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Court Calls into Question Securities Trading Restrictions on Entities Designated as Communist Chinese Military Companies

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The U.S. District Court for the District of Columbia last week ruled that certain securities trading restrictions will be prevented from going into effect with respect to Xiaomi Corporation ("Xiaomi") under Section 1237 of the National Defense Authorization Act for Fiscal year 1999, as amended ("Section 1237"). In its opinion, the court found that Xiaomi was likely to succeed on the merits of its claims that the United States government's designation of Xiaomi as a Communist Chinese military company ("CCMC") was not supported by substantial evidence and violated the Administrative Procedure Act ("APA"). Accordingly, the court enjoined restrictions on the trading of Xiaomi securities and derivatives that had been imposed due to its CCMC designation. Although the preliminary injunction order specifically applies to Xiaomi, the case may ultimately impact other Chinese companies designated as CCMCs under Section 1237, or U.S. persons investing in securities of designated CCMCs.

Background on Section 1237 Designations.

On January 14, 2021, the U.S. Department of Defense ("DoD") designated Xiaomi as a CCMC. Section 1237 defines a CCMC as: (i) an entity owned or controlled by, or affiliated with, the People's Liberation Army, or a ministry of the government of the People's Republic of China, or that is owned or controlled by an entity affiliated with the defense industrial base of China; and that (ii) is engaged in providing commercial services, manufacturing, producing, or exporting. Under Executive Order 13959 issued on November 20, 2020, as amended ("EO 13959"), U.S. persons cannot engage in certain transactions with respect to the publicly traded securities and derivatives of CCMCs 60 days after the designation by DoD. We previously issued an update on EO 13959 and Section 1237. DoD has designated a total of 44 entities under Section 1237 in five tranches that have been issued since June 2020.

As a result of DoD's designation of Xiaomi, U.S. persons would have been barred from engaging in certain transactions with respect to Xiaomi's securities or derivatives as of March 15, 2021. EO 13959 permits U.S. persons to engage in divestment transactions

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for one year following a Section 1237 designation, after which time merely possessing the securities becomes prohibited for U.S. persons.

The U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") is tasked with administering and enforcing the sanctions against CCMCs. OFAC guidance states that EO 13959 broadly applies not only to the securities of CCMCs, but also to derivatives and other investment vehicles that provide exposure to the securities of the CCMCs (e.g., exchange traded funds ("ETFs")). Certain of the CCMCs have securities traded on U.S. exchanges while others have securities traded on non-U.S. exchanges. Notably, EO 13959 applies to trading activities of U.S. persons, and covers transactions outside of the United States that involve U.S. persons, including U.S. persons that merely facilitate or have tangential involvement in trading of CCMC securities. Accordingly, the impact of EO 13959 includes companies involved in investing in a variety of financial instruments and financial activities worldwide. OFAC has issued a general license authorizing certain activities of securities exchanges operated by U.S. persons.

Court Opinion.

Xiaomi challenged the DoD designation of Xiaomi as a CCMC and the restrictions under EO 13959 in a complaint and a subsequent request for a preliminary injunction to the U.S. District Court for the District of Columbia. In an opinion issued on Friday March 12, 2021, the court granted Xiaomi's request preliminarily to enjoin restrictions from becoming effective on U.S. person trading of Xiaomi's securities or derivatives. The court's opinion found, preliminarily, that:

1. DoD's explanation for designating Xiaomi a CCMC is inadequate. The court found that DoD had failed adequately to connect its conclusions to facts relating to Xiaomi.
2. Xiaomi does not meet the statutory criteria to be designated a CCMC. Xiaomi is a publicly traded company with an independent board of directors and controlling shareholders and, accordingly, the court did not find support for designating Xiaomi as owned or controlled by or affiliated with the Government of China, the PLA or other Chinese security services (e.g., the defense industrial base of China).
3. DoD's designation of Xiaomi lacked substantial evidentiary support under the APA. DoD defended its decision by pointing to Xiaomi's involvement in fifth generation ("5G") internet networks and artificial intelligence, and the receipt by Xiaomi's founder of an award from the Government of China. The court found that this evidence was insufficient to find that Xiaomi is a CCMC and stated it was "troubled by the lack of any limiting principal" in DoD's interpretation of Section 1237 as it was applied to Xiaomi.

The court then found that Xiaomi established imminent irreparable harm because of the EO 13959 restrictions and the CCMC designation, and that the balance of harms favored Xiaomi's request for a preliminary injunction. It is unclear at this time how the Xiaomi lawsuit will proceed in light of this ruling.

Impact on Other CCMCs.

The court's preliminary injunction order specifically applies only to Xiaomi. However, DoD to date has designated 43 other Chinese companies as CCMCs. The Xiaomi case could impact these other CCMCs, or U.S. persons who trade in their securities or derivatives.

Other than Xiaomi, DoD has not publicly released information indicating why it has designated other Chinese companies as CCMCs, or what factual support exists for such designations. Nonetheless, other CCMCs could challenge their designations as well in federal court. Their likelihood of success will depend on DoD's factual support for the designation and the Chinese entity's proximity to the Chinese government, the PLA, and other parts of the Chinese defense industrial base.

As an example, Luokung Technology Corp. ("Luokung") has also filed a complaint with the U.S. District Court for the District of Columbia, and is represented by Dorsey & Whitney in that case. OFAC also released a frequently asked question ("FAQ") on March 14, 2021 clarifying that restrictions as to Luokung were delayed until May 8, 2021 because DoD had misspelled the company's name. Luokung had initially been designated by DoD on January 14, 2021 in the same tranche of CCMCs that included Xiaomi. DoD corrected the error in Luokung's name on March 9, 2021, after Luokung filed its lawsuit against DoD.

In addition, it is possible that the Biden Administration could review CCMC designations and the scope of restrictions under EO 13959, although the Biden Administration has not indicated that it intends to do so. Also, to date, neither DoD nor OFAC have established an administrative review process of Section 1237 designations.

Conclusion.

Dorsey & Whitney attorneys are experienced in helping clients examine EO 13959, and assessing their ability to challenge restrictions imposed under EO 13959. Please do not hesitate to reach out to attorneys linked with this e-Update for further information.