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CLIENT ALERT

Creation of a New Hong Kong-Related Sanctions Program

Jul.17.2020

On July 14th, President Trump signed into law the Hong Kong Autonomy Act (the "Act") that Congress unanimously passed earlier this month, and simultaneously issued Executive Order 13936 (the "HK EO") that implements many of its provisions. These actions follow the June 30th imposition by the government of the People's Republic of China ("China") of a far-reaching national security law on Hong Kong ("National Security Law"). Taken together, the Act and the HK EO create a new Hong Kong / China-related sanctions program that targets non-U.S. persons making "material contributions" to the failure of the Government of China to uphold its obligations under the Joint Declaration and Basic Law, the law that codified China and Hong Kong's 'one country, two systems' paradigm (the "Basic Law"). They also, along with the recent Uighur Human Rights Policy Act and designations against Chinese companies under existing authorities, such as the Magnitsky Human Rights Accountability Act, can be understood as part of the emergence of a broader sanctions policy targeting China.

While the Act and the HK EO contain a number of elements that are not sanctions-related, the following are the key sanctions aspects.

The Hong Kong Autonomy Act (the "Act")

The Act creates a structure for the potential future imposition of sanctions, requiring the Department of State ("State") to issue a report (the "State Report") within 90 days after its enactment and annually thereafter. The initial State Report must be published by October 12, 2020, 90 days after the Act was signed into law on July 14, 2020. The structure for the Report and the sanctions it requires are below:

- Persons Identified in the State and Treasury Reports: State must identify in the State Report any non-U.S. persons that have "materially contributed" to the failure of the Government of China to uphold its obligations under the Basic Law. Between 30 to 60 days after the State Report, the Treasury Department ("Treasury") is required to issue a separate report (the "Treasury Report") that identifies any foreign financial institution ("FFI") that "knowingly conducts a significant transaction with the foreign persons."
    - *The Act defines an FFI by cross-referencing a much broader definition of "financial institution" in the U.S. code, and not the definition of "foreign financial institution" used by the U.S. Financial Crimes Enforcement Network ("FinCEN"), which is cross-referenced in other U.S. sanctions legislation, such as the Countering America's Adversaries Through Sanctions Act ("CAATSA"). This means that a number of non-U.S. entities, including, in particular, insurance companies, that are not considered FFIs in most aspects of U.S. sanctions, would be subject to this provision.*
- Sanctions on Non-U.S. Persons: Under the Act, once the State Report is issued, the President "may," impose blocking sanctions on those non-U.S. persons named in that initial report or any subsequent report. However, if a non-U.S. person is named in any two State Reports then the President "shall" impose blocking sanctions on that non-U.S. person.
- Sanctions on FFIs:The Act structures sanctions against FFIs differently**.**

- Sanctions After One Year: Following the expiration of one year after an FFI has been included in a Treasury Report, State is required to impose five or more sanctions from the following "menu" of sanctions, unless the FFI has been removed from the Treasury Report: (1) prohibitions on loans from U.S. financial institutions; (2) prohibition on designation as a primary dealer of United States Government debt instruments; (3) prohibition from serving as an agent of the United States Government or from serving as a repository for United States Government funds; (4) prohibition on foreign exchange transactions subject to U.S. jurisdiction in which the FFI has an interest; (5) prohibition on U.S. correspondent banking services to the FFI; (6) imposition of blocking / asset freezing on any property or interest in property within U.S. jurisdiction of the FFI; (7) restrictions or prohibitions on exports to the FFI; (8) ban on United States persons "investing or purchasing significant amounts in equity or debt instruments of the foreign financial institution"; (9) denial of Unites States entry to corporate officers of the FFI; and (10) imposition of sanctions options (1)–(8) on principal executive officer(s) of the FFIs or persons with similar functions or authorities.
- Sanctions After Two Years: If an FFI remains on the Treasury Report for two years, the President is statutorily required to impose all10 of these sanctions against the FFI.

The President can remove entities from either the State Report or Treasury Report, if he determines that the entity's actions (1) "do not have a significant and lasting negative effect that contravenes" China's obligations under the Basic Law; (2) "are not likely to be repeated in the future"; and (3) "have been reversed or otherwise mitigated through positive countermeasures taken" by the FFI or foreign person.

The President's Executive Order on Hong Kong Normalization ("HK EO")

The President simultaneously issued the HK EO, which includes provisions beyond those required by the Act. The HK EO includes a number of elements that require "normalizing" the U.S. treatment of Hong Kong to be consistent with how the U.S. Government treats the rest of China on everything from passports to export controls, which we do not summarize here; we did recently summarize export control related developments with respect to Hong Kong in a separate alert.

The HK EO also creates a new sanctions program, which provides additional designation criteria beyond those enumerated in the Act. Specifically, the as-yet unnamed sanctions program grants either the Secretary of State or the Secretary of the Treasury (in consultation with the other) to designate for blocking sanctions any non-U.S. person they determine to:

i. be or have been involved, directly or indirectly, in the coercing, arresting, detaining, or imprisoning of individuals under the authority of, or to be or have been responsible for or involved in developing, adopting, or implementing, the Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Administrative Region (also referred to herein as the "National Security Law");
ii. be responsible for or complicit in, or to have engaged in, directly or indirectly, any of the following:
    a. actions or policies that undermine democratic processes or institutions in Hong Kong;
    b. actions or policies that threaten the peace, security, stability, or autonomy of Hong Kong;
    c. censorship or other activities with respect to Hong Kong that prohibit, limit, or penalize the exercise of freedom of expression or assembly by citizens of Hong Kong, or that limit access to free and independent print, online or broadcast media; or

d. the extrajudicial rendition, arbitrary detention, or torture of any person in Hong Kong or other gross violations of internationally recognized human rights or serious human rights abuse in Hong Kong;

iii. be or have been a leader or official of:
   a. an entity, including any government entity, that has engaged in, or whose members have engaged in, any of the activities described in subsections (a)(i), (a)(ii)(A), (a)(ii)(B), or (a)(ii)(C) of this section; or
   b. an entity whose property and interests in property are blocked pursuant to this order;

iv. have materially assisted, sponsored, or provided financial, material, or technological support for, or goods or services to or in support of, any person whose property and interests in property are blocked pursuant to this section;

v. be owned or controlled by, or to have acted or purported to act for or on behalf of, directly or indirectly, any person whose property and interests in property are blocked pursuant to this section; or

vi. be a member of the board of directors or a senior executive officer of any person whose property and interests in property are blocked pursuant to this section.

Practical Considerations

The simultaneous passage into law of the Act and the implementation of the new HK EO raise a number of compliance issues for companies, including:

- Identifying Direct Exposure to Sanctionable Conduct: The Act was designed to provide a built-in implementation period for companies to evaluate their exposure to potential sanctions risk by tying sanctions to a report that was only going to be issued 90 days after its enactment (October 12, 2020). The HK EO changes that dynamic by providing an immediate sanctions authority that could be exercised today. In the first instance, companies with operations in Hong Kong and China will need to immediately evaluate their operations to determine if they are undertaking any activity that could meet the designation criteria in the HK EO.
- Indirect Exposure: The primary risk for most persons that are not actively engaged in activity that may be considered to meet the designation prongs is indirect; specifically, the risk that a company's customers or other counterparties may become designated, creating legal and commercial exposure for the company. For companies that are subject to U.S. jurisdiction and operating in Hong Kong or China, this risk is immediate because they would be required to immediately terminate relationships with any non-U.S. person designated as subject to asset freezing measures, regardless of any contractual commitments they might have to such entities. Entities operating outside of U.S. jurisdiction will have a risk calculation to make regarding whether they want to continue to transact with U.S.-sanctioned parties and run the risks of (a) being designated themselves (for "material support") and (b) counterparty pressure from banks and insurers unwilling to transact with persons transacting with U.S.-sanctioned parties.
- Potential FFI Exposure: One specific variation of the above theme is the exposure to FFIs. The Act is designed to force the Administration to publicly identify FFIs that undertake a "significant" transaction for a designated person and to incentivize the FFI to change its behavior by only mandating sanctions 12 months later if it remains on the list. The net effect is that there may be a number of FFIs identified in the Treasury Report that will be issued between November 11 and December 10 (assuming the State Report is issued on time). Companies will then be forced to assess their risk appetite in interacting with those FFIs, knowing that they might be sanctioned within a year, and which may include some of the largest Chinese banks, insurers, or other financial institutions.

- Conflict of Law Challenges: Finally, if the United States were to utilize the new designation authority, it could create conflict of law challenges for any persons operating in Hong Kong or China that are also subject to U.S. jurisdiction. Specifically, companies subject to the oversight of both U.S. and Chinese regulators will be forced to try and balance U.S. prohibitions on transacting with sanctioned persons with ambiguous requirements under China's National Security Law.

We will continue to monitor this rapidly evolving scenario and provide guidance regarding the scope of the U.S. implementation of the Act and the HK EO.

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