

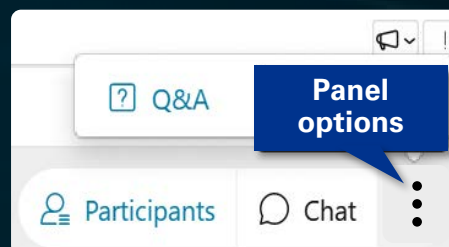


Morgan Lewis

Executive Order 13959 Sanctions against Communist Chinese Military Companies

7 April 2021

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EXECUTIVE ORDER 13959

SANCTIONS AGAINST

CHINESE MILITARY

COMPANIES

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BACKGROUND



- Section 1237 of the National Defense Authorization Act (NDAA) of FY 1999 required the US Department of Defense (DOD) to
 - Identify “Communist Chinese military companies” (CCMCs) operating directly or indirectly in the United States and publish a list of CCMCs
 - Make additions or deletions to the CCMC list “on an ongoing basis”
 - Statute amended/supplemented twice
- June 2020 – first time companies identified – 20 companies
 - August 2020 – 11 additional companies added
 - December 2020 – 4 additional companies added
- Section 1237 authorizes the President to impose sanctions on CCMCs under the International Emergency Economic Powers Act (IEEPA)

E.O. 13959



- Issued on November 12, 2020
- Bases for action
 - China's Military-Civil Fusion development strategy
 - To stem the availability of US capital to such companies
- Initial Effective date January 11, 2021

E.O. 13959 - Prohibitions



- Prohibits any transaction in publicly traded
 - securities of CCMCs,
 - securities derivative of CCMC securities
 - securities designed to provide “investment exposure” to CCMC securities
- Prohibitions apply to “US persons”
 - First effective January 11, 2021
- For CCMCs designated after November 12, 2020, prohibitions begin 60 days after date of designation
- Prohibits transactions that cause violations, are designed to evade or avoid violations or that attempt to violate the E.O.

E.O. 13959 – Key Terms



- Communist Chinese military company
 - Section 1237 companies
 - Can be designated by DOD and/or Treasury
- Security
 - Coordinate with “security” in section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10)
 - Includes currency, note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance not exceeding 9 months, exclusive of days of grace
 - Any renewal of the maturity that is likewise limited
- Transaction
 - A “purchase for value” of any publicly traded security
- U.S. Person
 - United States citizen or permanent resident alien, or any person in the U.S.
 - An entity organized under U.S. law (including foreign branches)



E.O. 13959 – Wind Down Period for Divestment Transactions Only

- Authorizes “purchases for value” or sales
 - Completed on or before November 11, 2021
 - Or 365 days after a future designation
 - So long as these transactions are “solely to divest from” covered CCMC securities

35 Entities Currently Identified

- DOD's initial Section 1237 List (20 entities -- June 2020) (Tranche 1)
https://media.defense.gov/2020/Aug/28/2002486659/-1/-1/1/LINK_2_1237_TRANCHE_1_QUALIFYING_ENTITIES.PDF
- DOD's additional Section 1237 Lists (11 entities -- Aug. 2020) (Tranches 2 and 3)
https://media.defense.gov/2020/Aug/28/2002486689/-1/-1/1/LINK_1_1237_TRANCHE-23_QUALIFYING_ENTITIES.PDF
- DOD's additional Section 1237 Lists (11 entities -- Aug. 2020) (Tranche 4)
https://media.defense.gov/2020/Aug/28/2002486659/-1/-1/1/LINK_2_1237_TRANCHE_1_QUALIFYING_ENTITIES.PDF
- Restated List as OFAC's Non-SDN CCMC List (currently 35 entities):
https://www.treasury.gov/ofac/downloads/ccmc/ns-ccmc_list.pdf

E.O. 13959 - Implementation

- Implementation by the Department of Treasury's Office of Foreign Assets Control ("OFAC")
 - Issue regulations
 - Allow exemptions and licenses
 - Enforcement
 - OFAC issues Frequently Asked Questions ("FAQs") as *non-binding* guidance
- OFAC has not issued regulations yet
- OFAC has promulgated several FAQs
 - FAQs 857 – 861 issued December 28, 2020
 - FAQs 862 – 864 issued January 4-6, 2021

Informal OFAC Guidance Provided to Industry Groups



- FAQs and verbal guidance from OFAC
 - U.S. persons may contribute to funds with existing holdings in CCMCs and not thereby violate the “investment exposure” prohibition
 - Due diligence required regarding CCMCs and their subsidiaries is that previously enunciated by OFAC
 - Due diligence is expected on one’s “customers”
 - Totality of the circumstances considered in other circumstances
- OFAC still considering whether a non-U.S. fund with a U.S. advisor is a U.S. person for purposes of the E.O.

Fund Structuring Options



- As suggested by the FAQs, pooled vehicles are directly impacted by the E.O.
 - US funds likely have no option other than to rely on the divestiture period, as they are directly covered
 - Non-US funds may have some options, but need to avoid characterization as an “indirect” exposure for US Person investors
- Option 1: Simply Rely on the FAQs
 - U.S. persons may contribute to funds with existing holdings in CCMCs and not thereby violate the “investment exposure” prohibition, so long as the fund will comply with the divestiture period

Fund Structuring Options



- Option 2: Drop CCMC securities into a subsidiary
 - CCMC securities may be dropped into a newly formed fund subsidiary
 - Interests in the subsidiary may be distributed to non-US Person fund investors
 - US Persons have no exposure to CCMC securities, while CCMC security investments are otherwise managed for the benefit of non-US Persons

Fund Structuring Options



- Option 3: Shift CCMC securities into a hard “side pocket” structure
 - CCMC securities may be moved into a newly formed or existing “side pocket” structure that siloes them for benefit of non-US Person investors
 - Interests in the “side pocket” established as separate series, so assets and liabilities are legally separate

Fund Structuring Options



- Option 4: Specially allocate income, gain and loss from CCMC securities to non-US Person investors
 - CCMC securities remain in main corpus of the fund, but all economic exposures to them are allocated to permitted (non-US Person) investors
 - May be thought of as a soft side pocket
 - Interests in the CCMC securities are not legally separate, so need to consider insolvency and other remote outcomes

THANK YOU

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US Federal Income Tax Considerations



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- Except as otherwise indicated, all section references herein are to sections of the United States Internal Revenue Code of 1986, as amended (the "**Code**"), and all regulation references are to the US Treasury regulations promulgated thereunder (the "**Regulations**").
- The following slides address certain US federal income tax considerations to the structures discussed and proposed by Morgan Lewis. KPMG expresses no view on whether these structures achieve the intended consequences from a regulatory perspective.

US Tax Considerations

OPTION 1 – SIMPLY RELY ON THE FAQS

Morgan Lewis Option 1

U.S. persons may contribute to funds with existing holdings in CCMCs and not thereby violate the “investment exposure” prohibition, so long as the fund will comply with the divestiture period.

US Federal Income Tax

To consider whether divestiture will create taxable income to be allocated to U.S. persons.

- Generally, gains from the sale of assets of the fund are generally taxable and if the gains are allocated to the US partners pursuant to the partnership agreement, then the US partners could be subjected to US tax.

US Tax Considerations

OPTION 2 – DROP CCMC SECURITIES INTO A SUBSIDIARY

Morgan Lewis Option 2

- CCMC securities are dropped into a newly formed fund subsidiary.
- Interests in the subsidiary are distributed to non-U.S. Person fund investors.

US Federal Income Tax

To consider whether contribution/distribution will create taxable income to be allocated to existing U.S. persons.

- If certain requirements are met, the contribution of the CCMCs to the subsidiary could be structured to be tax-free.
- The subsequent distribution to non-US partners would not in and of itself be a taxable event to US partners unless the fund owns certain other assets (very generally, assets producing ordinary income as opposed to capital gains, if disposed) and as a result of the distribution, each partner's share of such assets is changed.

US Tax Considerations

OPTION 3 – SHIFT CCMC SECURITIES INTO A HARD “SIDE POCKET” STRUCTURE

Morgan Lewis Option 3

- CCMC securities are moved into a newly formed or existing “side pocket” structure that siloes them for benefit of non-US Person investors.
- Interests in the “side pocket” established as separate series, so assets and liabilities are legally separate.

US Federal Income Tax

To consider whether movement to “side pocket” structure will create taxable income to be allocated to existing U.S. persons.

- If the move to the side pocket is done in a tax free manner for US tax purposes, then it would generally not create a US taxable event for the US partners. If certain requirements are met, the move could be structured to be tax free.

US Tax Considerations

OPTION 4 – SPECIALLY ALLOCATE INCOME, GAIN AND LOSS FROM CCMC SECURITIES TO NON-US PERSON INVESTORS

Morgan Lewis Option 4

CCMC securities remain in main corpus of the fund, but all economic exposures to them are allocated to permitted (non-US Person) investors.

US Federal Income Tax

To consider whether the special allocation to permitted (non-US Persons) will be respected for US tax purposes.

- So long as the partnership allocations provisions are drafted properly in the fund agreement and comply with the US tax rules, then special allocations would generally be respected for US tax purposes, in which case the US partners would generally not be subject to US tax on income from the CCMCs if none of such income is allocated to them.



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Q&A



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Thank You



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