

United States Bans Certain Investments by U.S. Persons in Companies Linked to the Chinese Military

November 16, 2020

On November 12, 2020 President Trump issued a new **Executive Order**, “Executive Order on Addressing the Threat from the Securities Investments that Finance Communist Chinese Military Companies” (the “**November 12 E.O.**”) which bans, as of January 11, 2021, certain transactions by any United States person (“**U.S. person**”) in publicly traded securities¹ of entities determined to be associated with the Chinese military and listed in the Annex to the November 12 E.O (“**Communist Chinese military companies**”). Transactions in derivatives of the Communist Chinese military companies’ securities or in securities “designed to provide investment exposure to” such companies’ securities are also prohibited. The November 12 E.O. does, however, permit sales and purchases of covered securities for the purpose of divestment until November 11, 2021. Although issued under the authority of the International Emergency Economic Powers Act (“**IEEPA**”) and drafted for implementation by the Treasury Department, the November 12 E.O. is unlike typical IEEPA-based sanctions programs in several respects, leaving important questions of scope to be clarified by agency regulations, guidance, FAQs or follow-up executive orders.

Overview

The November 12 E.O. aims to deny companies determined to be associated with the Chinese military access to U.S. capital through publicly traded securities, whether equity or debt. The preamble to the order states that the “[People’s Republic of China] exploits United States investors to finance the development and modernization of its military” by raising capital through the sale of securities on exchanges both in the United States and abroad, and by lobbying index providers and funds to include the securities of Communist Chinese military companies in their offerings. In this manner, the November 12 E.O. appears to target investment products with exposure to Communist Chinese military companies whether within or outside of the U.S. At the same time, the November 12 E.O. is narrower than most IEEPA-based sanctions orders; it does not block accounts or assets or deny access to the U.S. financial system, including U.S. dollar clearing; and it does not prohibit commercial transactions between U.S. persons and the targeted entities. Provided that dealings with a Communist Chinese military company are in compliance with other U.S. laws and regulations, such as export restrictions, a U.S. bank, could, for example, lend U.S. dollars to a targeted Chinese entity so that the entity could buy a U.S.-built ship or to finance the construction of a factory in the United States. The U.S. bank might even be able to accept a pledge of the entity’s publicly traded shares as security for the loan, but a U.S. person could not purchase those securities.

As noted above, the November 12 E.O.’s prohibitions also extend to securities “designed to provide investment exposure” to the publicly traded securities of designated entities. No guidance has yet been provided on whether a fund with a very small exposure to targeted securities would be ineligible for purchase by U.S. persons or whether an index fund that includes such securities in proportion to their weight in the relevant index will be deemed to be “designed” to provide investment exposure to targeted securities. The lack of specificity surrounding the application of the November 12 E.O. in these

¹ For purposes of the November 12 E.O., a “security” or “securities” are defined as the definition of “security” in section 3(a)(10) of the Securities Exchange Act of 1934, Public Law 73-291, as codified and amended at **15 USC 78c(a)(10)**, except 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.” The November 12 E.O. does not define when a security is “publicly traded” or specify when a security is “of” a listed entity.

circumstances creates substantial uncertainty in financial markets that we expect the Treasury Department will seek to address and clarify in guidance issued in the coming weeks and months.

Definition of a “Communist Chinese military company”

The November 12 E.O. prohibits U.S. persons from engaging in transactions in the publicly traded securities of “Communist Chinese military companies,” which are defined as:

- Any person that the Secretary of Defense has listed, as of November 12, 2020, as a Communist Chinese military company,² and that is identified in the Annex to the November 12 E.O.³
- Any person that the Secretary of Defense, in consultation with the Treasury, determines to be a Communist Chinese military company, and thus added to the existing list of 31 designated entities.⁴
- Any person that the Treasury Secretary determines to satisfy the criteria in [section 1237\(b\)\(4\)\(B\) of Public Law 105-261](#) or publicly lists as a subsidiary of a person already determined to be a Communist Chinese military company.

The November 12 E.O. addresses only entities identified by the Secretary of Defense or the Secretary of the Treasury. The order’s prohibitions appear not to extend automatically to the subsidiaries, parents or affiliates of such entities, even though some of the entities previously identified by the Department of Defense as Communist Chinese military companies are not issuers of publicly traded debt or equity, but nonetheless have parents or subsidiaries that are issuers of publicly traded securities.

As the stated intent of the November 12 E.O. is to limit the flow of United States capital to Communist Chinese military companies, we expect that the Treasury Secretary will ultimately determine that certain listed subsidiaries or affiliates of the entities previously identified by the Department of Defense will be subject to the sanctions provided for by this order as well. On its face, this order does not automatically apply to subsidiaries or affiliates of currently listed Communist Chinese military companies, however, and there is precedent for the U.S. government to exclude certain listed subsidiaries or affiliates for policy reasons. For example, the U.S. government has issued general licenses excluding certain U.S. subsidiaries of Venezuelan state-owned entities from financial sanctions imposed against the Government of Venezuela. Ultimately, the identification or exclusion of listed subsidiaries or affiliates is a matter that will require clarification from the Treasury Department.

Entities added to the Communist Chinese military company list will retain their designations until the Secretary of Defense or the Treasury removes them.

Definition of a “United States person”

Prohibitions specified in the November 12 E.O. only apply to transactions by “U.S. persons.” For purposes of the November 12 E.O., a U.S. person is defined 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 person⁵ in the United States. If a person meets the definition

² Specifically, any person listed by the Secretary Defense as a Communist Chinese military company pursuant to [section 1237 of Public Law 105-261, as amended by section 1233 of Public Law 106-398 and section 1222 of Public Law 108-375](#). The 31 companies currently listed as Communist Chinese military companies can be found [here](#).

³ The Annex can be found [here](#), and is identical to the Department of Defense’s list of Communist Chinese military companies as of the date of this memorandum.

⁴ Pursuant to [section 1237 of Public Law 105-261, as amended by section 1233 of Public Law 106-398 and section 1222 of Public Law 108-375](#).

⁵ The term person means an “individual or entity.”

of U.S. person, no matter if it is located outside of the United States, the prohibitions specified in the November 12 E.O. apply to its activities. However, under a plain reading of the U.S. person definition, an entity organized under the laws of a jurisdiction other than the United States that is controlled by a U.S. person is not a U.S. person for purposes of the November 12 E.O.

Notably, the November 12 E.O. does not separately prohibit transactions “in the United States,” as is the case in most IEEPA-based sanctions orders. This limitation, coupled with the narrow definition of “transaction” discussed below, may limit the impact of the order on non-U.S. financial institutions.

Definition of a “Transaction”

The prohibitions defined in the November 12 E.O. only apply to *transactions* as defined by the order. For the purposes of the November 12 E.O. a “transaction” is “the purchase for value of any publicly traded security.”

On its face, the definition of a “transaction” is narrowly limited to purchases for value, suggesting that Section 1(a) of the order does not prohibit a U.S. person from holding or selling a targeted security. The definition of “transaction” also does not appear to prohibit the acceptance of benefits flowing from a U.S. person’s holdings in a targeted security, such as capital gains or dividends.

In addition, the definition of “transaction” targets only *publicly traded securities*. As noted above, “Publically traded,” however, is not defined in the November 12 E.O. and does not have a single, widely-recognized meaning.

Section 2(a) of the November 12 E.O. provides that any transaction by a U.S. person, or within the United States, that evades, avoids, attempts to evade or avoid, causes a violation of, or attempts to violate the prohibitions set forth in the November 12 E.O. is also a prohibited act. The scope of this provision, when read in conjunction with the narrow definition of “transaction” specified by the order, is unclear, and the order may need to be amended to correct this issue.

Effective Dates and Timing

- **January 11, 2021 at 9:30 a.m. EST** – the November 12 E.O. becomes effective at this date and time. From this point onward, the purchase for value by U.S. persons of publicly traded securities of targeted Communist Chinese military companies, derivatives of those securities, or securities that are designed to provide exposure to targeted securities, will be prohibited, except where incident to a permitted divestment transaction through November 11, 2021. Following this effective date, the November 12 E.O. provides for a 10-month wind down period.
- **November 11, 2021 at 11:59 p.m. EST** – As noted above, the November 12 E.O. includes a 10-month wind down period that ends at this date and time. During this period, purchases of covered securities solely for the purpose of divestment of covered securities that a U.S. person held as of the effective date are permitted.⁶⁶ This allowance appears to be similar to authorizations under the Venezuela and Russia-related sanctions permitting divestment of securities issued by sanctioned entities to non-U.S. persons, though it introduces a requirement that the transaction be “solely” for the purpose of divestment that may require clarification through regulation or guidance.

These prohibitions in the November 12 E.O. do not apply retroactively, however publicly traded securities issued by an entity within the scope of the order prior to January 11, 2021 will become subject to the order’s prohibitions beginning on January 11, 2021 and going forward. While there is a grace period provided for transactions by U.S. persons to divest interests in Communist Chinese military companies, divestiture is not required under the November 12 E.O.

⁶⁶ Section 1(b) of the November 12 E.O. also states that “sales” of covered securities are permitted during this wind-down period, but it is not clear why affirmative authorization for sales would be needed, as they do not appear to be prohibited by Section 1(a) of the order.

If any additional entity is determined to be a Communist Chinese military company, any transaction by a U.S. person in such company's publicly traded securities, or any derivatives of such security or securities designed to provide investment exposure thereto, will be prohibited at 9:30 a.m. EST on the date that is 60 days after such determination. In the event that a company is later determined to be a Communist Chinese military company, purchases for value or sales by U.S. persons to divest, in whole or in part, from such securities are permitted for 365 days from the determination that it is a Communist Chinese military company.

Looking Forward

As noted, the November 12 E.O. authorizes the Secretary of the Treasury, in consultation with the Secretary of State, the Secretary of Defense, the Director of National Intelligence, and the heads of other executive departments and agencies, to promulgate rules and regulations to carry out the order. Given the ambiguities in drafting, and the relatively short period until the initial effective date, guidance from Treasury will be crucial to the global securities and financial industries.

We will update this memorandum as further guidance is released.

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