

China's Unreliable Entity List has posed risks and uncertainties to international trades

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Introduction

On May 31st, 2019, the Ministry of Commerce of People's Republic of China ("MOFCOM") first announced through a press conference that China would set up a Unreliable Entity List (UEL) system with a sanctioning effect. On Sept. 19th, 2020, *the UEL Regulations on the Unreliable Entity List* ("UEL Regulations") (MOFCOM Order No. 4 of 2020), approved by the State Council, are promulgated with immediate effect. It has taken more than 1 year for this new legislation to come into effect. The UEL Regulations consists of 14 provisions and introduces the administration mechanism of UEL. As of the date, no foreign entity or individual has been listed on the UEL.

This article aims to provide an overview of China's unreliable entity list system, including its regulatory targets, the consequences of being listed on the UEL, how to remove from the UEL and so on. We hope that this article may help multinational enterprises to understand this new legislation and potential risks they are confronted with.

Overview

1. Legal Basis

The UEL Regulations are formulated and established in accordance with the Foreign Trade Law of the People's Republic of China, the National Security Law of the People's Republic of China and other relevant PRC laws.

Specifically, we reference the following articles which may constitute the legal basis of the UEL Regulations:

1) Article 16 and 26 of the Foreign Trade Law

The State may restrict or prohibit the import or export of goods or technologies/ related international service trades if it is necessary to safeguard national security, public interests or public moral.

2) Article 19 of the National Security Law

The State shall safeguard national basic economic system and socialist market economic order, improve the systems and mechanisms to prevent and resolve economic security risks and protect the security of key sectors and key areas, key industries, key infrastructure and key construction projects as well as other significant economic benefits related to the lifeline of national economy.

3) Article 59 of the National Security Law

The State shall establish a review and regulation system and mechanism for State security, and carry out State security review against foreign investment, specific items and key technologies and network information technology products and services, construction projects that affect or may affect State security, other magnificent projects and matters relating to State security in order to effectively prevent and resolve State security risks.

It is worth noting that, in the announcement published in May last year, MOFCOM stated that the Anti-monopoly Law (AML) may constitute a legal basis for the UEL system. However, in the final rule of the UEL Regulations, the AML is not explicitly listed as a stated legal basis. From our understanding, if certain activities of a foreign entity violate both the UEL Regulations and the AML, for example the restrictions or prohibitions imposed by the foreign entity in the transactions with Chinese companies do constitute abuse of its dominant market position, the AML enforcement agency may investigate and enforce punishment against it.

2. Legislative Purpose

According to the interview of the official of Department of Treaty and Law of MOFCOM, the purpose of the establishment of the UEL system, is mainly to protect the legitimate rights and interests of Chinese enterprises, other organizations or individuals, correct the illegal acts of specific foreign entities, safeguard national sovereignty, security and development interests, and maintain fair and free international economic and trade order. We noted that the legislative purposes are also stated in the Article 1 of the UEL Regulations, with protection of national sovereignty, security and development interests as the primary purpose, safeguard of fair and free international economic and trade order and protection of legitimate rights and interests of Chinese enterprises, other organizations and individuals as secondary purposes.

General Rules

1. The Regulatory Authority

According to Article 4 of the UEL Regulations, China has established a “working mechanism” (hereinafter referred to as “the working mechanism”) composed of relevant central departments to take charge of implementation of the Unreliable Entity List System, which is similar to the composition of the End-User Review Committee¹ of U.S Ministry of Commerce that is in charge of the additions, removals and changes to the BIS Entity List. The Office of the working mechanism will be established at MOFCOM. From the perspective of the requirements to implement the UEL system, in addition to the Ministry of Commerce, we guess that the Ministry of Foreign Affairs, the Ministry of National Defense, the Ministry of Public Security, the Ministry of Human Resources and Social Security, and the General Administration of Customs may participate in the working mechanism.

2. Sanctioned Activities of Foreign Entities

Pursuant to Article 2 of the UEL Regulations, China’s UEL system is established in response to certain actions taken by a foreign entity in international economic trade and other relevant activities. Specifically, if the working mechanism finds or by investigation determines that a foreign entity is conducting the following activities, the working mechanism may list this foreign entity on the UEL:

- i. **endangering** national sovereignty, security or development interests of China;
- ii. suspending normal transactions with a Chinese enterprise, organization, or individual or taking discriminatory measures against a Chinese enterprise, organization, or individual, which violates normal market transaction principles and **causes serious damage** to the legitimate rights and interests of the Chinese enterprise, other organization, or individual.

¹ The End-User Review Committee is composed of representatives of the Departments of Commerce, State, Defense, Energy and, where appropriate, the Treasury.

The two standards listed in the UEL Regulations are related respectively to national interests and the interests of enterprises/individuals. Although the above two standards are not linked by any “and/or” conjunction, according to our interpretation, the two standards should be applied in parallel, that is, if the activities of a foreign entity meets either of the two standards, it may be listed in the UEL. We believe that this interpretation is not only in line with international common practice, but is also conducive to the realization of the legislative goal of the UEL. The first standard corresponds to the primary goal of safeguarding national sovereignty, security and development interests, while the second standard corresponds to the secondary goal of maintaining fair and free international economic and trade order and protecting the legitimate rights and interests of enterprises, other organizations, and individuals of China.

According to the press conference on May 31st, 2019, the main regulatory targets are the foreign enterprises that “fail to comply with market rules, deviate from the spirit of the contract, and impose non-commercial blockade or suspension of supply on Chinese companies. We speculate that the legislative agency is concerned of the situation that certain market activities of foreign entities may harm China’s national security or interests, therefore in the final legislation of the UEL system, such market activities are included in the scope of regulation.

Similarly, regarding the U.S. Department of Commerce’s Entity List, the reasons that entities are listed in the Entity List are mainly related to two categories. On the one hand, companies that violate U.S. export control or economic sanctions rules and conduct illegal transactions may be listed; on the other hand, according to the Export Administration Regulations (EAR), the End-user Review Committee (ERC), which is the agency that manages the Entity List, is authorized to on reasonable grounds determine that an entity is involved, or poses a significant risk of being or becoming involved, in activities contrary to the national security or foreign policy interests of the United States, and add such entity to the Entity List. At present, there are a few Chinese companies that have been added to the Entity List for being involved in activities contrary to the national security or foreign policy interests of the United States. Therefore, we believe that the relevant regulations of UEL Regulations is of great significance, not only regarding its consistency with the UEL’s legislative goal, but also regarding the establishment of a legal basis for China to counter unreasonable sanctions imposed by other countries.



3. Considering factors

Pursuant to Article 7 of the UEL Regulations, the working mechanism will consider **the following factors** and determine whether to list a foreign entity on the UEL after investigation of facts:

- i. the degree of danger to national sovereignty, security or development interests of PRC;
- ii. the degree of damage to the legitimate rights and interests of Chinese enterprises, other organizations, or individuals;
- iii. whether consistent with internationally accepted economic and trade rules;
- iv. other factors that shall be considered.

It is important to note that, generally, according to Article 93 of the Legislation Law, "laws, administrative regulations, local regulations, autonomous region regulations, separate regulations and rules shall not be retroactive, except for the regulations formulated specially for the purpose of better protecting the rights and interests of citizens, legal persons and other organizations." The UEL Regulations do not specifically regulate that retroactivity may be applied; therefore, it can be inferred that **the UEL Regulations is not retroactive**. When the working mechanism takes into overall consideration of the above factors according to the results of the investigation, it is likely that **only violations of laws committed after the promulgation of the Provision will be a direct reason for a foreign entity to be listed on the UEL**.

4. Scope of Foreign Entities

According to Article 2 of the UEL Regulations, the term "foreign entity" refers to **an enterprise, other organization, or individual of a foreign country**. **Under this definition, a Chinese foreign investment enterprise does not fall under the administrative scope of the UEL Regulations**. However, if a foreign entity is listed in the UEL and sanctioning measures related to foreign investment prohibitions are imposed on such entity, the operation of its Chinese subsidiaries, portfolio companies and affiliates may still be affected, this includes a VIE entity which is established in China and controlled by a WFOE through VIE agreements. Also, the definition provides legal ground for the PRC government to designate any individual target worldwide, which means the senior management of a foreign entity may be a potential target of the UEL.

5. The Consequences of being listed on the UEL (Sanctions)

When a foreign entity is listed on the UEL, the working mechanism may, based on actual circumstances, decide to take one or several of the following measures against this foreign entity, and make an announcement of the decision:

- i. restricting or prohibiting the foreign entity from engaging in China-related import or export activities;
- ii. restricting or prohibiting the foreign entity from investing in China;
- iii. restricting or prohibiting the foreign entity's relevant personnel or means of transportation from entering into China;
- iv. restricting or revoking the relevant personnel's work permit, stay permit or residence qualification in China;
- v. imposing a monetary fine of the corresponding amount according to the severity degree of the activities;
- vi. other necessary measures.

The restriction or prohibition on import and export activities is comparable to the function and effect of the US's Entity List and OFAC sanction, with the differences as follows: 1) no measures to block the assets in China of relevant entities are stated; 2) no prohibition of transaction with Chinese persons are stated. If a foreign entity is listed on the UEL, it will be difficult for the entity to directly obtain Chinese product, technology or service or make direct sales on Chinese market or with Chinese entities. Considering the severity of this measure, the UEL Regulations also established a special licensing procedure which is stated below, allowing a Chinese Entity to continue certain transactions with a UEL entity.

Regarding the investment restriction or prohibition, the ongoing and potential investment activities of a UEL entity in China will be subject to close regulatory scrutiny. However, regarding to the UEL Regulations, it is unclear if their past investment transactions may also be subject to any retrospective review (like CFIUS mechanism), in other words, the actual impact of the investment restriction / prohibition measures applied on foreign entities listed in the UEL which has investment in China remains unclear, and awaits

further elaboration from relevant departments or clarification on a case by case basis.

It is notable that the 2nd Draft of Export Control Law of PRC has also stipulated a Control List system and for those foreign entities who are listed on the UEL may also be prohibited from conducting certain transactions concerning controlled items under Export Control Law of PRC. As this new legislation is expected to be promulgated within this year or early next year, relevant entities should pay attention to the formal version of this legislation, especially the relationship between Control List and UEL, to evaluate the potential risks involved in certain transactions

In addition, from the description of the above measures, we can see that the UEL Regulations have left room for discretion for the working mechanism to determine the specific measures to be taken, which is supported by the lack of definition of “relevant personnel”, the lack of interpretation of when “restriction” applies or when “prohibition” applies, the possibility of applying “other necessary measures.”

6. The Investigation Procedures

The working mechanism is in charge of the organization and implementation of the UEL. According to the UEL Regulations, the working mechanism shall organize and implement the UEL by the following procedures:

1) The Investigation Procedures

a. Initiation of Investigation

The working mechanism shall, **in accordance with its duties and functions or upon suggestions and reports from relevant parties**, decide whether to investigate the actions taken by the relevant foreign entity; if it decides to investigate, an announcement shall be made.

b. Investigation Methods and Scope

When investigating the actions of a foreign entity, the working mechanism may inquire the relevant parties, review or copy the relevant documents and materials, and take other necessary means. The foreign entity may state or defend its case during the investigation. Therefore, we can conclude that, **the investigation is an open investigation, where the entity subject to the investigation will have notice.**



Regarding the scope of investigation, although it can be inferred that the UEL Regulations do not have a retroactive effect, and although not specified, it is possible that **past documents and materials of relevant parties may be included in the investigation scope to determine whether an entity ever engaged in certain customized behavior, etc.**

c. Suspension and Termination of the Investigation

The working mechanism may, based on actual circumstances, decide to suspend or terminate the investigation. For example, the relevant foreign entity has rectified its violation behaviors and resumed normal transaction. If the facts on which the decision to suspend the investigation is based have substantially changed, the investigation may be resumed.

d. Direct designation without investigation

According to the UEL Regulations, there are two pathways the working mechanism determines to list a foreign entity on the UEL: i) by investigation, or ii) where the facts are clear, directly designate such entity.

Where the facts about the activities taken by the relevant foreign entity are clear, the working mechanism may, by taking into overall consideration the factors specified above, directly determine whether to designate the relevant foreign entity in the UEL. Therefore, **under certain circumstances where facts are clear, no open investigation process stated above will be held prior to the decision.**

2) The Decision Procedures

When the working mechanism determines to include a foreign entity in the UEL, an announcement shall be made. In the announcement in which the relevant foreign entity is included in the UEL, where the working mechanism, based on actual circumstances, decide to take one or several of the measures according to the Provision, the decision of the measures to be taken shall also be announced. According to the UEL Regulations, **it is possible that the working mechanism will not impose any sanctioning measures on a listed entity of the UEL.**

Also, an alert about the risks of conducting transactions with the said foreign entity may be made in the announcement. This confirms that not all transactions with entities listed in the UEL are prohibited, which for Chinese companies, the main risk comes from import and export transactions.

3) Possibility of Rectification

When a foreign entity is listed in the UEL by a working mechanism decision, and when based on actual circumstances, the time limit for the foreign entity to rectify its actions is specified, there is a possibility of rectification.

Before the specified rectification period elapses, the decided measures will not be implemented. Where the relevant foreign entity **fails to make rectifications within the specified time period**, the decided measures will be implemented.

4) Import/Export Exception Application

The working mechanism is authorized by the UEL Regulations to **grant approvals to the Chinese entities² that intends to engage in restricted or prohibited import/export activities on a transaction-by-transaction based review.**

Where, under special circumstances, it is necessary indeed for a Chinese enterprise, other organization, or individual to conduct transactions with the foreign entity that is restricted or prohibited from engaging in China-related import or export activities under the UEL Regulations, an application shall be submitted to the Office of the working mechanism, and the transactions with the foreign entity in question will be allowed upon approval.

5) Possibility of Removal

The working mechanism may, based on actual circumstances, decide to remove the foreign entity from the Unreliable Entity List. The decision to remove the foreign entity from the Unreliable Entity List shall be announced, and the measures taken according to the UEL Regulations shall be ceased as of the date of the announcement.

The UEL Regulations states the following methods for removal:

- i. The working mechanism may, **based on actual circumstances**, decide to remove the foreign entity from the Unreliable Entity List.

² A Chinese entity is defined as an enterprise, other organization, or individual of China.

- ii. Where the relevant foreign entity **rectifies its actions within the time period** specified in the announcement and takes measures to eliminate the consequences of its activities, the working mechanism shall make a decision to remove it from the Unreliable Entity List.
- iii. A foreign entity may **apply for its removal** from the Unreliable Entity List, the working mechanism shall decide whether to remove it based on actual circumstances.



Implications

1. UEL is a defensive legislation

Since the announcement of the UEL system from last year, and the promulgation of the UEL Regulations, there has been many doubts on the Chinese Government's intentions on direct investment and international trade.

During the press conference regarding the UEL Regulations held on Sept. 20th, head of Department of Treaty and Law of MOFCOM further emphasis the following unchanged positions of the Chinese Government:

- i. **The position of the Chinese Government in maintaining multilateralism will remain unchanged.** China's position of firmly supporting and defending multilateralism remains unchanged, which is clearly reiterated in Article 3 of the UEL Regulations. Meanwhile, the UEL Regulations are not specific to targeted countries or entities, and China will implement the UEL Regulations in a manner in line with international rules.
- ii. **The position of the Chinese Government in deepening reform and opening wider to the outside world will remain unchanged.** "Reform and opening up" is not only the China's basic national policy, but also the fundamental driving force to promote China's development. The Foreign Investment Law along with its Implementing Regulations and the Regulation on Optimizing the Business Environment came into effect on January 1 this year, which conveys a clear sign that China is determined to expand the opening-up policy. The level of openness will only be increased. In the next stage, the Chinese government will continue to work to expand the policies of "opening-up", "optimizing business environment" and share China's development opportunities with investors from all countries.
- iii. **The position of the Chinese Government in resolutely protecting the legitimate rights and interests of all market players will remain unchanged.** The UEL Regulations are intended for the very few foreign entities that disrupt the rules of the market and violate Chinese laws. There is no need for a trustworthy and law-abiding foreign entity to worry. In the meantime, the Chinese government has continued to improve and strengthen legal systems to protect various

market players. (Such as the enactment of the Civil Code, as well as the Trademark Law, the Copyright Law and the Patent Law amendments that are undergoing amendments.) In the next stage, the Chinese government will continue to strengthen the protection of the legitimate rights and interests of all types of market players.

Based on the above, we can conclude that the UEL Regulations is a defensive legislation and will be implemented and enforced with prudence and deliberateness.

2. Whether the UEL Regulations may function as a blocking statute remains unknown

During the press conference regarding the UEL Regulations, MOFCOM made a denying statement when asked whether the UEL Regulations are China's counter-reaction towards U.S. measures against Huawei, Wechat, TikTok and other Chinese enterprises. MOFCOM stated that the establishment of the UEL system and the promulgation of the UEL Regulations is an established work arrangement, which was first announced in May last year, that have recently reached completion. MOFCOM further confirms that the UEL Regulations are not specific to any specific country nor to particular entities.

However, it is worth noting that MOFCOM's first announcement in May, 2019 came shortly after the U.S. began to list Huawei-related entities into the Entity List; and the promulgation came a day after the U.S. Commerce Department's identifications of prohibited transactions related to Wechat, which came out according to the 45-day period timeframe set by the relevant Executive Order.

Regarding the U.S companies that is providing services to or otherwise dealing transactions with Wechat or Tiktok, it is possible that such companies will be held liable under the UEL Regulations for following U.S Department of Commerce regulations of president executive orders. Though this issue is not clearly defined or addressed under the current UEL Regulations language, theoretically the UEL Regulations may function as a blocking statute to some extent. In practice, whether the UEL Regulations may function as a blocking statute to confront the extraterritorial effect of laws and regulations under a foreign jurisdiction remains unknown.

3. Potential UEL Entities

MOFCOM confirms in the press conference regarding the UEL Regulations on September 20, 2020 that the UEL Regulations are not specific to targeted countries or entities. Which enterprises will be on the list depends on i) whether the enterprise itself violates Chinese law, ii) whether it endangers China's national sovereignty, security and development interests; iii) whether it violates the normal principles of market transactions, and iv) whether it has imposed blockade, suspension of supply or other discriminatory measures on Chinese enterprises, other organizations and individuals. Also, MOFCOM stated that **there is no timetable nor any preset list of enterprises of the UEL** and emphasized that the UEL will be "strictly limited to only few foreign entities that break market norms and violates the applicable laws and regulation".

According to a news coverage by CNBC, a Eurasia report states that actions from the Chinese side would likely focus on products with a domestic competitor and avoid disrupting imports of products that China's technology industry needs. Another factor, could be companies involved with U.S. arms sales to Taiwan. The consulting firm also listed a few U.S. companies that are plausible targets of the UEL system, including Cisco, Dell/EMC, HP, Lockheed Martin, Rockwell Collins. The report further touched companies such as Apple, Microsoft, Qualcomm, Intel, AMD, Boeing, etc.

On another note, when the establishment of the UEL system was first announced in May last year, according to a news coverage from Global Times, a source close to the Chinese government stated that U.S. companies such as Apple, Cisco, Qualcomm, and Boeing may become subject to relevant investigation. The source also pointed out these investigations may be launched according to the Cybersecurity Review Measures and the Anti-monopoly Law, which although not specifically stated, could still be among the legal basis of the implementation of the UEL system according to the UEL Regulations.

Takeaways

All foreign entities that engages in business with China, especially for those companies whose key clients or distributors are located in China, should implement internal precaution measures regarding the UEL system. Also, such foreign entities should conduct a self-evaluation of its past business operation customs and procedures to determine the possibility of violating the UEL Regulations and other Chinese laws, which may lead to being listed in the UEL, if such customs and procedures are upheld. If determined that a risk may arise, mitigating and correction measures shall be taken accordingly.

Regarding to general Chinese entities, when damage caused by a foreign entity arises from a violation of the UEL Regulations or other Chinese laws, such Chinese entity may report the clear facts of such violation to the working mechanism, or suggest an initiation of open investigation. All Chinese entities should also maintain and update a monitoring system of the UEL and relevant announcements from the working mechanism, in order to timely adjust, suspend or cease business activities with listed foreign entities to avoid risks of administrative penalties. Moreover, Chinese entities should make sure that their foreign business partners follow the rules of the UEL Regulations and other Chinese laws, in order to secure the stability of their business relationship. If a foreign business partner is in the procedure of UEL investigation, relevant Chinese entities should cooperate with the regulating authority's investigation.

Regarding to Chinese entities that engages in import/export business with foreign entities, when such Chinese entities hopes to maintain prohibited or restricted import/export activities with a listed foreign entity, the Chinese entity must apply for the working mechanism's import/export license before the transaction.

In addition, since the 2nd Draft of Export Control Law of PRC will be reviewed for the third time, its formal promulgation can be expected soon. Both Chinese companies and foreign companies that engages in import and export businesses with China should pay attention to the legislative process of the Export Control Law and prevent potential risks and improve their compliance systems in advance.