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U.S. Set to Bar Investments in Communist Chinese Military Companies

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President Trump issued an Executive Order (the "Order") on November 12, 2020 prohibiting "U.S. persons" from trading in securities, both in the U.S. and abroad, that finance Communist Chinese military companies (generally defined as companies owned or controlled by Chinese military or government services and supporting military services, manufacturing or production). There were about 30 companies initially identified by the U.S. government, but the list is fluid and is likely to expand over time. "U.S. person" is broadly defined as "any United 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." Thus, the Order impacts both RIAs and individual investors.

The Order prohibits U.S. persons from transacting in publicly traded securities, or any securities that are derivative of, or are designated to provide investment exposure to such securities, of any Chinese military company, beginning on January 11, 2021 or within 60 days after be added to the list of Chinese military companies by the Secretary of Defense. The Order also contains a limited exception to the prohibited transactions, allowing U.S. persons until November 11, 2021, solely to divest, in whole or in part, from securities held as of January 11, 2021.

A likely outcome of the Order is that U.S. Exchanges may halt trading of securities that fall on the Chinese military company list. As the Order is currently written, U.S. firms will be required to examine their portfolio holdings and identify potential prohibited transactions and securities positions. Now is the time for RIAs to review their portfolios and flag qualifying entities for potential trade restrictions or liquidation. The review must include individual securities and derivatives and extends to underlying securities positions in mutual funds, ETFs and alternative investments. Thus, ETF and mutual fund managers will need to implement surveillance measures designed to avoid trades that involve prohibited securities in their respective funds.

The Treasury Department is tasked with issuing rules and regulations to help implement the Order (hopefully including more guidance relative to specific authorized or prohibited transactions). Firms should start reviewing their current portfolio holdings to assess exposure to Chinese military companies. Firms should also be prepared to block purchases of listed companies when the Order comes into effect in January. The Order is currently limited in scope, affecting a relatively small portion of U.S. investments in Chinese equity and bond holdings (including one significant firm, China

Mobile). The current version of the Order does not specifically call for firms to liquidate listed securities, and it is unclear whether simply holding such positions will constitute a prohibited transaction. If planning to liquidate listed securities, firms would need to do so by the November 2021 deadline.

The Order's future will also be reviewed by the incoming Biden administration, which will have broad flexibility in Order implementation. The Biden administration may revoke or limit the Order, or simply allow it to expire before going into full effect in November 2021. In summary, firms can take certain proactive steps now in preparation for the January 2021 implementation date. Firms should remain vigilant to any additional Treasury Department guidance relative to the Order and to Biden administration policy changes.

Separate Legislation Will Force Chinese Companies to Comply With PCAOB Audit Standards

A separate bill, known as the "Holding Foreign Companies Accountable Act" (the "Act") has been passed by Congress and would require foreign-based companies to submit to oversight by the U.S. Public Company Accounting Oversight Board ("PCAOB") . The Act would require auditors of foreign public companies to allow the PCAOB to inspect their audit work papers for audits of non-US operations as required by the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). The Act is intended to prevent abuses by Chinese-based organizations that present financial information not subject to the usual level of accounting scrutiny, including independent audit requirements, applied to other public companies listed on U.S. exchanges. If President Trump signs the Act into law, the SEC and the PCAOB would share enforcement duties.

The Act will mandate the delisting of Chinese companies that refuse to comply with PCAOB audit requirements. Specifically, the Act would prohibit a company's securities from being listed on any of the U.S. securities exchanges if that company has failed for three consecutive years to meet PCAOB requirements. The Act would also require publicly traded companies to certify that they are not owned or controlled by a foreign government and to make specific disclosures, such as whether officials of the Chinese Communist Party are members of their board. The Act potentially affects a number of companies using audit reports issued by audit firms in China and Hong Kong (including firms such as Alibaba and Baidu). Many of these companies either have been, or will seek to be, listed on additional exchanges in Hong Kong or mainland China exchanges (signaling potential departures from U.S. exchanges).

The SEC is currently reviewing other rule proposals that address non-compliance with PCAOB audit inspection requirements. Currently, it is unclear whether the SEC would seek to implement the Act in its present form, or whether it would recommend changes to align with the separate rule proposals. As with the Executive Order, the manner in which the Act is implemented may be subject to change by the incoming Biden administration. It is expected, however, that the U.S. and China will reach a compromise with respect to PCAOB requirements in an effort to reduce the potential for U.S. Exchange delistings.

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