Fried Frank International Trade and Investment *Alert*™

President Biden Amends Investment Restrictions on Chinese Military Companies

On June 3, 2021, President Biden issued Executive Order 14032 (the "New EO") prohibiting investments in publicly traded Chinese companies that are part of China's military-industrial complex ("CMIC"). This order replaces Executive Order 13959, which was issued on November 17, 2020 and prohibited U.S. investors from trading securities or derivatives related to Communist Chinese Military Companies ("CCMCs"), on which we previously reported. The New EO designated 59 Chinese companies that operate in the defense or surveillance technology sector of the Chinese economy. While the New EO has the same general structure as Executive Order 13959, it slightly changes the designation focus and is intended to remove some confusion over scope and provide a stronger legal footing—two issues that had plagued the implementation of the earlier order.

For the 59 companies listed in the New EO, the prohibition on investments goes into effect on August 2, 2021. U.S. persons already invested in the designated CMIC companies have one year—until June 3, 2022—to divest those interests. For companies subsequently designated pursuant to the New EO, the trading prohibitions will take effect 60 days following designation, and U.S. persons will have a one-year grace period to divest from securities of those companies.

Key Provisions and Scope

The New EO prohibits U.S. persons from investing or otherwise transacting in publicly traded securities of designated CMIC companies and any "securities that are derivative of or are designed to provide investment exposure to such securities." The Executive Order defines "publicly traded securities" to include any "security" as defined in the Securities and Exchange Act of 1934 that trades on a securities exchange or over the counter. The U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") issued guidance indicating that the New EO prohibits investments in, among other instruments, index funds, mutual funds, and exchange-traded funds that hold publicly traded securities of a CMIC company. The New EO also prohibits derivative contracts that are tied to the value of such publicly traded securities.

A majority of the CMIC companies designated under the New EO were designated because they operate in the Chinese defense sector, according to a White House fact sheet. Two companies, Hangzhou Hikvision Digital Technology Co., Ltd. ("Hikvision") and Huawei Technologies Co., Ltd. ("Huawei") were designated for operating in the Chinese surveillance sector. Both Hikvision and Huawei were previously designated under Executive Order 13959.

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Concurrent with the announcement of the New EO, OFAC issued FAQs clarifying its scope with respect to non-U.S. investment funds. Specifically, OFAC indicated that U.S. persons may still provide investment advisory, investment management, or similar services to a non-U.S. person in connection with the non-U.S. person's purchase or sale of a security covered by the New EO, provided that the underlying transaction would not otherwise violate the New EO. Additionally, U.S. persons who are employed by non-U.S. entities and who, in the ordinary course of their employment, are involved in purchases or sales of the securities of CMIC companies on behalf of their non-U.S. employer, may continue to be involved in and facilitate such transactions, provided that the underlying transactions do not violate the New EO. In practice, this means that U.S. persons working in investment management, advisory, and similar roles may continue to participate in transactions of covered securities, so long as the purchase or sale is not for the ultimate benefit of a U.S. person, nor is it a willful attempt to avoid the prohibitions of the New EO.

OFAC also clarified that market makers may participate in activities necessary to effect the divestiture of covered securities during the one-year wind-down period applicable to U.S. persons currently invested in CMIC securities. U.S. financial institutions, registered broker-dealers, securities exchanges, and other market intermediaries may rely upon the information available to them in the ordinary course of business in order to determine whether transactions in covered securities are permissible.

Much of OFAC's previous guidance also remains in place. In particular, U.S. persons may continue to invest in U.S. investment funds that hold CMIC securities during the one-year wind-down period as long as those funds are working to divest those securities in accordance with the sanctions. OFAC has also specified that the trading restrictions with respect to derivatives and funds that provide exposure to CMIC securities apply to the extent that such financial instruments meet the definition of "publicly traded security" in the New EO. In the past, similar language had been interpreted to mean that security futures based on broad-based indices were outside the scope of the prohibitions because the statutory definition of a "security future" is limited to a narrow-based security index. However, this part of the New EO introduces some uncertainty that OFAC has not yet resolved because the New EO defines "publicly traded securities" to *include* (but not be limited to) any "security" under the Securities and Exchange Act.

Changes from Executive Order 13959

One of the main changes from Executive Order 13959 is that OFAC is now responsible for designating Chinese companies, whereas the previous executive order assigned that responsibility to the Department of Defense. Additionally, the scope of the New EO is potentially wider, requiring only that OFAC determine that a given company operates in the defense and related materiel or surveillance sectors of the Chinese economy, rather than requiring a finding that a given company is affiliated with the People's Liberation Army. The designations of Xiaomi and Luokung Technology Group as CCMCs by the Department of Defense were both rejected by federal courts, which found that both designations lacked the requisite evidence linking the companies to the People's Liberation Army.

Another notable change is that the prohibitions of Executive Order 14032 do not apply to a subsidiary of a CMIC unless that subsidiary is itself designated by OFAC. OFAC's 50 Percent Rule, which normally blocks the property of entities directly or indirectly owned 50 percent or more by one or more blocked persons, does not apply to entities listed solely pursuant to this Executive Order.

Takeaways

Executive Order 14032 signals that the Biden administration intends to continue the firm stance against China from the previous administration and use a range of measures to compete with China and respond to Chinese companies that facilitate human rights abuses. The New EO also indicates that the Biden administration takes seriously the legal challenges to Executive Order 13959 and intends to implement investment prohibitions that rest on a sturdy legal basis.

U.S. persons should review their investments to see if they are affected, and take appropriate measures to divest in those securities as necessary. If you have any questions regarding this new executive order or how it may affect your business, please reach out to the contacts listed below.

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Authors:

Michael T. Gershberg

Justin A. Schenck

Gregory Bernstein

This alert is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this alert, please call your regular Fried Frank contact or the attorneys listed below:

Contacts:

Washington, D.C.

Michael T. Gershberg	+1.202.639.7085	michael.gershberg@friedfrank.com

London

Dr. Tobias Caspary	+44.20.7972.9618	tobias.caspary@friedfrank.com

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