

SECURITIES MARKET PLAYERS MUST CONSIDER RECENT ACTIONS FOCUSED ON CERTAIN CHINESE COMPANIES

By Larry E. Bergmann

A. Introduction

Concern and frustration with Chinese companies that do not comply with United States (“U.S.”) regulatory standards has resulted in a variety of measures that will have material consequences for the U.S. trading markets for the securities of those issuers. Among others, U.S. broker-dealers, Alternative Trading Systems (“ATS”), and securities exchanges will need to incorporate trading restrictions into their policies and procedures.¹ As discussed below, one of the most significant restrictions starts on **January 11, 2021**.

B. Developments Affecting U.S. Trading Markets

1. Executive Order on Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies (November 12, 2020),

<https://home.treasury.gov/system/files/126/13959.pdf> (“Order”)

As of **January 11, 2021**, Executive Order 13959 (“Order”) prohibits U.S. persons² from engaging in “any transaction in any publicly traded securities” of the Chinese companies included on lists issued by the U.S. Secretary of Defense (as modified from time to time). The Office of Foreign Assets Control (“OFAC”) publishes a list on its website containing the names of entities identified in or pursuant to the Order as Communist Chinese military companies, along with additional identifying information where possible.³ The Order allows for “divesting” trades (which can be purchases or sales) until November 11, 2021 of affected securities that a U.S. person held as of January 11, 2021.

There are some definitional ambiguities in the Order. For example:

- a. The Order applies to “transactions” in affected securities.⁴ That term is defined as “the purchase for value of any publicly traded security.”⁵ Textually, this means that *purchases* of affected securities are prohibited after January 11, 2021. However, the Order also permits

¹ Derivatives markets also will be affected. For example, the Order discussed in Section B.1. prohibits trading in securities that are derivative of, or designed to provide investment exposure to, securities designated pursuant to the Order. OFAC FAQ 860 (December 28, 2020) states: “Examples of financial instruments covered by this provision include, but are not limited to, derivatives (e.g., futures, options, swaps), warrants, American depository receipts (ADRs), global depository receipts (GDRs), exchange-traded funds (ETFs), index funds, and mutual funds, to the extent such instruments also meet the definition of ‘security’ as defined in section 4(d) of [the Order].” <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/860>. Moreover, the prohibition applies to U.S. and foreign funds “regardless of such securities’ share of the underlying index fund, ETF, or derivative thereof.” OFAC FAQ 861 (December 28, 2020), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/861>.

² United States person” is defined broadly to include “any person in the United States.” Order Section 4.(f).

³ OFAC, Non-SDN Communist Chinese Military Companies List, https://www.treasury.gov/ofac/downloads/ccmc/ns-ccmc_list.pdf (updated as of December 22, 2020).

⁴ “Security” is defined to include the expansive definition in Section 3(a)(10) of the Securities Exchange Act of 1934 (“Exchange Act”) except that the instruments excluded by that definition are included within the term used in the Order.

⁵ Order Section 4.(e).

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divesting purchases and *sales* until November 11, 2021. If only purchase “transactions” are prohibited, it does not appear that an exception for sales is needed. A clue may be provided in Section 2 of the Order which broadly prohibits “any transaction by a United States person or within the United States that evades or avoids, has the purpose of evading or avoiding, *causes a violation of*, or attempts to violate the prohibitions set forth in this order” (emphasis added). It may be that sales, which necessarily involve a purchase, might be seen as “causing” a violative purchase.

- b. Are broker-dealer quotations for affected securities prohibited? While in some contexts the term “transaction” has been held to cover quotations, as noted above, transactions are more narrowly defined in the Order. Once again, however, Section 2 of the Order may be seen as bringing quotations within its scope because they may “cause” or “attempt to violate” the purchase prohibition.
- c. What is the scope of “publicly traded” security? The prohibition is limited to transactions in “publicly traded securities,” although that term is not defined in the Order. OFAC FAQ 859 states that OFAC “intends to interpret the term ‘publicly traded securities’ to include securities (as defined in section 4(d) of [the Order]) denominated in any currency that trade on a securities exchange or through the method of trading that is commonly referred to as ‘over-the-counter,’ in any jurisdiction.”⁶

The U.S. securities laws and the U.S. Securities and Exchange Commission (“SEC”) recognize that not all trading markets are “public” in nature.⁷ For example, are securities resold pursuant to Securities Act Rule 144A “publicly traded” within the scope of the Order? Recently, the SEC published for public comment a “Notice of Proposed conditional Exemptive Order Granting a Conditional Exemption ... for Broker-Dealer Quotations on an Expert Market”.⁸ Among other things, the SEC noted that an Expert Market “is not available to the general public” and only Qualified Experts could participate in that market.⁹ Would securities that migrate to such an Expert Market be “publicly traded” within the meaning of the Order?

Comment. As of January 11, 2021, U.S. persons are prohibited from engaging in transactions in the securities of designated Chinese companies. *It seems clear that, despite some drafting ambiguity, the Order is intended to stop U.S. persons from directly or indirectly investing in those securities.* That likely means that, as of that date, U.S. broker-dealers will not be able to publish quotations for affected securities in any securities trading market, with the possible exception of quotations that represent proprietary or customer orders that solely are intended to divest affected securities held as of that date. Broker-dealers should have reasonable policies and procedures and related supervisory procedures in place to: (1) identify the securities of affected companies; (2) restrict transactions in those securities, including derivatives, between January 11 and November 11, 2021 to “divesting” trades;¹⁰ and (3) document compliance with the Order. In addition, broker-dealers may consider proactively alerting their customers to the imminent restrictions. ATSs and securities exchanges also should be considering what actions are needed to achieve compliance with the Order.

2. ***Holding Foreign Companies Accountable Act***, <https://www.congress.gov/congressional-record/2020/12/02/house-section/article/H6031-1> (“Act”)

This Act became Public Law 116-222 on December 18, 2020. The law targets foreign issuers where the issuer’s government does not permit the Public Company Accounting Oversight Board (“PCAOB”) to inspect the issuer’s audit reports. In such cases, if the PCAOB has been unable to inspect an issuer’s audit reports for three consecutive years, the SEC is required to prohibit the issuer from becoming listed on U.S. exchanges, and – in the case of those issuers already listed – to prohibit trading of such an issuer’s securities. The scope of the trading prohibition is even more comprehensive: it applies to trading on national securities exchanges and “any other method that is within the jurisdiction of the Commission to regulate, including through the method of trading that is commonly referred to as

⁶ OFAC FAQ 859 (December 28, 2020), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/859>.

⁷ See, e.g., Section 4(a)(2) of the Securities Act of 1933 (“Securities Act”) and Rule 144A under the Securities Act, 17 CFR 230.144A.

⁸ Release 34-90769 (December 22, 2020), 85 FR 68124, <https://www.govinfo.gov/content/pkg/FR-2020-10-27/pdf/2020-20980.pdf>.

⁹ Id. at 14.

¹⁰ Among other things, broker-dealers and their associated persons should not recommend transactions in affected securities to their customers other than perhaps for qualifying “divesting” trades.

the ‘over-the-counter’ trading of securities.” Therefore, the prohibition covers trading on ATs and traditional over-the-counter markets.¹¹

Although the law is not limited to Chinese companies, those issuers were its principal focus. As noted, the SEC would not take action to prohibit trading in a covered issuer’s securities¹² until the PCAOB has been unable to inspect the company’s audit reports for three consecutive years. Accordingly, because 2021 would be the first “non-inspection year” for such companies, a trading prohibition could not be imposed until 2023 at the earliest. Moreover, the SEC undoubtedly will need to adopt procedures to identify subject companies and provide a process to determine whether a trading ban is warranted.

Comment. As with the Order discussed above, broker-dealers, ATs, exchanges, and other market participants will need to adopt appropriate policies, procedures, and controls in anticipation of SEC trading restrictions that may be imposed by this law.

3. Securities Exchange Proposals

The Nasdaq exchange has filed proposed rule changes with the SEC to enhance its listing standards for companies primarily operating in a jurisdiction that has secrecy laws, blocking statutes, national security laws or other laws or regulations restricting access to information by regulators of U.S.-listed companies in such jurisdiction, so-called “Restrictive Markets.”¹³ The proposal includes a focus on countries that interfere with the PCAOB’s ability to inspect the audit work and practices of auditors in those countries.¹⁴ In addition, Nasdaq has proposed to adopt rules to enhance the qualification of management for companies in Restrictive Markets that seek to list securities on Nasdaq.¹⁵ Once again, there is a significant focus on Chinese companies.¹⁶

Comment. Should these proposals (and perhaps others by other securities exchanges) be approved by the SEC, the securities of subject companies, in particular Chinese issuers, may be denied initial or continued listing on the exchange. That alone would be disruptive for the market in the securities, but even an attempted migration to the over-the-counter (“OTC”) market could be thwarted because broker-dealer quotations for the securities may be precluded by operation of Exchange Act Rule 15c2-11.¹⁷

4. SEC Activity

The Chairman of the SEC has commented frequently about the need to address “the risks associated with investing in emerging markets, including China.”¹⁸ Among other things, he noted the multifaceted elements that were identified in the President’s Working Group on Financial Market’s “Report on Protecting United States Investors from Significant Risks from Chinese Companies” (“PWG Report”)¹⁹ relating to investing in Chinese securities, and directed SEC staff to prepare proposals consistent with the PWG Report’s recommendations for consideration by the Commission. According to the Chairman, as of December 18, the staff was “finalizing recommendations for proposed

¹¹ See Murphy & McGonigle, “ALERT UPDATE: U.S. House Unanimously Passes S.945,” https://www.mmlawus.com/newsitem/pdf/client_alert_us_unanimously_passes_s945_950.pdf.

¹² Covered issuers are companies that are required to file public reports with the SEC pursuant to the Exchange Act.

¹³ Release 34-89027 (June 8, 2020), 85 FR 35962, <https://www.govinfo.gov/content/pkg/FR-2020-06-12/pdf/2020-12685.pdf>. See also Release 34-90559 (December 3, 2020), 85 FR 79249; Release 34-90549 (December 2, 2020), 85 FR 79048, <https://www.govinfo.gov/content/pkg/FR-2020-12-08/pdf/2020-26898.pdf>.

¹⁴ 85 FR at 35963 n.14.

¹⁵ Release 34-89028 (June 8, 2020), 85 FR 35967, <https://www.govinfo.gov/content/pkg/FR-2020-06-12/pdf/2020-12686.pdf>. See also Release 34-90553 (December 2, 2020), 85 FR 79062.

¹⁶ 85 FR at 35967 n.5.

¹⁷ 17 CFR 240.15c2-11. The SEC recently adopted amendments to Rule 15c2-11 that substantially increase the compliance burden with regard to many securities. Release 34-89891 (September 16, 2020), 85 FR 68124, <https://www.govinfo.gov/content/pkg/FR-2020-10-27/pdf/2020-20980.pdf>.

¹⁸ SEC Chairman Jay Clayton, “Statement after the Enactment of the Holding Foreign Companies Accountable Act” (December 18, 2020), <https://www.sec.gov/news/public-statement/clayton-hfcaa-2020-12> (“Clayton Statement”). See also id. n.1.

¹⁹ PWG Report (July 24, 2020), <https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf>.

rules regarding enhanced listing standards for U.S. securities exchanges and auditor qualifications,” and he noted relevant recent guidance by the Division of Corporation Finance²⁰ and the Division of Investment Management.²¹

After the enactment of the Act discussed in Section B.2 above, the Chairman directed the staff to consider providing a single consolidated proposal for Commission consideration on:

- a. Issues related to the PCAOB’s access to audit work papers;
- b. Exchange listing standards;²² and
- c. Trading prohibitions.²³

Comment. The Chairman’s directive relates to many of the topics and activity discussed above. A consolidated proposal could provide a comprehensive and coherent picture of what the SEC expects from market participants and how it will implement its statutory obligations and rulemaking authority to address risks to U.S. investors and markets relating to emerging market securities and securities of Chinese issuers in particular.

C. Summary and Conclusion

This article identifies a number of events that will alter the market for securities of Chinese issuers in the U.S. Therefore, broker-dealers, ATSS, securities exchanges, and others need to be fully aware of changes that will affect them and their customers as soon as January 11, 2021. A failure to be prepared with effective policies, procedures, and controls can have serious adverse effects, including criminal charges. It is a near certainty that compliance with the requirements discussed above will be on the top of regulators’ examination and inspection programs in 2021 and beyond. Also, SEC rulemaking can be expected to continue to focus on implementing recent legislation and the recommendations in the PWG Report.

				
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²⁰ Division of Corporation Finance Disclosure Guidance: Topic No. 10 Disclosure Considerations for China-Based Issuers (November 23, 2020), <https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers>.

²¹ Division of Investment Management ADI 2020-11 Registered Funds’ Risk Disclosure Regarding Investments in Emerging Markets (December 14, 2020), <https://www.sec.gov/investment/accounting-and-disclosure-information/principal-risks/registered-funds-risk-disclosure>.

²² The PWG Report suggested that the SEC could amend the listing standards of securities exchanges pursuant to its authority in Exchange Act Sections 23(a) and 6(b)(5). PWG Report at 11. It is doubtful that Section 6(b)(5) provides such authority, and Section 23(a) is a general delegation of authority to implement the provisions of the Exchange Act. As the PWG Report also notes, the SEC has authority in Exchange Act Section 19(c) to “abrogate, add to, and delete” the rules of exchanges. That authority seems much more direct and relevant to implementing the PWG’s recommendation.

²³ Clayton Statement.