

November 17, 2020

U.S. Economic Sanctions Targeting Chinese Military Companies

New Executive Order Prohibits U.S. Persons from “Transacting” in Publicly Traded Securities of “Communist Chinese Military Companies”

SUMMARY

On November 12, 2020, President Trump issued an Executive Order prohibiting U.S. persons from “transacting” in publicly traded securities of “Communist Chinese military companies.” The new restrictions, which go into force on January 11, 2021, initially target 31 companies that have been identified by the U.S. Department of Defense as “Communist Chinese military companies.” Those targeted include some of China’s largest industrial and technology firms, with several having subsidiaries that are listed on U.S. stock exchanges. The Executive Order also prohibits “transacting” in publicly traded securities of companies that may be identified by the Department of Defense or the Department of the Treasury as “Communist Chinese military companies” in the future, and provides authority to the Treasury Department to further target subsidiaries of any company determined to be a Communist Chinese military company.

BACKGROUND

Section 1237 of the National Defense Authorization Act for Fiscal Year 1999 (“NDAA 1999”), as amended, directs the Secretary of Defense to identify companies operating directly or indirectly in the United States or in any of its territories or possessions that are linked to China’s military, and provides the President with additional authorities to sanction such companies.¹ Specifically, pursuant to § 1237(a)(1) of the NDAA 1999, as amended,² the President is authorized, but not required, to impose sanctions under the International Emergency Economic Powers Act (“IEEPA”)³ in the case of any commercial activity in the

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United States by a person that is on the list of “Communist Chinese military companies” published by the Department of Defense.

On June 12, 2020, following Congressional correspondence, the Defense Department issued its first tranche of identifications, naming 20 Chinese companies.⁴ The June 2020 list included major state-owned industrial corporations, as well as technology firms such as Huawei and Inspur Group.⁵ The Defense Department identified additional firms on August 28, 2020, bringing the total number of identified companies to 31.⁶

EXECUTIVE ORDER

On November 12, 2020, President Trump issued Executive Order 13959 declaring a national emergency with respect to the threat to the national security, foreign policy and economy of the United States posed by the People’s Republic of China’s military-industrial complex and authorizing certain IEEPA-based restrictions on identified “Communist Chinese military companies.”⁷

The Executive Order defines the term “Communist Chinese military company” in two principal ways. First, it includes any person identified by the Department of Defense, either currently or in the future, as meeting the criteria in § 1237 of the NDAA 1999, as amended.⁸ Second, the term “Communist Chinese military company” also includes any entity that the Secretary of the Treasury may publicly list as meeting the criteria of being “owned or controlled by the People’s Liberation Army and . . . engaged in providing commercial services, manufacturing, producing, or exporting,” or as a subsidiary of a company already determined to be a Communist Chinese military company.⁹ In each case, the identification is valid until such time as the Secretary of Defense or the Secretary of the Treasury, as applicable, removes the listing and identification of such entity. The Executive Order does not block the property of identified entities; therefore, it appears that OFAC’s “50-Percent Rule”, which provides that entities owned 50 percent or more by blocked parties are property of the blocked party, and also blocked, does not apply to automatically subject majority-owned subsidiaries of identified entities to the transactional prohibitions.¹⁰ Thus, it appears that U.S. persons are not prohibited from transacting in securities of a subsidiary of an identified firm, provided the subsidiary itself has not been identified by the Department of Defense or the Treasury Department. However, a subsidiary potentially could be identified as a Communist Chinese military company by either Defense or Treasury in the future, or as a subsidiary of a company already determined to be a Communist Chinese military company by Treasury, in which case the prohibitions would attach.

Beginning at 9:30 a.m. Eastern Standard Time on January 11, 2021, U.S. persons are prohibited from engaging in “any transaction in publicly traded securities, or any securities that are derivative of, or are designed to provide investment exposure to such securities” of Communist Chinese military companies identified by the Defense Department as of November 12, 2020.¹¹ The same prohibition on “transactions” will apply to Communist Chinese military companies identified by the Defense Department or the Treasury

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Department (or a subsidiary thereof identified by the Treasury Department) in the future. The transactional prohibition for such companies will apply following a 60-day period from the date of identification.

The prohibitions in the Executive Order appear to be narrowed by the definition of the term “transaction,” which for purposes of the Executive Order means “the purchase for value of any publicly traded security.”¹² As such, the Executive Order, read literally, prevents only any transactions (i.e., the purchase for value of any publicly traded security) 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. Thus, it does not appear to prohibit the passive holding of investments or the sale of securities to non-U.S. persons. The inclusion of the phrase “of any publicly traded security” within the definition of “transaction” also raises a question as to how to interpret the application of the prohibition to the purchase for value of “securities that are derivative of, or are designed to provide investment exposure to such [publicly traded] securities,” as these derivative or synthetic investment vehicles may not themselves be publicly traded.

Additional interpretive complications arise from the fact that the terms “investment exposure” and “publicly traded” are not defined in the Executive Order. If interpreted broadly, the term “investment exposure” could encompass a wide range of activity. Although the term “publicly traded” is not defined, the reference to “public exchanges” in the preamble text of the Executive Order may indicate that the goal is to target transactions related to investment securities traded in public markets. However, the definition of “security” in § 4(d) of the Executive Order, though based on the definition of the same term in the Securities Exchange Act of 1934 (“Exchange Act”), also includes a number of financial products expressly excluded from the definition of “security” in the Exchange Act and not typically viewed as investment securities or traded in public markets.¹³

The Executive Order expressly authorizes purchases for value or sales solely to divest from securities held by U.S. persons in identified Communist Chinese military companies, so long as those transactions are made by November 11, 2021 for securities of companies identified by the Defense Department as of November 12, 2020 (or within 365 days from the date of identification for companies identified at a later time). This authorization may suggest that the Executive Order is intended to incentivize divestment by U.S. persons of any securities of Communist Chinese military companies, despite the apparent limitation built into the definition of “transaction,” as described above.

The Executive Order provides regulatory and enforcement authority to the Secretary of the Treasury, and it appears likely that the Office of Foreign Assets Control (“OFAC”) will be responsible for publishing relevant regulations, as well as clarifying guidance.

IMPLICATIONS

According to National Security Adviser Robert O'Brien, the measures "serve[] to protect American investors from unintentionally providing capital that goes to enhancing the capabilities of the People's Liberation Army and People's Republic of China intelligence services."¹⁴ It is clear that the new Executive Order will impede trading of the securities of Communist Chinese military company securities on U.S. exchanges, and presumably will threaten the inclusion of such securities in U.S.-based indexes and funds, as well as limit trading in such securities by U.S. persons on foreign exchanges. Less certain is how the order will affect subsidiaries of identified firms. At this time, only a small number of the 31 identified companies are listed on public exchanges, and all of these listings are outside the United States. However, nearly all have subsidiaries or affiliates that are themselves listed on exchanges, both within the United States and abroad. While the Executive Order grants the Treasury Department the authority to identify subsidiaries of Communist Chinese military companies, subsidiaries are not automatically subject to the prohibitions, as the 50% Rule does not apply.

The Executive Order also provides that "transactions" (as defined by the Executive Order) that "cause a violation" of the prohibitions are prohibited. Therefore, it is possible that the Executive Order could have wide-ranging effects on non-U.S. holders of securities that have ties to the United States. For instance, a non-U.S. investor could potentially be subject to liability for purchasing securities of an identified entity on a non-U.S. exchange if the payments are routed through the United States or a U.S. financial institution wherever located. Similarly, U.S. investors may be concerned about investing in non-U.S. funds that hold prohibited securities. The ambiguities highlighted above also raise questions regarding the scope of the Executive Order's prohibitions and potential liability that may arise out of transactions in financial products not typically viewed as investments or securities. Finally, the potential for future identification as a Communist Chinese military company will likely dampen enthusiasm for future public offerings of securities by Chinese companies that are not yet identified but which have ties to the Chinese military.

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ENDNOTES

- 1 § 1237 of Pub. L. 105-261 (1999)
- 2 § 1237 of Pub. L. 105-261 (1999), as amended by § 1233 of Pub. L. 106-398 (2001) and § 1222 of Pub. L. 108-375 (2004).
- 3 50 U.S.C. §§ 1702–05.
- 4 See Letter from David L. Norquist, Deputy Sec’y of Defense to Sen. Tom Cotton (June 24, 2000), *available* at <https://www.cotton.senate.gov/files/documents/Sen%20Cotton%20NDAA%20FY%201999%20Sec%201237%20Response%2006242020.pdf>.
- 5 U.S. Dep’t of Defense, “Qualifying Entities Prepared in Response to Section 1237 of the National Defense Authorization Act for Fiscal Year 1999” (June 12, 2020), *available* at https://media.defense.gov/2020/Aug/28/2002486659/-1/-1/1/LINK_2_1237_TRANCHE_1_QUALIFYING_ENTITIES.PDF.
- 6 U.S. Dep’t of Defense, “Qualifying Entities Prepared in Response to Section 1237 of the National Defense Authorization Act for Fiscal Year 1999” (August 28, 2020), *available* at https://media.defense.gov/2020/Aug/28/2002486689/-1/-1/1/LINK_1_1237_TRANCHE-23_QUALIFYING_ENTITIES.PDF. An Annex to the Executive Order consolidates the two Department of Defense listings into a single source. See Exec. Order No. 13,959, 85 Fed. Reg. 73,185 (November 17, 2020), *available* at <https://www.govinfo.gov/content/pkg/FR-2020-11-17/pdf/X20-11117.pdf>
- 7 *Id.*
- 8 Under § 1237 of the NDAA 1999, as amended, the term “Communist Chinese military company” includes any entity that has been identified in specified Defense Intelligence Agency publications, and also includes any entity that is identified by the Department of Defense as operating directly or indirectly in the United States or any of its territories and possessions that is “owned, or controlled, or affiliated with, the People’s Liberation Army or a ministry of the government of the People’s Republic of China or that is owned or controlled by an entity affiliated with the defense industrial base of the People’s Republic of China; and is engaged in providing commercial services, manufacturing, producing, or exporting.” Pub. L. 105-261, § 1237(b)(4)(B)(i)–(ii), as amended by § 1233 of Pub. L. 106-398 (2001) and § 1222 of Pub. L. 108–375 (2004).
- 9 The definition of “Communist Chinese military company” for purposes of the Secretary of the Treasury’s identification of companies is a narrower definition, taken from the original version of the NDAA 1999 and not the definition of the term as amended by Pub. L. 108-375 (2004) as used by the Secretary of Defense. The definition used by Treasury omits expansions covering: (i) entities “affiliated with” the People’s Liberation Army and (ii) entities owned or controlled by, or affiliated with, “a ministry of the government of the People’s Republic of China or [...] owned or controlled by an entity affiliated with the defense industrial base of the People’s Republic of China.”
- 10 It is possible that the Treasury Department could issue a rule or clarifying guidance that all 50 percent or more owned companies of listed Communist Chinese military companies are covered by the transactional prohibitions.
- 11 *Id.* § 1(i). “Securities” are defined as in § 3(a)(10) of the Securities Exchange Act of 1934, with the addition that “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, shall be a security for purposes of this order.” *Id.* § 4(d).
- 12 *Id.* § 4(e).

ENDNOTES (CONTINUED)

- ¹³ The expansion of the definition of “security” beyond § 3(a)(10) of the Securities Exchange Act of 1934 may be designed to prevent evasion of the restrictions by the Communist Chinese military companies through selling in the capital markets short-term obligations that would not otherwise meet the definition of security. See *supra* note 11.
- ¹⁴ Statement from National Security Advisor Robert C. O’Brien (November 12, 2020), available at <https://www.whitehouse.gov/briefings-statements/statement-national-security-advisor-robert-c-obrien-111220/>.

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