

## EXECUTIVE ORDER 13959 EXPANDED, OFAC ISSUES LICENSES AND NEW FREQUENTLY ASKED QUESTIONS

We previously issued a Client Memorandum concerning the impact of certain U.S. Government actions that will affect the markets for securities of certain Chinese issuers.<sup>1</sup> In this Update, we focus on recent developments concerning Executive Order 13959 addressing transactions in the securities of companies designated as Communist Chinese military companies. Specifically, we discuss the “Executive Order Amending Executive Order 13959,”<sup>2</sup> and the issuance by the Office of Foreign Assets Control (“OFAC”) of General License No. 1,<sup>3</sup> General License No. 2,<sup>4</sup> and additional Frequently Asked Questions (“FAQ”s). The new material clarifies some issues but leaves other important aspects unresolved.<sup>5</sup>

The Amended Order makes three significant changes to the original order:

1. After November 11, 2021, possession by a U.S. person is prohibited of any publicly traded securities of designated Communist Chinese military companies that such person held as of January 11, 2021. Section 1(b), as amended. Also, if a company is designated as a Chinese military company at a later date, possession of the securities of such issuers by U.S. Persons is prohibited 365 days after the date of such determination. Section 1(c), as amended. That clarifies an ambiguity in the original Executive Order, which applied only to “transactions” in such securities but did not address possession. OFAC FAQ 872 reiterates the amended terms and states that “United States persons are thus prohibited from holding covered securities after the relevant deadline.”<sup>6</sup>
2. The definition of prohibited “transactions” has been expanded to include sales of such securities. Section 4(e), as amended. That also addresses an ambiguity in the original Executive Order which defined “transaction” as “purchase for value” although the Executive Order also covered “divesting” purchases and sales. OFAC FAQ 873 reiterates the revised definition.<sup>7</sup>
3. The Amended Order also clarifies that the prohibitions apply when the Secretary of Defense “publicly lists” a person as a Communist Chinese military company, or the Secretary of the Treasury

<sup>1</sup>[https://www.mmlawus.com/newsitem/pdf/securities\\_market\\_players\\_must\\_consider\\_recent\\_actions\\_focused\\_on\\_certain\\_chinese\\_companies\\_955.pdf](https://www.mmlawus.com/newsitem/pdf/securities_market_players_must_consider_recent_actions_focused_on_certain_chinese_companies_955.pdf).

<sup>2</sup> <https://www.whitehouse.gov/presidential-actions/executive-order-amending-executive-order-13959-addressing-threat-securities-investments-finance-communist-chinese-military-companies/> (“Amended Order”).

<sup>3</sup> [https://home.treasury.gov/system/files/126/chinese\\_military\\_gl1.pdf](https://home.treasury.gov/system/files/126/chinese_military_gl1.pdf) (“License No. 1”).

<sup>4</sup> [https://home.treasury.gov/system/files/126/chinese\\_military\\_gl2\\_1.pdf](https://home.treasury.gov/system/files/126/chinese_military_gl2_1.pdf) (“License No. 2”).

<sup>5</sup> This publication is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

<sup>6</sup> OFAC FAQ 872 (January 14, 2021), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/872>. See also OFAC FAQ 865 (January 6, 2021) which states: “Divestment must be completed by November 11, 2021” for securities identified in the January 11, 2021 OFAC list.

<sup>7</sup> OFAC FAQ 873 (January 14, 2021), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/873>.



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**For more information,  
Contact**

**Larry E. Bergmann  
202.661.7032**

[lbergmann@mmlawus.com](mailto:lbergmann@mmlawus.com)

“publicly lists” a person as meeting the criteria applied by the Secretary of Defense, or the Secretary of the Treasury “publicly lists” a subsidiary of a person already determined to be a Communist Chinese military company. Section 4(a)(ii) and (iii), as amended. This seems to be consistent with OFAC FAQ 857, i.e., that a company or a subsidiary of a company is subject to the Executive Order only when it is included on a public list.<sup>8</sup>

## UNRESOLVED MATTERS.

**Scope of Affected Companies.** There still is some uncertainty about the application of the prohibitions of the Amended Order to a company with a name that “closely matches” the name of a company on the published lists. This issue was raised initially by OFAC FAQ 858, which states: “The prohibitions in E.O. 13959 apply with respect to publicly traded securities ... of an entity with a name that exactly or closely matches the name of an entity identified in [an OFAC list].” The scope of is even broader, because the FAQ states that the prohibition applies to “*any publicly traded securities that are derivative of, or are designed to provide investment exposure to such securities*[] of an entity with a name that exactly or closely matches the name” of a company on an OFAC list [emphasis added]. OFAC FAQ 864, issued on January 6, 2021, states that “OFAC has published and will continue to update a list on its website to aid in the implementation of E.O. 13959, including the names of certain entities that closely match the name of entities identified in [the public list].”<sup>9</sup> The latter FAQ could suggest that only entities whose names appear on an OFAC list are covered by the Executive Order. However, on January 8, 2021, OFAC issued License No. 1 which permits transactions until January 28, 2021 in securities of an entity “whose name closely matches” the name of a designated company but has not been included on a public list.<sup>10</sup> That indicates that OFAC views the Executive Order as applying to companies with names that closely match the names of designated companies but are not on a public list, and that License No. 1 provides only a temporary reprieve. In light of the focus on the Amended Order on companies that are publicly listed, further clarification of its application to companies with names that closely match companies on a public list would be most welcome.

**Scope of Permitted Intermediary Activity.** Many broker-dealers and other market participants are trying to understand what market activity is permitted under the Executive Order. OFAC FAQ 863 provided initial guidance that “activity by U.S. persons *related to* the following services are considered permissible, to the extent that such support services are not provided to U.S. persons in connection with prohibited activities: clearing, execution, settlement, custody, transfer agency, back-end services, *as well as other such support services.*” [Emphasis added.]<sup>11</sup> Although guidance on the identified services provides some clarity, the italicized text raises the question of what other “related” or “support services” are included.<sup>12</sup> OFAC FAQ 865 addresses what activity market intermediaries and other participants can do to facilitate

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<sup>8</sup> OFAC FAQ 857 (December 28, 2020), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/857> [“The prohibitions in E.O. 13959 apply to any subsidiary of a Communist Chinese military company, after such subsidiary is publicly listed by Treasury pursuant to section 4(a)(iii) of the Order.”]. Press reports indicate that the Secretary of Defense intends to add more than 100 subsidiaries to the list in the near future “China Tech Giants Seen Avoiding Blacklist,” Wall St. J., B1 (January 14, 2021). The January 14, 2021 list issued by the Secretary of Defense added nine company names, <https://www.defense.gov/Newsroom/Releases/Release/Article/2472464/dod-releases-list-of-additionalcompanies-in-accordance-with-section-1237-of-fy/>.

<sup>9</sup> OFAC FAQ 864 (January 6, 2021), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/864> [“[T]he prohibitions of E.O. 13959 apply with respect to ‘publicly traded securities’ ... of an entity with a name that exactly matches or closely matches the name of an entity identified in [lists published on the OFAC website], including the names of certain entities that closely match the name of entities identified in [the published lists].”] See also OFAC FAQ 858 (December 28, 2020), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/858>.

<sup>10</sup> License No. 1 may be intended as a short-term reprieve for legitimate mistakes regarding transactions in securities of companies with closely matching names. As noted, it expires on January 28, 2021.

<sup>11</sup> OFAC FAQ 863 (January 6, 2021), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/863>.

<sup>12</sup> Additional uncertainty about the scope of permitted activity is suggested by the formulation of the question that FAQ 863 addresses because it does not match the scope of permitted services identified in the response: “Can U.S. persons custody, offer for sale, serve as transfer agent, and trade in covered securities?”

divestment from securities of designated companies.<sup>13</sup> The FAQ states: “Market intermediaries and other participants may engage in *ancillary or intermediary activities* that are *necessary to effect divestiture* during the relevant wind-down periods or that are otherwise not prohibited under the E.O.” [Emphasis added.] Ancillary and intermediary activities that market intermediaries generally engage in to facilitate trading by their customers include posting quotations for securities as market makers, providing order routing facilities to customers, executing trades for customers as agent or principal, and settling trades for customers (which involves movement of securities and cash).<sup>14</sup> Depending on the context, some or all of these activities may be considered by market participants as “necessary to effect divestiture.”

While no doubt intended to address uncertainty, License No. 2 may cloud the situation for market intermediaries. That license generally permits “all transactions and activities by securities exchanges operated by U.S. persons prohibited by section 1(a)(ii) of the Amended Order ... involving publicly traded securities [including derivatives] of any entity listed on the [OFAC list] after 12:01 a.m. ... January 14, 2021, are authorized through ... the date that is 365 days after the date the entity is listed in the [OFAC list].”<sup>15</sup> This license raises a number of questions and concerns.

- First, why was there a need to address securities exchanges beyond the guidance provided to “market intermediaries and other participants” in OFAC FAQ 865? Neither License No. 2 nor OFAC FAQ 871 explains that.
- Second, why is the permission to engage broadly in “all transactions and activities” in securities of certain OFAC-listed companies limited to securities exchanges?<sup>16</sup> The scope of permitted activity appears to be far broader than that covered by OFAC FAQ 865 for market intermediaries and other participants, which, as noted, appears to cover securities exchanges.
- Many of the securities of designated companies trade in the over-the-counter (“OTC”) market rather than on exchanges.<sup>17</sup> If the securities of a company designated after January 14, 2021 trade only OTC, should Alternative Trading Systems<sup>18</sup> and market makers<sup>19</sup> operated by U.S. persons have similar flexibility to engage in all transactions and activities in such securities?

We understand that further clarification of the application of the prohibitions to non-exchange market making activities may be under consideration by OFAC.

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<sup>13</sup> OFAC FAQ 865 (January 6, 2021), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/865>.

<sup>14</sup> Moreover, broker-dealers are subject to a variety of rules and regulations that may require them to engage in other market activity, for example, to achieve best execution for customer trades (e.g., Securities and Exchange Commission (“SEC”) Rule 611 in Regulation NMS), borrow securities to complete short sales (SEC Rule 203 in Regulation SHO), and purchase or borrow securities to close-out failures to deliver (SEC Rule 204 in Regulation SHO).

<sup>15</sup> OFAC FAQ 871 (January 14, 2021) contains essentially identical text in response to the question: “What are the compliance obligations of securities exchanges operated by U.S. persons with respect to Executive Order 13959, as amended?” <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/871>. Section 1(a)(ii) of the Executive Order generally applies to securities designated after January 11, 2021.

<sup>16</sup> License 2 and OFAC FAQ 871 do not explain why the relief is limited to companies listed on or after January 14, 2021. Curiously, the license does not extend to securities of companies with names the “closely match” the names of listed companies.

<sup>17</sup> It is also possible for a security to trade on an exchange and OTC concurrently.

<sup>18</sup> Alternative Trading Systems are entities that essentially qualify as securities exchanges but elect to be regulated as broker-dealers. See SEC Regulation ATS, 17 CFR 242.300-304, [https://www.ecfr.gov/cgi-bin/text-idx?node=17:4.0.1.1.3&rgn=div5#sg17.4.242\\_1204.sg2](https://www.ecfr.gov/cgi-bin/text-idx?node=17:4.0.1.1.3&rgn=div5#sg17.4.242_1204.sg2).

<sup>19</sup> Securities Exchange Act Section 3(a)(38), 15 USC 78c(a)(38), defines “market maker” as “any [exchange] specialist permitted to act as a dealer, any dealer acting in the capacity of a block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.”

**Documentation of Compliance.** Market participants will want to document their compliance with the Amended Order and with applicable OFAC FAQs. However, the original Executive Order, the Amended Order, and the OFAC FAQs do not provide guidance as to what diligence procedures market intermediaries might follow and how compliance could be demonstrated. While OFAC FAQ 650 is not related to the Executive Order, it deals with another situation where divestment of certain securities by U.S. persons was required.<sup>20</sup> Specifically, the licenses issued by OFAC in that context required that the divestment be to a non-U.S. person. In the context of the Executive Order, divestiture similarly will require transmission of the affected securities to non-U.S. persons.<sup>21</sup> Therefore, OFAC FAQ 650 may provide some insight into compliance with respect the Executive Order. For example:

- OFAC FAQ 650 provided that: “Financial institutions or registered broker-dealers in securities may rely upon the information ordinarily available to them for purposes of conducting the activities authorized under the [applicable licenses].” From this, market intermediaries may infer that their regular “know your customer” obligations<sup>22</sup> and “customer due diligence” requirements<sup>23</sup> may be sufficient to comply with the Executive order.
- How can market intermediaries reasonably determine that the purchaser is a non-U.S. person? Many, if not most, of the securities of designated companies have one or more active non-U.S. trading markets, particularly in Hong Kong. Again, OFAC FAQ 650 suggests that information normally available to such intermediaries in the ordinary course of conducting their securities business should be sufficient to comply with the Executive Order. Intermediaries might look to their procedures established to qualify for the exemption from securities registration in SEC Regulation S for offers and sales of securities made outside the U.S.<sup>24</sup> Regulation S generally requires offer and sales to be made in “offshore transactions” which is defined in Rule 902(h) of the regulation. Such offshore transactions generally must be executed on the physical trading floor of an established foreign securities exchange located outside the U.S. or executed in, on, or through the facilities of a “designated offshore securities market,” and neither the seller nor any person acting on its behalf knows that the transaction has been pre-arranged with a buyer in the U.S. “Designated offshore securities markets” are identified in Rule 902(b). Of particular relevance in the context of the Executive Order, The Stock Exchange of Hong Kong is so designated.

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<sup>20</sup> OFAC FAQ 650 (February 11, 2019), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/650>.

<sup>21</sup> OFAC FAQ 116 related to OFAC FAQ 650 highlights an additional important consideration for U.S. persons seeking to comply with the Executive Order, namely that they must consider whether the covered securities constitute property or interests in property of an entity that are blocked pursuant to an Executive Order or regulations administered by OFAC. <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/116>. See also OFAC, “Specially Designated Nationals And Blocked Persons List (SDN) Human Readable Lists” (updated January 15, 2021), <https://home.treasury.gov/policy-issues/financial-sanctions/specially-designated-nationals-and-blocked-persons-list-sdn-human-readable-lists>. This Client Memorandum addresses only the Executive Order and related OFAC FAQs.

<sup>22</sup> See, e.g., Financial Industry Regulatory Authority Rule 2090, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2090>.

<sup>23</sup> See, e.g., Financial Crimes Enforcement Network, “Customer Due Diligence” Rule for Brokers or Dealers in Securities, 31 CFR 1023.210, <https://www.law.cornell.edu/cfr/text/31/1023.210>.

<sup>24</sup> 17 CFR 230.900-905, [https://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.12&rgn=div5#sg17.3.230\\_1802.sg14](https://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.12&rgn=div5#sg17.3.230_1802.sg14).