China and Hong Kong Developments: Sanctions, Export Controls, and Supply Chain Risks

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Over the last month, the United States has taken a variety of steps to increase pressure on China in response to the imposition of China's National Security Law in Hong Kong and alleged human rights abuses in Xinjiang. These measures include new sanctions programs targeting Hong Kong, export and trade control restrictions, and sanctions targeting actors in the Xinjiang region. The U.S. government also issued a lengthy Advisory warning U.S. and global companies of supply chain risks related to forced labor and other human rights issues in Xinjiang.

In this post, we highlight some key risks that companies should consider when doing business in the region against the backdrop of rising U.S.-China tensions.

1. *Hong Kong*

On July 14 , 2020, the President signed the Hong Kong Autonomy Act of 2020 (HKAA) into law and issued Executive Order 13936 in response to the imposition of China's National Security Law in Hong Kong. The new U.S. rules authorize sanctions on parties in Hong Kong and China and eliminate the differential treatment between China and Hong Kong under U.S. export control and international trade rules. Companies with significant operations or investments in Hong Kong need to carefully monitor this evolving situation and assess their exposure to government officials and financial institutions that may be named as sanctions targets under the HKAA or become subject to sanctions under E.O. 13936. As we've previously noted, exporters also need to ensure that exports to Hong Kong comply with the new export control restrictions.

a. *The HKAA: Reports, Blocking Sanctions, and Foreign Financial Institution Secondary Sanctions*

The HKAA requires the Administration to issue two reports to Congress, which must be followed by sanctions on identified parties.

The first report must identify foreign persons who have materially contributed to the "failure of the Government of China to meet its obligations under the Joint Declaration or the Basic Law" within 90 days.* Once identified in the first report, the President may impose sanctions on the listed parties. Within a year, however, the President must impose sanctions on the listed parties, which may include blocking sanctions and visa restrictions. Blocking sanctions essentially prohibit a sanctioned party from conducting business dealings or financial transactions that involve the United States, cutting the sanctioned party off from the United States and much of the global financial system.

The first HKAA report must be followed up within 60 days with a second report identifying foreign financial institutions that knowingly conduct a "significant transaction" with a person identified in the first report. The HKAA then requires the president to impose at least five “secondary sanctions” on the offending financial institution within a year of the report and impose the full menu of ten secondary sanctions within two years of the report.**

Sanctions under the HKAA can be waived if the actions of the listed parties or foreign financial institutions did not have a significant and lasting effect on Hong Kong, the actions are not likely to be repeated in the future, and the party or foreign financial institution has reversed or otherwise mitigated its sanctionable conduct.

b. *E.O. 13936 Blocking Sanctions*

In addition to the sanctions authorized by the HKAA, Section 4 of E.O. 13936 authorizes the imposition of blocking sanctions against parties that engage in a variety of practices that undermine democratic processes or institutions of Hong Kong. While the E.O. appears primarily aimed at government officials and entities, it could also be used to target companies and other private sector actors engaged in the activities described in Section 4. Unlike the HKAA, the E.O. does not require the issuance of a report prior to the imposition of sanctions, so sanctions under the E.O. may be issued without warning.

c. *Export Controls & Trade “Normalization” with Hong Kong*

In addition to new sanctions, E.O. 13936 requires U.S. government agencies to take a variety of steps to “normalize” trade with Hong Kong and eliminate any differential treatment between Hong Kong and mainland China. From an export control perspective, "normalization" generally means treating exports and other transfers to Hong Kong as if they were being shipped directly to mainland China. Among other measures, the E.O. requires U.S. government agencies to: 1) amend any regulations which provide preferential treatment to Hong Kong as compared to China; 2) revoke license exceptions for exports, reexports and transfers (in-country) to Hong Kong of items subject to the Export Administration Regulations (EAR) that don’t also apply to China (BIS had already suspended these exceptions); and 3) terminate export licensing suspensions for defense articles transferred to Hong Kong persons physically located outside of Hong Kong and China and who were authorized to receive defense articles prior to the date of the E.O. The E.O. also mandates changes to a variety of other trade control rules, including origin marking, and may have implications for duties on goods imported from Hong Kong.

Companies that export or import goods to or from Hong Kong need to review these changes and ensure their trade compliance programs account for the updated rules. Companies relying on license exceptions in the past must ensure they have processes in place to obtain individual licenses from U.S. authorities before exporting, re-exporting, or transferring items subject to U.S. export control laws to Hong Kong.

2. *Xinjiang Sanctions & Supply Chain Risks*

In addition to the new Hong Kong measures, the United States has also expanded sanctions on China in response to what the U.S. government calls “serious human rights abuse against ethnic minorities in Xinjiang” including “mass arbitrary detention and severe physical abuse, among other serious abuses targeting Uyghurs” in western China. The U.S. government also issued comprehensive guidance warning companies of supply chain risks related to human rights abuses in the region.

Taken together, these measures amount to significant new trade compliance risks for companies that operate in or deal with companies in Xinjiang. To address these risks, companies should adopt robust due diligence procedures to screen for the involvement of sanctioned parties or supply chain risks that could result in financial or reputational damage to the company.

a. *Blocking Sanctions*

Only July 9 and July 31, the Office of Foreign Assets Control (OFAC), the U.S. agency with primary responsibility for U.S. sanctions, announced new sanctions on current and former Chinese government officials for their role in human rights abuses Xinjiang and on the Xinjiang Production and Construction Corps (XPCC, also known as the "Bingtuan"), which OFAC identified as a paramilitary organization that is responsible for implementing Beijing's repressive policies in the region. OFAC added these parties to the List of Specially Designated Nationals (the SDN List) pursuant to E.O. 13818 and the Global Magnitsky Human Rights Act, which authorizes the imposition of sanctions against parties responsible for human rights abuses and corruption around the world. As regular readers of this blog know, persons subject to U.S. jurisdiction are broadly prohibited from conducting transactions or business with parties on the SDN List or with entities owned 50 percent or more by SDNs under OFAC's "50 percent rule." Pursuant to an OFAC general license, however, U.S. persons may engage in limited activities necessary to wind down transactions with or divest from entities that are owned 50 percent or more by the XPCC, subject to certain restrictions and reporting requirements, before September 30, 2020.

Even with the general license, the designation of the XPCC could have far-reaching effects for U.S. and global companies that do business in or related to Xinjiang. According to media reports, the XPCC has broad reach in Xinjiang and elsewhere, employing a significant percentage of the population and controlling up to 20 percent of the economy of the region. Companies doing business in the region must adopt rigorous due diligence procedures to identify business partners that may be ultimately owned by the XPCC to prevent violations of the new U.S. sanctions.

b. *Entity List Restrictions*

In addition to the OFAC designations, the Bureau of Industry and Security (BIS), the U.S. dual-use export control regulator, added 11 companies to its Entity List on July 20 due to the parties' alleged involvement in human rights abuses in Xinjiang. U.S. and non-U.S. persons are prohibited from transferring any items "subject to the EAR" to the designated parties. The restrictions broadly apply to any person dealing in goods, software, and technology (collectively, "items") in the United States, U.S.-origin items, certain items manufactured outside the United States that contain sufficient U.S.-origin content, and certain items manufactured using U.S. technology. The July 20 Entity List designations follow similar actions by BIS in June 2020 and October 2019.

As with the designation of the XPCC, the only way to comply with the new Entity List restrictions is to screen transactions for the involvement of sanctioned parties.

c. *Supply Chain Risks*

On July 1, the U.S. Departments of Commerce, State, Treasury, and Homeland Security issued the "Xinjiang Supply Chain Business Advisory" to highlight supply chain risks related to Xinjiang and suppliers outside of Xinjiang that may engage in human rights abuses, such as the use of forced labor. The Advisory identifies three primary supply chain risks related to Xinjiang:

- The provision of surveillance goods, services, or technology (e.g., cameras, tracking technology, biometric devices, among others) that may be deployed in Xinjiang;
- Relying on labor or goods sourced in Xinjiang or from factories in China that may utilize forced

labor from Xinjiang; and

- Assisting with the construction of internment facilities used to detain Muslim minority groups, and/or manufacturing facilities that are located nearby these internment camps.

The Advisory cautions that third-party audits alone may not be a reliable source of information on whether human rights abuses exist, and that businesses should consider collaborating with industry groups to share information on risks in the region. The Advisory also encourages companies, to the extent they have a reason to know, to perform reasonable due diligence before supplying companies with goods and services to ensure they are not potentially supporting Chinese customers that may be involved in human rights abuses in Xinjiang.

The Advisory also identifies the following industries as having a heightened risk of involving forced labor sourced from Xinjiang: Agriculture; Cell Phones; Cleaning Supplies; Construction; Cotton Yarn, Cotton Fabric, Ginning, Spinning Mills, and Cotton Products; Electronics Assembly; Extractives (including coal, copper, hydrocarbons, oil, uranium, and zinc); Fake Hair and Human Hair Wigs, Hair Accessories; Food Processing Factories; Hospitality Services; Noodles; Printing Products; Footwear; Stevia; Sugar; Textiles (including such products as apparel, bedding, carpets, wool); and Toys.

Companies involved in these sectors in China, or that may otherwise have supply chain exposure to Xinjiang, should review the Advisory in detail and consider their exposure to Xinjiang-related risks with respect to existing relationships and future transactions.

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Please contact our sanctions and export control team with any questions related to these or other trade control risks in China and Hong Kong.

* In the past, the U.S. government has issued similar sanctions reports well after the statutorily imposed deadline.

** Secondary sanctions on foreign financial institutions (FFIs) authorized under the HKAA include prohibitions on: loans from U.S. financial institutions; designation as a primary dealer in U.S. government debt instruments; as service as a repository of government funds; foreign exchange transactions subject to U.S. jurisdiction involving the FFI; transfers of credit or payments between financial institutions or by, through, or to any financial institution where such transfers/payments are subject to U.S. jurisdiction and involve the FFI; conducting transactions involving property interests of the FFI; exports, reexports, and transfers (in-country) of commodities, software, and technology involving the FFI; and investments by U.S. persons in significant amounts of equity or debt of the FFI. The penalties also include the exclusion from the United States of corporate officers and sanctions on principal executives.