INTERNATIONAL LAW ADVISORY

HKSE Listing Applicants: What You Should Know about Sanctions and Export Controls Due Diligence

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Overview
Despite the global pandemic, Hong Kong's capital markets continue to see a rush of activity. The pandemic has not diminished the Hong Kong Stock Exchange (HKSE) as an attractive listing venue for mainland Chinese companies looking to benefit from international investors.

Meanwhile, the United States continues to use economic sanctions and export controls to target certain mainland Chinese companies, including several companies with shares listed on major exchanges. With a broad scope and jurisdictional reach, these restrictions can negatively impact a company's operations and even prohibit certain types of investment by US persons. Investors globally are increasingly factoring sanctions and export controls risks into their decision making.

The HKSE, like other exchanges, publishes guidance for listing applicants and issuers for assessing potential sanctions and export controls risks that may require market disclosure as part of an Initial Public Offering (IPO). This alert outlines some of the considerations issuers may need to consider as part of their pre-IPO due diligence process in Hong Kong or elsewhere.[1]

The HKSE Guidance Letter
The HKSE's March 2019 Guidance Letter on Sanctions Risks (GL101-19) (the Guidance Letter) identifies some of the factors the HKSE may consider when assessing the suitability of a listing applicant. Specifically, the Guidance Letter sets expectations for listing applicants that engage in, or have previously engaged in, activities involving countries, persons, or entities subject to economic sanctions imposed by jurisdictions relevant to the listing applicant (Relevant Jurisdictions). For this purpose, a Relevant Jurisdiction could include the United States or any other jurisdiction "that is relevant to the listing application." In separate guidance, the HKSE states that the principles in the Guidance Letter may also apply to a listed issuer's suitability for continued listing and secondary equity fundraisings.

Reasoned Legal Analysis
For issuers in any jurisdiction, the HKSE Guidance Letter provides instructive guidance for analyzing and addressing potential sanctions and export controls risks. For instance, the Guidance Letter requires listing applicants to determine if they have engaged in "Primary Sanctioned Activities" or "Secondary Sanctionable Activities." If so, a listing applicant should obtain a "reasoned analysis from its legal adviser," usually in the form of a legal memorandum or opinion, on the sanctions risks posed to the listing applicant, its investors, shareholders, and persons who might be involved in the listing, trading, clearing, or settlement of its shares (together, Relevant Persons).[2]
In our experience, this reasoned analysis provides listing applicants an opportunity to satisfy the requirements of the Guidance Letter while also receiving advice on compliance measures to minimize legal, operational, and reputational risks. For some issuers, the IPO process is the first time that sanctions and export controls are brought to light, offering an ideal moment for remediation.

Whether written according to the standards of the HKSE Guidance Letter or another jurisdiction, a typical analysis may consider multiple topics including: (i) the applicable sanctions and export controls laws in Relevant Jurisdictions; (ii) whether any of the listing applicant’s activities are subject to or may have violated such laws; and (iii) whether those activities could result in a material risk to the issuer or another party. Examples of risks include administrative or criminal penalties, adverse media, or even the imposition of secondary sanctions.

What is a Relevant Jurisdiction?

Under the HKSE Guidance Letter, the term “Relevant Jurisdiction” is broadly understood to encompass any jurisdiction that promulgates sanctions laws applicable to the applicant. As a rule of thumb, this may include any jurisdiction where the listing applicant is based, has operations, or conducts business.

It makes sense to consider the potential application of United Nations (UN) sanctions first because all UN member states are obliged to implement UN Security Council sanctions. Therefore, a review of the listing applicant’s exposure to UN sanctions would likely account for the sanctions regimes of many countries.

However, other jurisdictions impose autonomous sanctions in addition to UN sanctions. These include the United States, the European Union (EU), the United Kingdom, Australia, and now the People’s Republic of China (PRC). Of these, the United States aggressively enforces its sanctions and export controls laws against foreign companies based on an increasingly expansive view of US jurisdiction and novel enforcement theories. The United States is a Relevant Jurisdiction for most multinational companies, particularly ones that rely on US-origin goods or the US financial system for their day-to-day business.

Accordingly, for companies with multinational operations, sanctions and export controls due diligence could touch on multiple jurisdictions. A typical company may need to assess its risks in relation to the United States, the United Nations, and its country of incorporation and headquarters. For some companies, the laws of the EU, Australia, or other jurisdictions may apply. This is true of due diligence for most corporate transactions, including mergers and acquisitions.

What are Sanctioned Countries and Sanctioned Targets?

The HKSE Guidance Letter distinguishes between a “Primary Sanctioned Activity” and a “Secondary Sanctionable Activity,” each requiring its own approach.

The Guidance Letter’s definitions of Primary Sanctioned Activity and Secondary Sanctionable Activity generally accord with the notions of “primary sanctions” and “secondary sanctions” as used by the US Treasury Department’s Office of Foreign Assets Control (OFAC). In broad terms, Primary Sanctioned Activities are activities or transactions that directly or indirectly involve “Sanctioned Countries” or “Sanctioned Targets” that could result in a violation of the laws of a Relevant Jurisdiction. For example, a transaction by a non-US company involving Iran that also involves the US financial system could constitute a Primary Sanctioned Activity for this purpose.

Secondary Sanctionable Activities are those which potentially attract secondary sanctions, regardless of whether the activity has a nexus to the Relevant Jurisdiction. For example, the United States may threaten to add a non-US company to OFAC’s List of Specially Designated National and Blocked Persons (the SDN List) to deter the company from engaging in certain activity outside the United States.

Before determining whether a listing applicant has engaged in either type of sanctioned activity, the company must undertake a reasonable amount of due diligence of its current and historical business, ideally for a period of five years preceding the proposed issuance, to identify and review any direct or indirect transactions with Sanctioned Countries or Sanctioned Targets.

For most companies, the straightforward approach is to segment their business activities by country to identify those that may be subject to either comprehensive or targeted sanctions. From the US perspective, there are five territories currently subject to comprehensive sanctions: Crimea, Cuba, Iran, North Korea, and Syria. These five territories are the “low hanging fruit” for due diligence. Other territories such as Russia and Venezuela are not subject to comprehensive sanctions, but present elevated sanctions risk due to US sanctions against the governments of these two countries and state-owned entities and numerous sanctioned individuals and corporations. Business with these territories require a closer look to understand how US sanctions restrictions may or may not apply. Similarly, many UN and EU sanctions seek to address threats from within specified states, although they are not comprehensive in nature. Given the complexity of these rules, and their tendency to change frequently, companies are strongly advised to seek expert assistance in devising a due diligence strategy that accounts for variations between jurisdictions.
Sanctioned Targets primarily include designated persons (e.g., persons on the SDN List). However, they may also include persons that are not on any official list but are owned or controlled by designated persons. In addition to searching corporate records for designated counterparties, a listing applicant may need to perform a risk-based review to identify counterparties that are potentially owned or controlled by designated persons. This type of due diligence can be time consuming and is best prioritized rather than put off until late in the process.

Issuers and investors are increasingly focused on Secondary Sanctionable Activities, due to the US government’s use of secondary sanctions to discourage certain types of activities outside the United States. Mainland Chinese and Hong Kong companies and individuals have been designated under US secondary sanctions authorities on several occasions, and prospective issuers should consider whether their activities fall within the scope of such authorities, ideally with the assistance of advisors who can provide insights into the relevant government policies.

Risk Mitigation

Regardless of the type of transaction contemplated, due diligence may uncover compliance gaps or identify areas for improvement. In this regard, the HKSE Guidance Letter encourages listing applicants to adopt appropriate measures to address material sanctions risks such as implementing internal controls to monitor for sanctions risk.

OFAC’s Framework for OFAC Compliance Commitments guidance document offers a rubric for building an effective sanctions compliance program, based on lessons learned from past enforcement cases. According to OFAC, the five elements of an effective program are: (i) management commitment, (ii) risk assessment, (iii) internal controls, (iv) training, and (v) testing and auditing.

No matter the jurisdiction of listing, prospective and current issuers can derive significant benefits from performing due diligence and a thorough sanctions risk assessment to identify business involving sanctioned (or potentially sanctionable) parties and territories.

[1] This alert offers general considerations about US economic sanctions and export controls risks and is not intended to provide guidance or advice on Hong Kong law or an interpretation of the HKSE Guidance Letter.

[2] Examples of previous HKSE listing decisions exemplifying the importance of this analysis can be found here, here, and here.

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