

US Imposes New Restrictions on Chinese Military Companies

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On November 12, 2020, President Trump signed [Executive Order 13959](#) prohibiting U.S. persons from engaging in any transaction in publicly traded securities in “Communist Chinese military companies” (CCMCs), effective January 11, 2021. The executive order also prohibits transactions in any securities that are derivative of any publicly traded securities in CCMCs as well as transactions designed to provide investment exposure to such securities.

The prohibitions in the executive order, although targeted in scope, apply to transactions involving securities of some of the largest companies in China, including companies involved in the aerospace, shipbuilding, construction and technology sectors. While the executive order represents a substantial increase in U.S. sanctions related to China, the executive order is directionally consistent with U.S. policy during the Trump administration. How the administration of President-Elect Biden will approach the matter is unclear.

Scope of the Prohibition

The executive order prohibits any transaction in publicly traded securities, or any securities that are derivative of, or designed to provide investment exposure to such securities, of any CCMC, by any U.S. person.¹ As is customary with sanctions-related executive orders, the executive order also contains an anti-circumvention provision that prohibits transactions by a U.S. person or within the United States that evade or avoid, have the purpose of evading or avoiding, cause a violation of, or attempt to violate the prohibitions set forth in the executive order.² The executive order does not more broadly restrict commercial dealings with CCMCs or transactions involving securities of a CCMC that are not publicly traded.

The scope of this prohibition hinges on the definition of certain key terms — in particular, the definition of a “Chinese Communist military company.” This term is taken from the National Defense Authorization Act for Fiscal Year 1999, as amended (the 1999 NDAA), which required the U.S. Department of Defense (DoD) to produce a list of entities determined to be operating directly or indirectly in the United States that are CCMCs. Under the 1999 NDAA, a CCMC is defined as a person that is (i) owned or controlled by the People’s Liberation Army, and (ii) engaged in providing commercial services, manufacturing, producing or exporting.³

Drawing on this definition, the executive order defines CCMCs as:

- any person that the DoD has already listed as a CCMC pursuant to the 1999 NDAA as of November 12, 2020, and as set forth in the Annex to the executive order;
- any person that the DoD, in consultation with the U.S. Department of the Treasury (Treasury), subsequently identifies and publicly lists as a CCMC pursuant to the 1999 NDAA; or
- any person that the Treasury publicly lists as (i) meeting the criteria set out in the 1999 NDAA (*i.e.*, a person that is owned or controlled by the People’s Liberation Army and engaged in providing commercial services, manufacturing, producing or exporting), or (ii) a subsidiary of an entity already determined to be a CCMC.

¹ *Executive Order on Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies* § 1(a)(i) (Nov. 12, 2020).

² *Id.* § 2.

³ The 1999 NDAA defines the “People’s Liberation Army,” in turn, as “the land, naval, and air military services, the police, and the intelligence services of the Communist Government of the People’s Republic of China, and any member of any such service or of such police.” 1999 NDAA § 1237(c).

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Thus far, the DoD has identified and listed 31 entities as CCMCs through an [initial list](#) issued in June 2020 and an [additional list](#) released in August 2020. Critically, the DoD list and the Annex to the executive order in most cases do not specify precisely which entity within a given corporate group constitutes a CCMC.⁴ This lack of specificity reflects the fact that, under the 1999 NDAA, there was no legal consequence for being listed as a CCMC. The executive order has taken this broadly framed list and operationalized it for a tailored objective, leaving some uncertainty regarding the specific legal entities targeted by the order. Since the executive order prohibits transactions in publicly traded securities (or derivatives of such securities), it presumably is intended to target only those entities within a corporate group that have issued publicly traded securities. We anticipate that Treasury will need to build out the list of targeted entities to include those entities whose publicly traded securities the Treasury wants to capture.

Prohibitions Apply to US Persons

The executive order defines a “U.S. person” 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.” Entities that are organized under the laws of a foreign country — such as a foreign subsidiary of a U.S. entity or foreign entity that is merely listed on a U.S. exchange — would not qualify. Thus, these foreign persons may be able to purchase or sell securities in CCMCs without running afoul of the executive order’s prohibition.

Subsidiaries of CCMCs

The executive order does not automatically prohibit transactions in securities issued by the subsidiaries of a CCMC. Specifically, Section 4(a)(iii) of the order permits Treasury to add subsidiaries of CCMCs to the list of prohibited entities — action that would be unnecessary if subsidiaries already fell within the scope of the order. Nevertheless, the Treasury could publish regulations or interpretive guidance that effectively expands the scope of the restrictions to include certain subsidiaries.

Derivatives and Synthetic Risk

As noted above, the executive order applies not only to the publicly traded securities of CCMCs, but also to “any securities that are derivative of, or are designed to provide investment exposure to such securities.” Thus, as written, the prohibition is broad enough

to encompass investments by a U.S. person that do not involve the actual purchase of publicly traded securities in a CCMC.

The executive order does not provide additional guidance on how this prohibition will be implemented. We note that the Treasury’s Office of Foreign Assets Control (OFAC) has addressed issues related to derivatives and synthetic risk in the context of other sanctions programs that may be instructive. In the context of Venezuela-related sanctions, OFAC issued guidance regarding exchange-traded funds (ETFs) that track, but do not hold, baskets of securities that include some restricted securities of blocked parties. In that case, OFAC allowed U.S. persons to continue to invest in such ETFs as long as the underlying basket being tracked included less than a predominant share by value of the restricted securities. In the Ukraine/Russia-related sanctions program, OFAC issued a general license broadly carving out derivatives from the debt and equity restrictions under the sectoral sanctions. We expect that OFAC will provide additional guidance regarding application of the new China-related sanctions in the coming weeks and months.

Divestiture

Notwithstanding the executive order’s broad prohibition of “any transaction” in CCMC securities, investors that hold CCMC securities may divest their holdings within a specific time period after the effective date of the executive order. With respect to entities that already had been designated CCMCs as of the date the executive order was issued (*i.e.*, November 12, 2020), the executive order allows a U.S. person to purchase for value or sell, on or before 11:59 p.m. eastern standard time on November 11, 2021, solely to divest, in whole or in part, securities in such entities that the U.S. person held as of 9:30 a.m. eastern standard time on the effective date (*i.e.*, January 11, 2021). For entities that are designated CCMCs after the executive order was issued, the prohibitions become effective 60 days following the date of determination that the company is a CCMC, and U.S. persons have 365 from that determination date to divest any securities held as of the effective date (*i.e.*, U.S. persons have 305 days to divest any securities held as of the effective date of the restrictions). These divestment authorizations are similar to general licenses that OFAC issued under the Ukraine/Russia-related program authorizing certain transactions, including via U.S. intermediaries, to divest or transfer debt, equity or other holdings in EN+ Group PLC, GAZ Group, and United Company RUSAL PLC to non-U.S. persons.

⁴ The names on the August 2020 DoD list and the names listed in the Annex published in the executive order are the same except for some nonsubstantive differences.

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Facilitating Transactions by Investors

A stated purpose of the executive order is to restrict investments by U.S. persons; however, the prohibitions in the order are drafted broadly to include “any transaction in”⁵ the restricted securities “by a U.S. person.” In the ordinary course, OFAC’s regulations prohibit a U.S. person from facilitating transactions by non-U.S. persons that the U.S. person cannot engage in itself. Therefore, U.S. financial intermediaries such as banks, broker dealers, custodians and investment advisers will also need to consider these new sanctions, even with respect to transactions between non-U.S. persons. We expect that the Treasury will clarify the scope of the restrictions applicable to such intermediaries in guidance, in implementing regulations or through licenses OFAC may issue.

⁵A “transaction” is defined, in turn, as a purchase for value of any publicly traded security.

Potential Implications of a Biden Administration

For the moment, how the incoming Biden administration will approach the executive order is unclear. The new administration could potentially withdraw the order or narrow its scope (by amendment or via implementing guidance or regulation) if the order does not reflect the administration’s view or priorities. As a result, U.S. investors may consider adopting a cautious approach with respect to the executive order. The mere holding of securities in CCMCs will not be prohibited — and divestment will be permitted — after January 11, 2021. U.S. investors will need to decide whether to divest their holdings immediately or to hold their shares until there is clarity on whether the new administration will continue or modify the policy outlined in the executive order.

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