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Update on U.S. sanctions against Communist Chinese Military Companies and the implications for Hong Kong's securities market

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This alert updates and supersedes our previous alert on this topic.

On 12 November 2020, the President of the United States issued Executive Order 13959 (“**EO13959**”) which prohibits certain transactions in securities linked to what EO13959 describes as “Communist Chinese Military Companies” (“**CCMCs**”).

EO13959 has caused significant market uncertainty. Indeed, EO13959 was so open to interpretation that the New York Stock Exchange altered its view on the application of EO13959 not once, but twice, in one week.

This uncertainty resulted in a further Executive Order being issued (“**EO13974**”) to amend key aspects of EO13959, including the definition of “transaction”, which is central to the application of EO13959.

In addition, the U.S. Department of the Treasury's Office of Foreign Assets Control (“**OFAC**”) has issued 15 FAQs and three General Licences in the few short months since EO13959 was issued.

The latest FAQs and General Licence have been issued under the Biden administration and delay the introduction of certain prohibitions.

This alert summarises the current status of EO13959, as amended by EO13974 [1], which together have a significant impact on a wide variety of securities traded in Hong Kong. It also considers whether compliance with EO13959 might violate Hong Kong and PRC [2] law, leaving financial institutions in Hong Kong walking a tightrope between compliance with EO13959 and local laws.

1. What is prohibited?

a. EO13959 primarily applies to U.S. persons, mean:

- i. any U.S. citizen or legally permitted U.S. resident (eg green card holder), wherever located;
- ii. any person, of any nationality, within the U.S.; and
- iii. any entity organised under the laws of the U.S. (including foreign branches of U.S. companies).

b. EO13959 prohibits U.S. persons from purchasing for value, selling or being in possession of:

- i. publicly traded securities;
- ii. securities that are derivative of publicly traded securities; an
- iii. securities that are designed to provide investment exposure to publicly traded securities, of any CCMC (collectively referred to as “**Affected Securities**”) once the prohibitions come into effect[3].

c. The prohibitions come into effect on different dates depending on when the CCMC was designated a CCMC.

d. The prohibitions commenced on 11 January 2021 for the CCMCs listed in the Annex to EO13959. For entities subsequently designated a CCMC pursuant to EO13959, the prohibitions commence 60 days after the designation.

e. Once designated, there is a wind-down period during which U.S. persons are permitted to conduct purchases for value, or sales, of Affected Securities so long as the transaction is conducted solely to divest, in whole or in part, the Affected Securities.

f. During the wind-down period, securities exchanges operated by U.S. persons are permitted to engage in transactions and activities involving Affected Securities.[4]

g. The wind-down period for the entities listed in the Annex to EO13959 ends on 11 November 2021. For entities subsequently designated a CCMC pursuant to EO13959, there is a 365-day wind-down period. [5]

h. Once the wind-down period expires, U.S. persons, including US funds, are prohibited from being in possession of Affected Securities. [6]

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- i. Securities exchanges operated by U.S. persons must also not engage in transactions and activities involving Affected Securities from that time. [\[7\]](#)
 - j. U.S. persons are also prohibited from transactions that evade or avoid, have the purpose of evading or avoiding, cause a violation of, or attempt to violate EO13959. [\[8\]](#)
 - k. Under general OFAC rules, U.S. persons also cannot “facilitate” a transaction by a non-U.S. person that would be prohibited (under sanctions) if conducted by the U.S. person. This means that U.S. persons wherever located may not approve, finance, facilitate or guarantee any transaction by a non-U.S. person that would be prohibited if conducted by a U.S. person. The risk of facilitation has been slightly diminished for EO13959, as U.S. persons are permitted to conduct certain services (see paragraph 2). However, the risk remains in certain circumstances. For example, guarantors must carefully consider whether EO13959 applies to their guarantee.
 - l. Non-U.S. persons are prohibited from conspiring to violate EO13959 [\[9\]](#) or causing a U.S. person to violate EO13959. [\[10\]](#)

2. What is not prohibited?

U.S. persons are permitted to provide the following services in relation to Affected Securities, to the extent they are not provided to U.S. persons in connection with prohibited transactions: clearing, execution, settlement, custody, transfer agency, back-end services, as well as other such support services. [\[11\]](#)

In practice, this means that so long as the transactions do not involve U.S. persons purchasing Affected Securities, U.S. staff members may continue to execute impacted trades, and U.S. entities that provide settlement services, for example, may continue to do so. This reduces the risk of falling foul of “facilitation” offences. Participants who issue, or trade in securities might further avoid “facilitation” by relying on selling restrictions that prohibit sales to U.S. persons.

3. Which entities are CCMCs and when do the prohibitions commence?

The following are CCMCs:

- a. the 31 companies named in the Annex to EO13959 (“**Group A**”);
 - b. the four companies [\[12\]](#) designated as CCMCs by the U.S. Department of Defense on 3 December 2020 (“**Group B**”);
 - c. issuers named in the [non-SDN CCMC list](#) (“CCMC List”) when it was first issued by OFAC on 28 December 2020 (“**Group C**”);
 - d. issuers added to the CCMC List on 8 January 2021 (“**Group D**”); and
 - e. companies not yet specifically named in the CCMC List, but which have names that closely match entities named pursuant to EO13959 (“**Group E**”). [\[13\]](#)
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NB: The terms Group A, B, C, D and E are used for the purpose of aiding the explanations in this alert and are not OFAC terms.

4. Which entities are not CCMCs?

Subsidiaries of CCMCs that OFAC has not publicly listed as a CCMC (and whose names do not closely match a publicly listed CCMC) are not subject to the prohibitions as yet.

However, OFAC has confirmed that it intends to publicly list any entity that is 50% or more owned, in aggregate, by one or more CCMC.^[14] As such, whilst such subsidiaries are not automatically designated (ie the usual 50% rule that applies to SDNs^[15] does not apply), they could soon be designated.

5. What is a “close match”?

OFAC has not defined what constitutes a “close match” (such that a company falls into Group E).

However, the CCMC List provides guidance by setting out which issuers OFAC has so far considered to closely match the name of an entity designated in, or pursuant to, EO13959. For example:

- a. EO13959 lists “China Mobile Communications”. “China Mobile Communications Group Co Ltd” was added to the CCMC List on 28 December 2020 and “China Mobile Limited” was added to the CCMC List on 8 January 2021, both being considered close matches; and
- b. EO13959 lists “China United Network Communications Group Co Ltd”. “China United Network Communications Ltd” was added to the CCMC List on 28 December 2020 and “China Unicom (Hong Kong) Limited” was added on 8 January 2021, both being considered close matches.

Market participants must identify further entities that are not:

- i. named in, or pursuant to, EO13959; or
- ii. named as an issuer in the CCMC List,

but that have names that closely match entities in those lists.

To allow time for that analysis to take place, OFAC issued General Licence 1, which was then superseded by General Licence 1A, which delays the effective date of the prohibitions for entities in Group E until 27 May 2021.

6. How do we track the prohibitions?

The timeline below sets out when the prohibitions on purchases commence and when the

wind-down periods end.



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Guidance has not yet been provided regarding the wind-down period applicable to Group E entities.

Tracking the different dates is likely to present challenges. This can be demonstrated by reference to the examples in paragraph 5:

- a. for China Mobile Communications Group Co Ltd, the prohibitions commence on 26 February 2021, and the wind-down period will end on 28 December 2021; whereas
- b. for China Mobile Limited, the prohibitions commence 9 March 2021, and the wind-down period will end on 8 January 2022, meaning companies within the same group are subject to sanctions on different, albeit close, dates.

7. What types of securities are impacted?

The definition of securities in EO13959 is very broad and includes anything generally known as a security. It includes futures, options, swaps, warrants, callable bull/bear contracts, American depositary receipts, global depositary receipts, exchange-traded funds (“**ETF**”), index funds, and mutual funds, that have an underlying in all or part of stocks relating to CCMCs, all of which are subject to EO13959. [\[16\]](#)

The level of exposure that a security has to a CCMC is not relevant, given the definition extends to

securities that are “*derivative of, or are designed to provide investment exposure to such securities*”. This has been confirmed in FAQ861, which provides that any transaction in Affected Securities is prohibited regardless of such securities’ share of the underlying index fund, ETF, or derivative thereof. [17]

It has therefore been confirmed that U.S. persons cannot invest in any index which includes any exposure to the Affected Securities.

8. Local Law considerations

In considering how to react to EO13959, entities in Hong Kong must also analyse the potential risks of violating the Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region (“**National Security Law**”).

The National Security Law forms part of Annex III of the Basic Law, being a PRC national law which applies in Hong Kong.

Article 29 of the National Security Law provides:

“...a person who ..conspires with a foreign country..of China, to commit any of the following acts shall be guilty of an offence:

...

(4) imposing sanctions or blockade, or engaging in other hostile activities against the Hong Kong Special Administrative Region or the People’s Republic of China ; or...” (our emphasis)

This may include activities such as implementing sanctions imposed unilaterally by other jurisdictions. It is therefore possible that taking action that is, for example, considered discriminatory toward PRC companies or causes material damage to PRC companies or related industries may be considered a “hostile activity”.

As such, compliance with EO13959 may constitute “other hostile activities”.

Further, on 9 January 2021, seemingly in response to U.S. sanctions, the PRC’s Ministry of Commerce issued Order No. 1 of 2021 on Rules on Counteracting Unjustified Extra-territorial Application of Foreign Legislation and Other Measures (“**Order No. 1 of 2021**”). [18] This provides for the establishment of a “working mechanism”, to allow the competent department of commerce of the State Council to issue a prohibition order to the effect that, “unjustified” extra-territorial foreign legislation and other measures are not to be accepted, executed, or observed. If a person (including an entity) then complies with that legislation, and this infringes on the rights of another, for example, a CCMC, that CCMC may apply for compensation from that person. Fines may also be issued by the PRC government.

9. Conclusion

To date, 35 companies, group company names and brand names are listed as CCMCs. Based on the list of 35, OFAC has specified 39 issuers in the CCMC List.

For these 39 names we can say for certain that they have been deemed CCMCs subject to prohibitions that have either already come into effect (for Groups A and B) or will come into effect on 26 February or 9 March (for Groups C and D, respectively).

Other entities, not yet specified but with names that closely match, will be subject to those same prohibitions, commencing 27 May 2021.

Further, majority owned subsidiaries that do not have similar names (and so are not already automatically captured) may soon be designated by OFAC as CCMCs.

It is clear that the overall impact on the companies listed will be significant.

Further, the definition of securities is so broad that the implications for the market in Hong Kong are equally significant and unprecedented.

Identifying all impacted securities must be a priority for market participants.

Since EO13959 was published, we have been assisting numerous clients to navigate its scope and application. Please reach out to us if you require guidance.

Any reference to “Hong Kong” or “Hong Kong SAR” shall be construed as a reference to “Hong Kong Special Administrative Region of the People’s Republic of China”.

[1] Throughout this alert, reference to EO13959 is as amended by EO13974.

[2] For the purposes of this alert, PRC refers to the People's Republic of China excluding Hong Kong, the Macau Special Administrative Region and Taiwan.

[3] Section 1(a)(i) and (ii), EO13959.

[4] General Licence 2, Authorising Securities Exchanges Operated by U.S. Persons to Engage in Transactions Involving Securities of Communist Chinese Military Companies.

[5] Section 1(b) and (c), EO13959.

[6] Section 1(b) and (c), EO13959, as amended by Section 1, EO13974.

[7] General Licence 2, Authorising Securities Exchanges Operated by U.S. Persons to Engage in Transactions Involving Securities of Communist Chinese Military Companies.

[8] Section 2(a), EO13959.

[9] Section 2(b), EO 13959.

[10] Section 1705, International Emergency Economic Powers Act.

[11] OFAC FAQ863.

[12] Namely, China Construction Technology Co. Ltd., China International Engineering Consulting Corp., China National Offshore Oil Corp., and Semiconductor Manufacturing International Corp.

[13] OFAC FAQ858.

[14] OFAC FAQ857.

[15] Persons on OFAC's Specially Designated Nationals and Blocked Persons List.

[16] Section 4(d) and FAQ860.

[17] OFAC FAQ 861.

[18] English translation is available here: <http://english.mofcom.gov.cn/article/policyrelease/announcement/202101/20210103029708.shtml>

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