

OFAC Belatedly Releases FAQs Regarding Ban on Investments by U.S. Persons in Companies Linked to the Chinese Military, Leaves Key Questions Unanswered

December 30, 2020 | Client Update | 6-minute read

On December 28, 2020 the U.S. Department of the Treasury's Office of Foreign Assets Control (**OFAC**) released [Frequently Asked Questions \(FAQs\)](#) relating to [Executive Order](#) 13959, "Addressing the Threat from the Securities Investments that Finance Communist Chinese Military Companies," issued on November 12, 2020 (**E.O. 13959 or the Order**), which bans, beginning on January 11, 2021, certain transactions by any United States person (**U.S. person**) in publicly traded securities of specified entities determined to be associated with the Chinese military (**Communist Chinese military companies or CCMC**). At the same time, OFAC published a consolidated [list](#) containing the names and additional identifying information of entities identified in or pursuant to E.O. 13959 as CCMCs.

The FAQs address a number of important interpretive questions concerning the novel form of sanctions the Order imposes with respect to CCMC securities, and perhaps most importantly, the FAQs confirm that securities issued by subsidiaries of listed CCMCs will only become subject to sanctions under E.O. 13959 after those entities are specifically added to the list of designated CCMCs by OFAC or the Department of Defense. However, the FAQs, issued less than a month prior to the effective date of the Order, are quite limited in scope and fail to address several key questions. Given [media reports](#) of significant interagency disagreement concerning the scope and interpretation of E.O. 13959 – which likely contributed to the delay in publishing even these limited FAQs – it is unclear whether any further guidance addressing these open issues can be expected before the Order takes effect on January 11.

Background on E.O. 13959

As described in our prior [client memorandum](#), E.O. 13959 bans certain transactions by U.S. persons in publicly traded securities of CCMCs. Transactions in derivatives of the CCMCs' securities or in securities, expressly including funds, "designed to provide investment exposure to" such securities are also prohibited. Although issued under the authority of the International Emergency Economic Powers Act (**IEEPA**) and drafted for implementation by the Treasury Department, E.O. 13959 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.

E.O. 13959 FAQs

In an effort to clarify some of the ambiguities in E.O. 13959, OFAC released five FAQs that provide that:

- The prohibitions of E.O. 13959 do not automatically apply to subsidiaries of CCMCs. Transactions in publicly traded securities are prohibited only if the subsidiaries are listed by OFAC. [FAQ 857](#) states that Treasury intends to list as CCMCs subsidiaries of entities that issue publicly traded securities and that are (1) 50% or more owned by one or more identified CCMCs; or (2) determined to be controlled by one or more CCMCs. OFAC will use its established "50% Rule" to guide its decisions on listing subsidiaries, but will not apply the rule automatically. The Secretary of Defense, in consultation with the Secretary of the Treasury, may also determine that a subsidiary is a CCMC and list it as such.

- The prohibitions of E.O. 13959 apply to publicly traded securities of an entity with a name that exactly *or closely* matches the name of an entity identified in or pursuant to the Order as a CCMC. See [FAQ 858](#). OFAC’s list of CCMCs also provides additional information to help identify entities that are covered by E.O. 13959. The FAQ does not explain what OFAC considers to be a “close match,” but seems intended, in conjunction with the additional information included in the list, to address errors and lack of precision in the original Defense Department lists that were incorporated into the Annex to the Order.
- The term “publicly traded securities” includes securities denominated in any currency that trade on any securities exchange or “over the counter,” in any jurisdiction. See [FAQ 859](#).
- The prohibitions apply to “any transaction in ... any securities that are derivative of, or are designed to provide investment exposure to” publicly traded securities of CCMCs, including derivatives (e.g. futures, options, swaps), warrants, American Depositary Receipts (**ADRs**), global depository receipts (**GDRs**), exchange-traded funds (**ETFs**), index funds, and mutual funds, though only to the extent that such instruments also meet the applicable definition of a security (which generally tracks the definition under U.S. securities laws). See [FAQ 860](#).
- E.O. 13959 prohibits U.S. persons from investing in U.S. or foreign funds such as index funds, ETFs or other mutual funds, or derivatives thereof that hold publicly traded securities of a CCMC. See [FAQ 861](#).

As noted above, FAQ 857’s clarification that prohibitions under E.O. 13959 do not automatically apply to securities issued by subsidiaries or affiliates of listed CCMCs is a significant positive development. While this interpretation appears to be compelled by the text of the Order, it was reportedly the subject of substantial interagency disagreement. A contrary interpretation would have significantly increased the immediate burden of compliance with the Order in advance of the January 11, 2021 effective date of its prohibitions with respect to the CMCC’s named on the Annex. This reprieve may be temporary, however, as OFAC has stated its intent to add such subsidiaries to the list of CMCCs in the future.

The broad language of FAQs 860 and 861 creates substantial compliance challenges for funds, assets managers, investors, and others, and is inconsistent with the more measured approach OFAC has taken with respect to funds holding securities of blocked issuers. See [FAQ 652](#). Among other things, this interpretation appears to create an unusual situation where a U.S. fund holding securities of a CCMC entity named in the Annex to the Order would be permitted to continue to take steps to divest those securities through at least November 11, 2021, but U.S. investors would appear to be prohibited from purchasing shares in that (entirely compliant) fund beginning on January 11, 2021. Uncertainty in this area is compounded by the fact that the FAQs published thus far offer no guidance on what it means for a security to be “designed to provide investment exposure” to a CCMC entity’s security. While the State Department issued a [press statement](#) following OFAC’s publication of the FAQs that suggests an extremely broad reading of this concept, it is not clear that this statement should be considered authoritative.

The FAQs also fail to address any questions of interpretation relating to the unusual and narrow definition of “transaction” under E.O. 13959, including with respect to how (or if) OFAC will apply the Order’s prohibitions to conduct by U.S. financial institutions that are not themselves purchasing covered securities, but may be facilitating or otherwise involved in such purchases by U.S. or non-U.S. persons. The FAQs also do not address the implications of this definition for Sections 1(b) and 1(c) of the Order, including with respect to whether OFAC takes the position that U.S. persons holding affected securities are required to divest those positions during the 365-day time frame provided for by those provisions. While the State Department has suggested that such divestment is required, there does not appear to be any basis for this in the actual text of the Order.

In the absence of further authoritative guidance, U.S. persons potentially affected by the Order will need to make their own risk-based decisions on how to approach compliance in light of the Order’s text and the limited guidance available. One hopes that OFAC will take into account the circumstances surrounding the roll-out of E.O. 13959 in any future enforcement proceedings relating to potential violations of its prohibitions.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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