

INTERNATIONAL BUSINESS ALERT

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China implements its long-awaited Unreliable Entities List mechanism

On Sept. 19, 2020, the Ministry of Commerce for the People's Republic of China (MOFCOM) released its long-awaited [Provisions on the Unreliable Entity List](#) (MOFCOM Order No. 4 of 2020) (UEL Regulation), which becomes effective immediately. This is the first time the MOFCOM has released details about the Unreliable Entity List mechanism, which was originally announced in late May 2019. Under this new mechanism, a foreign entity included in the Unreliable Entity List will likely bear severe consequences, including restrictions or prohibitions on the entry of trade, investment, personnel and transportation in China. Licenses will be required to conduct business with those companies on the list. In addition, companies worldwide may be more vigilant of any risks associated with conducting business with companies on the list.

What is the Unreliable Entity List and who is at risk?

According to Article 2 of the UEL Regulation, any "foreign entities", including any "enterprise, other organization or individual of a foreign country," may be included in the Unreliable Entity List if they are found to have taken actions related to international economic or trade that are deemed to: (1) endanger the national sovereignty, security or development interests of China, or (2) suspend normal transactions with or apply discriminatory measures against Chinese companies or individuals that violate "normal market transaction principles" and cause harm to Chinese companies or individuals.

Article 7 of the UEL Regulation provides a list of factors when deciding whether to include a foreign entity on the Unreliable Entities List. Those factors include: (1) the degree of danger to the national sovereignty, security or development interests of China; (2) the degree of damage to the legitimate rights and interests of Chinese companies and individuals; (3) compliance with internationally-accepted economic and trade rules;

and (4) other appropriate factors. Compared with the factors listed in the MOFCOM's original announcement in May 2019, China moved up perceived national security and development risks as its top considerations when determining entities to be added to the list. As to the degree of damage to Chinese companies and individuals, it is generally understood that actions would have to cause severe harm before a foreign entity would be put on the list. Also, this is the first time China has raised any violation of international economic and trade rules as grounds for putting a foreign entity on the list. This is an important concept, particularly given that the World Trade Organization has recently ruled that the U.S. has violated international trade rules in its trade war with China.

The Unreliable Entity List is a completely new legal scheme in China. The MOFCOM cited the *Foreign Trade Law and the National Security Law* as the legal basis for its authority to enact the Unreliable Entity List, but it is still possible that a new statute might need to be enacted, or that current statutes may be amended, to add more teeth to the Unreliable Entity List scheme. Notably, while the *Anti-Monopoly Law* was first cited as a legal basis for the enactment of the Unreliable Entity List in May 2019, the *Anti-Monopoly Law* was not cited in the UEL Regulation upon its release. It is suspected that the reason that statute was not referenced in the UEL Regulation is because if the *Anti-Monopoly Law* were used as legal authority for the enactment of the list, then an entity could be put on the list only if it has "dominant market position" with the capacity to control the price, quantity or other trading conditions of commodities in a relevant market, or to hinder or affect any other business operator from entering the relevant market—requirements which would be difficult to meet in practice.

Many questions are left unanswered in the current UEL Regulation. For multinational companies operating in China, questions arise as to whether their Chinese subsidiaries, branches or local offices should be treated as Chinese enterprises or foreign entities. If the foreign parent companies are included in the list, is a license required for intra-company transactions? Conversely, are overseas branches established by Chinese companies "foreign entities" under the UEL Regulation? If an overseas organization of a Chinese company violates the relevant regulations, would it fall within the scope of the Unreliable Entity List? The current UEL Regulation is vague on these questions, and we expect that corresponding rules and explanations will be issued to clarify those questions.

Why was the Unreliable Entity List promulgated?

While the MOFCOM claims that the Unreliable Entity List is not intended to target any specific country or specific entity, most commentators believe that the Unreliable Entity List is a retaliatory mechanism enacted by China in response to the escalation of the recent trade war with the U.S. Reports suggest that China debated the enactment of the Unreliable Entity List internally, but recent U.S. actions—from blocking imports of some Xinjiang products, adding numerous Chinese companies and individuals to the Entity List and the Specially Designated Nationals and Blocked Persons List (SDN List), prohibiting transactions related to WeChat and TikTok in China,

the amendment of export control rule specific to Huawei--probably have prompted the promulgation of the Unreliable Entity list.

The Unreliable Entity List is a legal weapon China enacted to enable it to take retaliatory countermeasures against the United States and other countries such as India. Its purpose is not necessarily to retaliate against or suppress U.S. or other foreign companies, but to direct the market to a position that is more beneficial to China and to better maintain today's globalization pattern.

China claims that the promulgation of the Unreliable Entity List does not mean that China's position on welcoming and protecting foreign investment has changed. [MOFCOM Press Release](#), Sept. 20, 2020. Mr. Shouwen Wang, Vice Minister of Commerce and Deputy Representative for International Trade Negotiations, recently stated that China will not waver in its determination to deepen reform and expand the Chinese economy. He further expressly welcomed American companies to continue to increase investments in China and share China's development dividends.

What are the procedures for foreign entities to be included and removed from the Unreliable Entities List?

An Office of Working Mechanism would be established to investigate and rule on which entities should be placed on the Unreliable Entity List. The office will be located in the MOFCOM, but it will likely also include the Ministry of Foreign Affairs, the Ministry of National Security, the General Administration of Customs, the Ministry of Public Security, the Ministry of Human Resources and Social Security, the State Administration for Market Supervision and Administration, the Ministry of National Defense, the Central Military Commission and other Ministries. This is the first time that China has expressly established this type of interagency mechanism.

A foreign entity may be included in the Unreliable Entity List by petition from a third party or on the office's own initiative. According to the UEL Regulations, the office may decide whether to investigate the conduct of a particular foreign entity in accordance with its authority or based on the suggestions and reports of relevant parties. The office then makes a decision on whether to include the relevant foreign entity in the Unreliable Entities List based on the Article 7 factors. In addition, if facts are clear, the office can also decide, on its own initiative, to add a foreign entity to the Unreliable Entity List.

After foreign entities are included in the Unreliable Entities List, they may also be removed depending on the circumstances. This is similar to the U.S. "Entity List" system. For example, a foreign entity may be removed from the Unreliable Entity List upon a change of circumstances indicating that the Article 7 factors are no longer applicable. Also, the office may remove a foreign entity if it corrects its behavior and takes measures to eliminate the consequences of the sanctioned behavior within a time limit specified in the announcement. See [MOFCOM Press Release](#), May 20, 2020. The foreign entity can also apply to be removed from the Unreliable

Entities List.

What are the consequences of being placed on the list?

Once a foreign entity is included in the Unreliable Entities List, it will need to bear corresponding legal responsibilities, and its trade, investment, personnel and transportation in China may be restricted or prohibited. According to Article 10 of the UEL Regulation, for foreign entities included in the Unreliable Entities List, the working mechanism may take any one or all of the following measures:

- Restrict or prohibit the entity from engaging in import and export activities related to China;
- Restrict or prohibit the entity's investment in China;
- Restrict or prohibit the entry of related personnel, transportation vehicles, etc.;
- Restrict or cancel the work permit, stay or residence qualification of relevant personnel in China;
- Impose fines according to the seriousness of the circumstances;
- Other necessary measures.

Foreign entities will be given a time limit for correction, and the above stated measures will not be taken against sanctioned companies within the correction period. However, if a foreign company fails to make timely corrections, any of the above measures could be taken against that company.

Moreover, the announcement of the inclusion of a foreign entity on the Unreliable Entities List may warn others about the risks of transactions with the foreign entity. See *Article 9*. In other words, placing an entity on the list notifies the public that the entity is at risk of being unreliable. Chinese companies will further be required to apply to the office for a license to transact business with companies on the Unreliable Entities List. See *Article 12*.

Unreliable Entity List and Export Control Law

There are certain overlaps in the Unreliable Entity List and China's soon-to-be-released *Export Control Law*. The phrase "possibly endangering national security" is stated as grounds to be included on both the Unreliable Entity List and the Control List. A document titled *Export Control Law (Draft) (Second Review Draft)* (hereinafter referred to as the "Second Review Draft") promulgated in July 2020 establishes a "Control List" system. Under the proposed system, the national export control management department is authorized to add importers and end-users to the Control List, upon a finding that those importers and/or end-users have violated certain end-user or end-use management requirements, possibly endangering national security, or using controlled items for terrorism. Importers and end-users included in the Control List will be prohibited or restricted from conducting any transactions involving related controlled

items, and may be further ordered to suspend any export of the controlled items.

Despite requiring companies to obtain a license to transact business with companies on the Unreliable Entities List, the UEL Regulations do not specify the legal consequences of violating that license requirement. However, Article 37 of the *Second Review Draft* provides that exporters violating the regulations and doing business with importers and end-users on the Control List may be given a warning, ordered to stop illegal activities, required to remit the illegal income, and assessed a fine of up to 20 times the illegal business amount. If the circumstances are serious, they will also be ordered to suspend business for rectification, or even have their export business qualifications revoked. *Article 37, Second Review Draft*. After the *Export Control Law* is officially promulgated and implemented, it may provide the Unreliable Entity List mechanism with a corresponding legal basis for export control penalties, which might be more stringent than the current *Foreign Trade Law* and the *Customs Law*.

Double-edged sword of the Unreliable Entity List

The Unreliable Entity List can be a double-edged sword. On the one hand, China realized the need to establish a legal mechanism to counter the U.S.'s technical blockade and suppression of China through its use of the U.S. Entity List and SDN Lists. On the other hand, companies cutting off supply to Huawei or suspending other transactions with companies on the Entity List or SDN List did not take those actions out of their own will, but were required to do so to comply with U.S. laws and regulations. Nevertheless, that commercial action could be considered as "endangering the national sovereignty, security or development interests of China" or violating "normal market transaction principles" under the UEL Regulation. Therefore, enforcing the Unreliable Entity List against those companies may not help China achieve its objective of changing U.S. policies; rather, it may result in further exclusion of those companies from the Chinese market. Such result will not be desirable to China, particularly if those companies also have other Chinese customers besides Huawei. China may be very slow and careful in announcing any entities on the Unreliable Entity List. While there are rumors suggesting that companies like Qualcomm, Cisco, Apple, FedEx and HSBC may be put on the Unreliable Entity List, it might be a while before we see any companies being formally and publicly listed.

Takeaway

Through the publication and implementation of the UEL Regulation, China has taken the first step in the implementation of an Unreliable Entity List mechanism. While detailed rules are yet to be released by the MOFCOM, the head of the Department of Treaty and Law of the MOFCOM has emphasized that the list does not have a preset timetable or a list of companies. If foreign entities are found to have participated in the above-mentioned acts, the Office of Working Mechanism will implement the UEL Regulations and comprehensively consider various factors.



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The current complicated international situation is putting companies in the crossfire and forcing companies to maintain a high degree of sensitivity. If the trade war continues and China adds companies to an Unreliable Entity List, all persons in the international market need to be more vigilant to prevent risks when trading and interacting with each other. In addition, the Unreliable Entities List may be only one part of the countermeasures taken by the Chinese government, which will require continuous attention. Companies should carefully monitor developments in this area, respect and abide by the relevant regulations, avoid approaching the red line of the law, and ensure that all production, operations, and trade behaviors are legal and compliant.

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