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Chinese Government Introduces Rules Restricting Application of Foreign Laws

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Last month the Ministry of Commerce of China ("MOFCOM") promulgated the *Rules for Blocking Unjustified Extraterritorial Application of Foreign Laws and Measures* (the "Rules").

The Rules function similarly to other blocking regulations. They give MOFCOM the authority to prohibit Chinese citizens and entities from complying with any "unjustified foreign measures." Such measures refer to any overseas legislation or regulations that MOFCOM considers to "unjustifiably prohibit or restrict Chinese citizens, legal persons or other organizations from engaging in normal economic, trade and related activities with a third State (or region) or its citizens, legal persons or other organizations."[1] The Rules therefore prohibit Chinese nationals and companies from complying with non-Chinese sanctions regulations and similar restrictions, if Chinese authorities so require.[2] Like similar blocking regulations, the Rules may lead to complicated conflicts of laws scenarios, particularly if Chinese authorities decide to enforce the Rules aggressively.

Background

The implementation of the Rules did not occur in a vacuum and follow a series of measures adopted by Chinese authorities in establishing MOFCOM's own sanctions regime. For example, in September 2020, MOFCOM adopted the "Unreliable Entity List" provisions, intended to function as China's sanctions list; however, no companies have been added to the list to date. In December 2020, MOFCOM and the National Development and Reform Commission ("NDRC") also issued *The Measures for the Security Review of Foreign Investments* in an effort to formalize the framework of China's national security review of foreign investments.[3] The Rules present an additional tool that Chinese authorities may invoke from a growing number of sanctions and trade control measures.

Summary of the Rules

Reporting, evaluation and subsequent prohibitions are the key elements to the Rules. The Rules also task the State Council—namely, MOFCOM and China's National Development and Reform Commission—to develop detailed working mechanisms to support the goals set out in the Rules.[4] Therefore, it remains to be seen how the Rules will be implemented in practice.

Reporting Obligations – Burden on Private Chinese Citizens and Entities

Article 5 of the Rules requires Chinese citizens and entities that encounter foreign measures that prohibit or restrict their normal economic and trade activities to make a report to the State Council within 30 days. The reporter can request confidentiality when making the reports; failure to report can result in a fine. However, additional detail on reporting logistics and fine calculations are not yet available. It is also unclear when the 30 days begin to run with respect to reporting obligations, how reporting should be made, and to which authority. Further, while the Rules place the burden on private citizens and corporations to determine whether a foreign measure should be reported, there is no clear guidance to date as to what it means to "encounter" a "foreign measure."

Evaluation – Four Factors

Once the authorities receive a report, they will determine whether there is any "unjustified foreign measure" based on four factors set out under Article 6 of the Rules, which are (1) whether international law or the basic principles of international relations are violated; (2) potential impact on China's national sovereignty, security and development interests; (3) potential impact on the legitimate rights and interests of the citizens, legal persons or other organizations of China; and (4) other factors.

Consequences – Prohibition Orders

If the relevant authorities determine that there are "unjustified foreign measures," MOFCOM will issue a prohibition order that blocks the application of the relevant foreign regulations under Article 7 of the Rules. Under the prohibition order, the Chinese citizen or entity will be required to disobey such "unjustified foreign measures."

Failure to comply can result in a warning or fine, although Chinese citizens or entities may apply for an exemption from MOFCOM under Article 8 of the Rules. However, the Rules do not state the criteria for receiving an exemption.

The Rules also provide a cause of action for Chinese citizens and entities to sue those who comply with unjustified foreign measures without an exemption. The Rules further provide the potential of restitution for complying with a prohibition order. Article 11 of the Rules states that the government may provide "necessary support" to a Chinese citizen or entity who suffers great loss as a result of complying with the prohibition order. However, the Rules do not specify the threshold of harm to trigger such support, nor the types and amount of support available.

Impact on Multinational Companies (MNCs)

Should the Chinese authorities decide to interpret the Rules broadly, the Rules could create significant challenges for MNCs conducting business in China, particularly for those who have a U.S. nexus given the breadth and enforcement under the U.S. sanctions regime.

MNCs may be required to comply with the U.S. sanction regime for a variety of reasons. Their Chinese-organized subsidiaries may choose to do the same, either required by law, or out of a concern of secondary sanctions,[5] or simply due to the broader policies that the MNC imposes. At the same time, these subsidiaries are also considered Chinese entities under the Rules. If the Chinese government decided to declare the existing U.S. sanctions regime to be "unjustified foreign measures," the Rules would place the MNCs in a direct conflict-of-laws situation; on the one hand, if the MNC cannot obtain an exemption in China but continues to comply with the U.S. sanctions, then it faces penalties in China, as well as potential civil lawsuits against it by its Chinese business partners. On the other hand, if the MNC chooses to comply with the Rules, it risks violating U.S. sanction rules and facing penalties from the U.S. regulators.

Furthermore, U.S. sanctions have broad extraterritorial reach, in part because U.S. and non-U.S. financial institutions tend to take a conservative approach regarding the application of U.S. sanctions due to the significant role that the U.S. banking system plays globally. As a result, not only are Chinese parties targeted by U.S. sanctions cut off from the U.S. marketplace, they may also find it quite difficult to find even non-U.S. financial institutions that will process payments on their behalf. Theoretically, the new Rules could ban such refusals to process payments by Chinese persons or entities, again placing multinational financial institutions in a delicate conflict-of-laws scenario.

Additionally, as OFAC has expanded its extraterritorial reach, many of its sanctions are discretionary. For example, OFAC has the authority to impose secondary sanctions against non-U.S. persons that engage in disfavored conduct, including with respect to a number of sanctioned jurisdictions and a number of disfavored activities. It remains to be seen how the conflicts-of- law issues would play out regarding parties that seek to minimize risk of secondary sanctions or enforcement by other OFAC authorities with extraterritorial reach.

Finally, traditional U.S. sanctions are only one of a number of tools that the U.S. government is using to exert pressure on China. Other tools include export control regulations, the CFIUS process, new sanctions that affect the ability to purchase securities of Chinese companies, and government contracting restrictions, among others. It would be interesting to see if the Rules are expanded to retaliate against a broader range of U.S. policy initiatives.

The E.U. Experience

The E.U. blocking regulations, originally enacted in 1998 and updated in 2018 in response to the U.S.'s departure from the JCPOA,[6] specifically prohibit compliance with certain U.S. sanctions regulations listed in its annex, with the primary focus on U.S. sanctions related to Cuba and Iran. As such, unlike the Rules at present, the E.U. blocking regulations provide a clear scope of "blocked" U.S. regulations. The E.U. blocking regulations have been retained under U.K. law following the end of the Brexit transition period.

The E.U. blocking regulations, like the Rules, will not recognize court judgments that enforce penalties issued by the U.S. authorities for violations of the listed U.S. sanctions. However, restitution lays with the courts, as E.U. or U.K. business and individuals may recover damages arising from the application of the listed U.S. sanctions in the relevant courts of those jurisdictions.

Despite these differences, the E.U. blocking regulations illustrate the issues that could arise from such conflict in laws. One obvious example is the impact E.U. blocking regulations have on the negotiation of contractual agreements, particularly where the agreement involves a U.S. person or entity. The European party, particularly those in jurisdictions that have promulgated the E.U. blocking regulations into local law, may argue that a blanket compliance with "all applicable sanctions" cannot include U.S. sanctions targeted by the E.U. blocking regulations. The U.S. party, however, may have legitimate concerns about leaving out such sanctions protections considering the significant enforcement risk presented by U.S. authorities balanced against the lack of enforcement by E.U. and U.K authorities. Furthermore, there could be other reasons why an individual or entity might not want to conduct business in Iran and Cuba outside of U.S. sanctions considerations given the other risks those jurisdictions present, such as corruption and risk of other illicit activities.

Moreover, we have seen some cases of E.U. and U.K. private parties—particularly, Iranian businesses and individuals operating or living in the E.U. or the U.K.—using the blocking regulations to bring private court actions against E.U. and U.K. defendants, if they believe those defendants caused them to incur losses by taking actions that were motivated by compliance with the prohibited U.S. sanctions.

Practical Recommendations

We recommend that companies monitor for additional guidance on the Rules, as well as potential enforcement activity. It is important to view the Rules in the context that trade sanctions are becoming an increasingly common tool in foreign policy. That said, despite adding this new set of countersanction measures to its legal arsenal, the Chinese government may decide to take a wait-and-see approach in light of the new Biden administration.

As with any conflict-of-laws issue, the ultimate question for companies and individuals is to decide *which* laws to comply with, after balancing the risks exposure posed by each set of laws. When conflicting obligations arise from different jurisdictions, it is imperative to carefully consider cross-jurisdiction risks and the corresponding legal impact as a whole. This is not a straightforward process, and will be dependent on each organization's risk appetite. As such, it is advisable to work with legal counsel from applicable jurisdictions to identify, understand, and evaluate legal risk exposure, at the same time considering potential financial, commercial and reputational repercussions.

One thing is clear—China is gradually building up its legal framework to counter what it perceives to be the "unjustified" long arm presence of the U.S., leading to an extra layer of complexity when considering compliance across borders.

1. Rules for Blocking Unjustified Extraterritorial Application of Foreign Laws and Measures (promulgated on January 9, 2021 and went into effect on the same day), Article 2.
2. In 2018, China already enacted the International Criminal Judicial Assistance law, which also functions as a blocking statute requiring approval by Chinese authorities before any institution, organization or individual within Chinese territories can provide evidence, materials or assistance to foreign countries' criminal proceedings. For more information, please see https://www.law360.com/articles/1130786.
3. For detailed information on China's National Security Review measures, see our previous client alert at https://www.ropesgray.com/en/newsroom/alerts/2021/January/Comparing-Chinas-New-Measures-on-National-Security-Review-of-Foreign-Investments-with-the.
4. Rules, Article 4.
5. In the last five years, the Office of Foreign Assets Control of the U.S. Treasury Department (OFAC) has expanded its extraterritorial reach and has been implementing a new type of supplementary sanctions, known as secondary sanctions. The secondary sanctions target third-country actors doing business with targeted regimes, persons, and organizations. Many of the secondary sanctions can be discretionary since OFAC has the authority to impose sanctions against non-U.S. persons that engage in disfavored conduct.
6. The Joint Comprehensive Plan of Action ("JCPOA") is an agreement amongst Iran, the five permanent members of the United Nations Security Council, and the European Union regarding Iran's nuclear program on July 15, 2015.