.C. 78c(a)(10),” but also “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.” FAQ 859 clarifies that OFAC intends to interpret the term “publicly traded securities” to include securities

³ See, e.g., Demetri Sevastopulo, *US Treasury Seeks to Water Down Trump’s Chinese Securities Ban*, Financial Times (Dec. 17, 2020), <https://www.ft.com/content/2093e63d-f04e-4819-85f0-a9a2c1ce27c8>.

denominated in any currency that trade on an exchange or over-the-counter, in any jurisdiction. This is a relatively broad scope since it specifically applies to securities trading beyond U.S. exchanges.

Covered Financial Instruments

OFAC has not yet defined the term “designed” or provided other, definitive guidance in the context of “designed to provide investment exposure.” It has, however, in FAQ 860, provided a list of examples of financial instruments that are “derivatives, or are designed to provide investment exposure to” the targeted, publicly traded securities. This list is illustrative, not exhaustive, and includes derivatives (e.g., futures, options, swaps), warrants, American depositary receipts, global depositary receipts, exchange-traded funds (ETFs), index funds and mutual funds.

Covered “Transaction”

As noted above, EO 13959 defines “transaction” as “the purchase for value of any publicly traded security.” One question arising since the issuance of the order has been whether OFAC addressed the provision of services that enable the purchase of publicly traded securities, such as brokering, clearing and settlement, and investment advising, among others. The OFAC FAQs do not address whether and to what extent such services are covered, though EO 13959 does not, by its terms, prohibit the provision of services. Nor does EO 13959 explicitly prohibit facilitation by a U.S. person of an otherwise permissible transaction by a non-U.S. person. Notably, many other U.S. sanctions programs administered by OFAC do prohibit facilitation.

Sec. 2 of EO 13959 does prohibit evading or avoiding, or causing a violation of, any prohibition under the EO, as well as any conspiracy formed to violate the EO’s prohibitions. But these prohibitions appear to require that there be an underlying violation of the order, i.e., the purchase of the targeted securities by a U.S. person.

Another question following the issuance of EO 13959 had been whether OFAC would establish some proportionality threshold for funds comprising—in part—CCMC securities. OFAC has affirmed in FAQ 861 that Executive Order 13959 prohibits U.S. persons from investing in (U.S. or foreign) index funds, ETFs or derivatives thereof, that hold CCMC securities, irrespective of the proportion of such fund represented by the CCMC security. This is a broad application of the order as well because any CCMC security would effectively “taint” a fund. Funds that comprise—in part—a CCMC security should consider whether they need to amend their risk disclosures and/or make new disclosures to prospective investors to account for the impact of EO 13959 on the fund and its underlying securities.

Covered Persons

Under Sec. 4(f) of EO 13959, the term “United States person” means a U.S. citizen, permanent legal resident alien, entity organized under U.S. law or any sub-federal jurisdiction within the United States (including foreign branches), or any person in the United States. This definition is comparable to the definition used in other U.S. sanctions programs and does not, by its terms, apply to foreign-incorporated subsidiaries or affiliates of U.S. companies. However, there continues to be interagency discussion about investments held by, and the activities of, the foreign subsidiaries and affiliates of U.S. financial institutions, particularly those in China.

The State Department stated in its December 28 press release that the Treasury Department’s guidance should mitigate concerns that US investors might unknowingly support CCMCs. According to the State Department: “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.” The State Department had previously issued a [Factsheet](#) highlighting that certain major index providers continued to list the securities of CCMCs, which meant that funds from U.S. investors were “often passively” flowing to the CCMCs in the index funds.

Given the timing of the EO and the January 11, 2021, implementation date, many firms are eager to see whether the Biden Administration will revoke or further delay implementation of the EO’s prohibitions. While the next administration will have relatively broad legal authority to blunt the impact of these prohibitions or even revoke them entirely if it chooses to, we do not expect that this will be an immediate priority. Once political appointees at the Departments of Defense, State and the Treasury are confirmed—after facing detailed questions on China in their confirmation hearings—the agency stakeholders will likely assess whether the EO is consistent with the Biden Administration’s broader China strategy. Members of President-elect Biden’s national security team have recently weighed in on the new investment agreement between the European Union and China,⁴ suggesting that the incoming administration would seek opportunities to coordinate its China strategy—including on investment matters—with traditional U.S. allies.

WilmerHale has experience advising on U.S. sanctions and cross-border investments. We are available to work with clients on assessing the potential impact of the EO on their portfolios and on their business.

⁴ Demetri Sevastopulo, “Biden team voices concern over EU-China investment deal,” *Financial Times* (Dec. 22, 2020), <https://www.ft.com/content/2f0212ab-7e69-4de0-8870-89dd0d414306>.

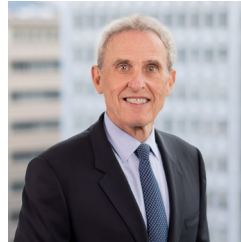
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