

China's Unreliable Entity List – An overview and implications for businesses

A. Background

On 19 September 2020, China's Ministry of Commerce (“**MOFCOM**”) issued the Provisions on the Unreliable Entity List (“**Provisions**”), 15 months after it was first announced. The Provisions are effective on promulgation.

The Unreliable Entity List (“**UEL**”) regime is widely believed to be one of China's countermeasures against U.S. export control measures that target Chinese enterprises. Under this regime, enterprises, organisations or individuals of a foreign country (“**Foreign Entities**”) that carry out certain actions which result in serious damage to the legitimate rights and interests of Chinese enterprises will be listed on the UEL and be subject to legal measures.

In this alert, we analyse the *Provisions*, consider the interaction between the *Provisions* and the newly-enacted *Export Control Law of the People's Republic of China*, promulgated on 17 October 2020 and effective from 1 December 2020 (“**ECL**”), and compare the respective UEL regimes of the U.S. and China.

B. Stated Objectives and Principles

The stated objectives of China's new UEL regime as set out in the *Provisions* are as follows:

- » To safeguard national sovereignty, security and development interests;
- » To maintain a fair and free international economic and trade order; and
- » To protect the legitimate rights and interests of Chinese enterprises, other organisations or individuals.

In that regard, the *Provisions* stipulate the following principles:

- » To pursue an independent foreign policy;
- » To adhere to the basic principles of international relations, including mutual respect for sovereignty, non-interference in each other's internal affairs and equality and mutual benefit;
- » To oppose unilateralism and protectionism;
- » To safeguard the core national interests and the multilateral trading system; and
- » To promote an open world economy.

C. Competent Agencies

The *Provisions* state that a working mechanism comprising relevant central government agencies (“**Working Mechanism**”) will be introduced to administer and enforce the UEL regime. The Working Mechanism office is to be set up under MOFCOM, most likely in the Bureau of Industry, Security, Import and Export Control.

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D. Foreign Entities Subject to UEL Regime

The *Provisions* provide that Foreign Entities will be subject to the UEL regime if they take any of the following actions that relate to international economic activity, trade and other relevant activities:

- » Endangering national sovereignty, security or development interests of China; and
- » Suspending normal transactions with or applying discriminatory measures against enterprises, other organisations or individuals of China (“**Chinese Entities**”), which violates normal market transaction principles and causes serious damage to the legitimate rights and interests of Chinese Entities.

E. Procedures to Designate Foreign Entities on UEL

The *Provisions* set out the following procedure for Foreign Entities to be designated on the UEL. This designation procedure comprises four distinct stages: (a) Initiation; (b) Investigation; (c) Decision; and (d) Announcement. Notwithstanding the designation procedure, in cases where the actions of the relevant Foreign Entity are clear, the Working Mechanism may make a decision without performing any investigation.

a) Initiation

The Working Mechanism shall, *ex officio* or upon suggestions and tip-offs from the relevant parties, decide whether to investigate the actions taken by the relevant Foreign Entity. The decision to investigate shall be disclosed to the public.

b) Investigation

The *Provisions* grant the Working Mechanism powers to investigate potential violations, including:

- » Making inquiries to the relevant parties;
- » Reviewing or copying any relevant documents and materials; and
- » Taking any other necessary actions to facilitate the investigation.

During the investigative process, the relevant Foreign Entity may be given an opportunity to state or defend its case. Based on this and the actual circumstances of the relevant Foreign Entity discovered during the investigation process, the Working Mechanism may suspend or terminate the investigation. Nonetheless, the Working Mechanism will be able to resume the investigation should there be a substantial change in the facts on which the decision to suspend the investigation had been made.

c) Decision

Following the investigation, the Working Mechanism will decide whether to designate the relevant Foreign Entity on the UEL. This involves an evaluation process, which considers the results of the investigation and an overall consideration of the following factors:

- » The degree of danger to the national sovereignty, security or development interests of China;
- » The degree of damage to the legitimate rights and interests of Chinese Entities;
- » Whether the relevant Foreign Entity is compliant with internationally accepted economic and trade rules; and
- » Any other relevant factors.

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d) Announcement

Following this process, the Working Mechanism will make an announcement on the decision to designate the relevant Foreign Entity on the UEL (“**Announcement**”). This Announcement may include an alert about the risks of transacting with the listed Foreign Entity and may also specify the time limit for the listed Foreign Entity to rectify its actions according to the specific facts of the case.

F. Consequences to the Listed Foreign Entity

Should a Foreign Entity be listed on the UEL, the *Provisions* stipulate that the Working Mechanism may take one or more of the following measures against the listed Foreign Entity:

- » Restricting or prohibiting the Foreign Entity from engaging in China-related import or export activities;
- » Restricting or prohibiting the Foreign Entity from investing in China;
- » Restricting or prohibiting the Foreign Entity’s relevant personnel or means of transportation from entering into China;
- » Restricting or revoking the relevant personnel’s work permit, status of stay or residence in China;
- » Imposing a fine of a commensurate amount according to the severity of the circumstances; and
- » Other necessary measures.

The measures to be taken against the listed Foreign Entity will be announced by the Working Mechanism.

For cases where the time limit for the relevant Foreign Entity to rectify its actions has been specified in the Announcement, none of the sanctions will be imposed before the time limit for rectification lapses. Where the relevant Foreign Entity fails to rectify its actions within the time limit, the abovementioned sanctions will apply.

Nonetheless, where Chinese Entities are required to transact with Foreign Entities that are restricted or prohibited from engaging in China-related import or export activities, an application can be submitted to the Working Mechanism office. These special transactions may be approved at the Working Mechanism’s discretion and may only be conducted upon approval.

G. Procedures to Remove Foreign Entities from UEL

Once designated on the UEL, listed Foreign Entities may be removed from the UEL. According to the *Provisions*, this requires an evaluation by the Working Mechanism. Circumstances which would justify a removal from the UEL include the following:

- » A substantial change in the facts on which the decision to designate the relevant Foreign Entity on the UEL was based;
- » The relevant Foreign Entity rectifying its actions within the specified time limit and taking measures to eliminate the consequences of its actions; and
- » The listed Foreign Entity successfully applying for its removal from the UEL.

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An announcement will be made by the Working Mechanism should the Foreign Entity successfully be removed from the UEL for any of the above reasons. Any sanction measures imposed on the Foreign Entity (under Section F above) will also cease as of the date of the announcement.

H. Statutory Liabilities and Penalties

The *Provisions* do not expressly impose any penalties on entities that enter into transactions with Foreign Entities designated on the UEL. Nevertheless, it remains to be seen whether additional penalties may be introduced by subsequent amendments or further implementing rules.

I. Comparisons between the U.S. and China Rules on Entity Lists

The new *Provisions* create a “menu” of various sanctions options that are similar to aspects of the U.S. Export Administration Regulations (“**EAR**”) administered by the U.S. Department of Commerce, Bureau of Industry and Security (“**BIS**”), economic sanctions regimes administered by the U.S. Department of the Treasury, Office of Foreign Assets Control (“**OFAC**”), the U.S. Department of State, as well as powers that can be exercised by the Committee on Foreign Investment in the United States (“**CFIUS**”).

The EAR’s Entity List has been used with increasing frequency against Chinese companies like Huawei, ZTE, Hikvision, and others, restricting exports, re-exports, and transfers of U.S.-origin goods. The *Provisions* seem to parallel these restrictions with both export and import restrictions that can be applied to Foreign Entities.

The restrictions on entering and working in China parallel immigration sanctions that have been imposed against Chinese officials and other individuals pursuant to U.S. Executive Orders and counterproliferation statutes.

Additionally, the restrictions on investment in China parallel the ability of the U.S. President, acting through CFIUS, to prevent foreign investments, or cause divestment of existing foreign investments, when it is determined that the investment is contrary to the national security interests of the U.S. The Trump Administration has used these powers more than the prior four administrations combined, with the primary target for divestment being Chinese companies.

Nonetheless, the *Provisions* differ from the U.S. restrictions in that they appear to authorise the imposition of penalties pursuant to a decision by the Working Mechanism. The parallel U.S. sanctions would require at least an administrative law finding of a violation of pre-existing export control or economic sanctions laws, subject to administrative or judicial proceedings, before civil or criminal penalties could be imposed.

J. Interaction with ECL

Both the *Provisions* and *ECL* share a stated objective of “protecting national security and interests”.

Similarly, both the *Provisions* and the *ECL* have an extraterritorial application. The *ECL* expressly provides that organisations and individuals outside China may also be liable for export control violations.

One major interplay between the *Provisions* and the *ECL* is the implementation of entity list regimes. Under the *ECL*, the competent agency is empowered to create entity lists for exporters and end-users who:

- » Violate the end-user and end-use compliance requirements;
- » May endanger national security; or
- » Use controlled items for purposes of terrorism.

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Importers and end-users who are added into the entity list may be designated as denied or restricted parties. They could also be subject to prohibition orders (i.e., prohibited from importing controlled items). Exporters are prohibited and restricted from entering into any transactions with parties on the entity list. In contrast, it is unclear at this point whether similar sanctions will be imposed on parties that transact with Foreign Entities designated on the UEL.

It remains to be seen how the UEL regime and the entity lists in the *ECL* will interact in practice and whether entities which are designated on one list will also be designated on the other. Nevertheless, it is clear that China is in the process of introducing mechanisms which are inspired by similar U.S. mechanisms in order to compel Foreign Entities to comply with Chinese export control and national security laws.

K. Our Observations

When the UEL was first broached by MOFCOM in May 2019, it was stated that the UEL would mainly be for retaliation against Foreign Entities which suspend or terminate the supply of goods and services to Chinese firms for non-commercial reasons. Such legislative intent is also partially confirmed by the stated objectives and principles in the *Provisions* as well as factors to be considered by the Chinese authorities in deciding whether to designate a Foreign Entity.

However, it appears that in the final version of the *Provisions*, national security (as opposed to retaliation against U.S. actions) has taken greater prominence and emphasis. This reflects China's new approach to national security, i.e., implementation of the Comprehensive National Security Perspective first mentioned by President Xi in 2014, which covers not only traditional security concerns, but also economic and trade concerns. With this broadened approach towards national security, the *Provisions* will not only affect firms in the military and defence industry, but also firms in sectors such as technology, internet, and even transport and finance.

Thus, the *Provisions* could affect Foreign Entities in all sectors, and it would be recommended to conduct a comprehensive review of trade, investments and transactions in and with China to identify potential vulnerabilities to UEL designation as well as taking the appropriate measures where possible to address such vulnerabilities.

According to the *Provisions*, Foreign Entities include foreign enterprises, other organizations and individuals. This means that foreign-invested enterprises in China are technically not covered as they are not foreign enterprises. Nonetheless, if a foreign enterprise is placed on the UEL, it is reasonable to expect that their Chinese subsidiaries and branches would also be affected.

In terms of the Working Mechanism, the fact that its office will be housed at MOFCOM does not mean that MOFCOM will be the primary decision-making agency. Instead, we expect that the Working Mechanism will involve several agencies, which will most likely include the National Development and Reform Commission, Cyberspace Administration of China, and Ministry of State Security. Given their relative importance in the bureaucratic hierarchy, it is likely that these agencies will play a more substantive role in the decision-making process.

For further consultations on the impact of China's *Provisions on the Unreliable Entity List* to your business or for further inquiries regarding this alert, please contact:

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