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Executive Order Prohibits Transactions in Securities Issued by Companies Associated with the Chinese Military

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On November 12, 2020, President Trump issued an Executive Order entitled [“Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies”](#) to prohibit U.S. persons¹ from engaging in transactions² involving publicly traded securities³ tied to certain companies designated in June and August by the U.S. Department of Defense (“Defense”) as associated with the Chinese military. *See also* 85 Fed. Reg. 73185 (Nov. 17, 2020). In a novel manner, the prohibitions exercise the extraordinary discretion granted to the President under the International Emergency Economic Powers Act (“IEEPA”), which is the authorizing legislation for a number of U.S. embargoes and sanctions programs and traditionally is invoked to block the assets of persons, such as terrorists, weapons proliferators and narcotics traffickers. They take effect on January 11, 2021, which also is the trigger date for a 10-month wind-down period for divestments, ending on November 11, 2021.

The View From Washington

The Executive Order is the first international trade-related action taken by the President since the election and raises the question of whether this is only the first of several actions to be taken with respect to China prior to the January 20, 2021, inauguration. While the Trump administration has adopted a number of conventional measures targeting China, such as the imposition of tariffs on Chinese imports and the implementation of more stringent export controls, the investment-related prohibitions are emblematic of the willingness of the administration to use its IEEPA authorities more unconventionally. Another prominent recent example of such usage of IEEPA is the imposition of restrictions targeted at the operation of TikTok and

WeChat mobile applications in the U.S., though the implementation of the relevant Executive Orders remains enjoined.

It remains to be seen whether the restrictions in their current form will survive the presidential transition, i.e., whether the incoming Biden administration will maintain the Executive Order altogether or further modify its prohibitions. It should be noted, however, that proposed legislation, which has passed the Senate and is pending before the House, would grant the U.S. government greater authority to delist Chinese companies on U.S. exchanges. Thus, beyond the Executive Order, there are calls in Congress to more closely scrutinize publicly traded Chinese companies. Furthermore, the U.S. Securities and Exchange Commission reportedly also intends to propose a regulation by the end of this year that could lead to the delisting of Chinese companies for not complying with U.S. auditing rules.

Scope of Applicable Prohibitions

According to the Executive Order, the Chinese national strategy of “Military-Civil Fusion” compels Chinese companies to support Chinese military and intelligence activities, even while such companies “raise capital by selling securities to United States investors that trade on public exchanges both here and abroad, lobbying United States index providers and funds to include these securities in market offerings, and engaging in other acts to ensure access to United States capital.” As of the date of the Executive Order, these designated companies are those [previously determined by Defense](#) to be “Communist Chinese military companies” operating directly or indirectly in the U.S. in accordance with the statutory requirement of Section 1237 of the National Defense Authorization Act for Fiscal Year 1999, as amended. The [initial designations](#) were made at the behest of Senators Schumer (D-NY) and Cotton (R-AK), though [a recent report](#) indicates more designations are forthcoming.

Accordingly, effective as of 9:30 a.m. EST on January 11, 2021, U.S. persons will be 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 any of the companies. These same prohibitions also will take effect 60 calendar days after a company is similarly designated either by Defense or the U.S. Department of the Treasury (“Treasury”).⁴

The Executive Order defines “transactions” narrowly as the “purchase for value of any publicly traded security.” By referencing the Securities Exchange Act of 1934, the

term “securities” should be understood to include both stocks and bonds, and it appears likely that the new restrictions will cover purchases of debt securities.

However, while the prohibitions regarding “transactions” in publicly traded securities seemingly are straightforward, the Executive Order does not define the terms “derivative of” or “designed to provide investment exposure,” which could create considerable uncertainty until Treasury, after consultation with the Secretary of State, the Secretary of Defense, the Director of National Intelligence and other federal agencies, as appropriate, promulgates implementing regulations or issues clarifying guidance. It seems, however, that beyond individual investments into these companies directly, these prohibitions are intended to capture investment vehicles such as mutual funds, as well as foreign investment funds, in which U.S. persons may be passively invested, such as through pension funds with diverse investments to track market indexes.

Furthermore, as noted above, U.S. persons are permitted to divest from affected securities until November 11, 2021, or for a period of 10 months after the effective date of the prohibitions for any companies designated at a later date (i.e., approximately one year from the date any such entity is listed). After the divestment period ends, presumably Treasury, likely through the Office of Foreign Assets Control (“OFAC”), will be empowered to issue licenses to U.S. persons to engage in “transactions” in such securities, but it remains to be seen whether licenses will be required to divest, in whole or in part, or to engage in ancillary transactions. For example, pending further guidance, the prohibitions in their current form do not appear to extend to publicly traded entities that are parents or subsidiaries of designated entities but are not themselves designated, which should be clarified.

Note that a significant number of the listed entities already are subject to restrictions imposed by the U.S. government, including those administered by the Federal Communications Commission and the Department of Energy. Notably, many of these entities appear on the Entity List, which is maintained by the Bureau of Industry and Security, U.S. Department of Commerce in accordance with the U.S. Export Administration Regulations (“EAR”).⁵ Consequently, these firms are generally prohibited from obtaining items that are “subject to the EAR,” which is a narrower set of restrictions that ordinarily would not impact securities investments. While a number of these companies were placed on the Entity List several years ago, some (such as CCCC, Hikvision and Huawei) are more recent additions and serve to advance U.S. foreign policy interests or promote human rights. CCCC, for example, was listed to counter Chinese infrastructure projects in the South China Sea, whereas Hikvision was listed to thwart human rights abuses in the Xinjiang Uyghur Autonomous Region

and Huawei was listed to inhibit Chinese technological leadership, particularly with respect to 5G.

Key Takeaways

- The Executive Order targets publicly traded securities, including stocks and bonds, and will likely also cover transactions in debt securities, issued by a number of Chinese companies, many of which already are subject to restrictions under U.S. export control and other regulations.
- The Executive Order's lack of definitions for certain key terms will likely, in the absence of clarifying guidance, create uncertainty regarding a broad range of transactions that may be ancillary to the holding of affected securities.
- The Executive Order applies IEEPA in a novel fashion that extends beyond its more conventional use as the statutory authority underpinning the embargoes, sanctions programs and asset blocking measures administered by OFAC.
- It remains to be seen whether the incoming Biden administration will object to the scope of the Executive Order or retain its prohibitions, but if the latter, we would expect carefully considered rulemaking implementing the prohibitions.
- Despite the inherent uncertainty regarding the ultimate implementation of the Executive Order, U.S. investors and their advisers are well advised to begin inventorying potentially affected securities and to consider divestment or other effective mitigation strategies.

1. For purposes of the Executive Order, the term "U.S. person" means "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."↩

2. The term "transaction" is defined as a "purchase for value" of any publicly traded security.↩

3. The term "security" includes the definition set forth 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), 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 nine 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.↩

4. Under the Executive Order, Treasury also is authorized to target for designation subsidiaries of those companies identified by the U.S. Department of Defense, or entities that are owned or controlled by the People's

Liberation Army or entities involve in China's defense industrial base.↵

5. Certain other of these entities also presumptively should be treated as military end users for purposes of applying the specific restrictions set forth at Section 744.21 of the EAR, resulting in stricter export license requirements.↵

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