



HKEx Sanctions Guidance Letter

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Executive Summary

On Friday 22nd March 2019, the Stock Exchange of Hong Kong (**HKEx**) released a guidance letter that provides additional clarity on the types of activities by listing applicants in jurisdictions, or with persons or entities, which are subject to economic or trade sanctions that may be a concern to the HKEx as it evaluates a listing applicant's suitability for listing (**Guidance Letter**). The Guidance Letter is in many ways consistent with HKEx Listing Decision LD76-2013, which was published by the HKEx in December 2013 (**LD76-2013**). However, the Guidance Letter goes beyond the LD76-2013 in several important ways:

- The Guidance Letter provides additional clarity as to what conduct is of concern to the HKEx through the use of a number of defined terms that have precise language.
- The Guidance Letter includes reference to both "primary" and "secondary" sanctions, an area that may be subject to confusion by persons that are not familiar with the way that sanctions work, and their extraterritorial application.
- It adds a new concept of a "Sanctions Trader" as an entity that will be subject to the Guidance, and states that a Sanctions Trader may not be suitable for listing.
- Lastly, the Guidance Letter expands the jurisdictions whose sanctions regulations a listing applicant must consider beyond the original four jurisdictions that were covered by LD76-2013.

As LD76-2013 was issued more than five years ago, and has become known among financial and legal advisors who assist listing applicants, this note focuses on changes and clarifications to that decision found in the Guidance Letter.

Background

International trade and economic sanctions have been attracting increasing attention as businesses of every size become more international. However, international trade regulations are complex and vary from jurisdiction to jurisdiction. Many businesses that are smaller and lack sophisticated compliance systems can inadvertently conduct business transactions in a manner that can run afoul of sanctions regulations. These issues are often identified in the due diligence process that a listing applicant undergoes in preparation for an initial public offering. In recognition of this, the HKEx in December 2013 published LD76-2013. Since that time, the amount of international trade, and trade regulation, has only increased, and with it has increased the amount of media attention given to these topics. Recent high profile cases, particularly those involving technology companies headquartered in China have furthered the attention given to these topics.

On Friday 22nd March 2019, the HKEx released the Guidance Letter, which provides significant insight into the way it will consider international trade and sanctions issues in the context of IPO transactions. While many of the concepts are similar to LD76-2013, the Guidance Letter includes precise definitions that while complex, provide more clarity as to what conduct the HKEx will consider important in this area, and expands the areas a prospective listing applicant must consider in a few key ways.

Key Points from the Guidance Letter Covered Scenarios

The Guidance Letter identifies three specific scenarios of concern: (1) the listing applicant has engaged in primary sanctioned activity, (2) the listing applicant has engaged in secondary sanctioned activity, and (3) a listing applicant is (i) itself a target of sanctions, (ii) located, incorporated, organized or resident in a country that is subject to sanctions, or (iii) is a "Sanctioned Trader".

The inclusion of both primary and secondary sanctions is an important distinction from LD76-2013, and is often an area of confusion for companies as they attempt to understand their exposure to international sanctions. Generally, to trigger primary sanctions, an activity must have a nexus to the jurisdiction. However, to have such nexus, a listing applicant need not have properties or subsidiaries in the jurisdiction, which the HKEx recognizes by including in its definition of primary sanctions activity – a listing applicant incorporated or located in a Relevant Jurisdiction (as explained below) **or which otherwise has a nexus with such jurisdiction with respect to the relevant activity, such that it is subject to the relevant sanctions law or regulation (emphasis added)**. This language recognizes that a listing applicant's commercial activity may subject it to a jurisdiction's sanctions laws without any physical presence in the jurisdiction, such as for example the way that transactions settled in U.S. dollars may trigger U.S. sanctions laws and regulations without otherwise having a nexus to the United States.

The Guidance Letter also covers listing applicants that engage in secondary sanctions activities. The Guidance Letter does not go into detail as to what these activities are, but simply states that it includes activities that may result in the imposition of sanctions against the listing applicant despite the lack of nexus with the sanctioning jurisdiction. Generally, secondary

sanctions are limited to sanctions enforced by the United States, and target entities that actively engage with persons or entities that are the direct target of U.S. sanctions. U.S. secondary sanctions actions are applicable only to U.S. sanctions that target Iran, Russia, North Korea, and Syria.

Further, the Guidance Letter covers listing applicants that are themselves a target of sanctions, or that are located, incorporated, organized or resident in a sanctioned country. It is perhaps not surprising that if a listing applicant were specifically targeted by sanctions, such as being named on the list of specially designated nationals and blocked persons (**SDN List**) maintained by the U.S. Treasury's Department of Foreign Assets Control (**OFAC**), that this would raise issues with the HKEx. Similarly, if a listing applicant resides in a country subject to comprehensive sanctions, it is unlikely that the listing applicant will be found suitable for listing. The new element, therefore, is the concept of a Sanctioned Trader. The Guidance Letter defines a Sanctioned Trader as any person or entity that does a material portion (10% or more) of its business with sanctioned targets and sanctioned country entities or persons.

The result of engaging in primary sanctions activities is that the listing applicant must obtain a reasoned analysis from its legal advisor on whether the activity violates applicable sanctions regulations or creates material sanctions risk. Further, the listing applicant must cease any activities that may have breached the regulations, and assess the impact on its results of operations of such cessation. The impact on engaging in secondary sanctions activities also requires a reasoned analysis of legal advisors, but in this case the view must state whether sanctions will be imposed. In the case of either primary or secondary sanctioned activities, internal control measures should be considered by the listing applicant to minimize

sanctions risks; this is consistent with the practice that developed following LD76-2013.

Lastly, if the listing applicant is a target of sanctions, is located in a sanctioned country, or is a Sanctioned Trader, the Guidance Letter indicates that the listing applicant may not be suitable for listing, or may be subject to restrictions on the listing applicant's offering. It is perhaps worth noting here that the Guidance Letter notes the lack of suitability could be due to "reputational risk" to the HKEx, which could give the HKEx considerable latitude in considering this issue as a means of finding a listing applicant unsuitable under the listing rules (*Main Board 8.04/GEM 11.06*).

Relevant Jurisdictions

Those familiar with LD76-2013 will recall that it specifically noted sanctions imposed by the United States, the European Union, the United Nations, and Australia. The Guidance Letter takes a more expansive view of international sanctions by employing the term "Relevant Jurisdiction"; stating the applicant must consider laws and regulations of any jurisdiction that is relevant to the listing applicant and has sanctions related laws or regulations.

Presumably, this will in practice require a listing applicant to consider whether any jurisdiction with which it has a relevant nexus, has sanctions laws and regulations, and whether the listing applicant has complied with them. This may in practice require a bit of extra due diligence on the part of the listing applicant and its advisors, particularly with respect to companies that have global operations. However, it is unlikely to create much additional exposure to sanctions violations, given that other jurisdictions outside the four named in LD76-2013 are unlikely to have sanctions regulations with broader scope than such four jurisdictions.

Measures to be adopted

The Guidance Letter specifically mandates that a listing applicant, which is subject to material sanctions risk must implement internal control measures that are effective to monitor exposure to sanctions risks. It also states that, depending on the materiality of the sanctions risk, the listing applicant may be required to make undertakings to the HKEx about (i) use of proceeds from the listing, (ii) termination of any contracts that expose it to sanctions risk, and (iii) to disclose in its annual, interim and quarterly reports details of any sanctioned activities, its efforts in monitoring its business exposure to sanctions risks, and the current or anticipated sanctioned activity. It reiterates the point that any breach of such undertakings may lead to a possible delisting of the listing applicant's securities from HKEx.

The Guidance Letter also affirms the existing practice of providing disclosure in a listing applicant's IPO prospectus about any past or current sanctioned activities and the risk they may present, together with the legal advisor's analysis, known material contingent liabilities in relation to sanctioned activities, and other information. This type of disclosure has become the norm for listing applicants since LD76-2013.

Other highlights

The Guidance Letter closes with a few final bits of guidance. First, it makes the point, perhaps somewhat obvious, that a listing application is unlikely to be approved if (a) any sanctions risks materially undermine the listing applicant's ability to continue its operations; (b) IPO proceeds will be used to finance sanctioned activities; or (c) the listing would cause a significant risk to the listing applicant's investors, the HKEx and its related parties. Second, at the other side of the spectrum, the Guidance Letter notes that if a listing applicant is not exposed to any material sanctions risk, then none of the disclosure and internal control

measures discussed in the Guidance Letter are required.

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As noted in the Guidance Letter, the rules and regulations that implement international economic and trade sanctions are frequently modified to include additional sanctions targets, whether persons, organizations or industries, or make other modifications or additions. Many recent developments, including the United States withdrawal from the Joint Cooperative Plan of Action involving Iran, the imposition of numerous sanctions targeting various industries and persons in Russia following its annexation of the region known as Crimea, and the ongoing changes to sanctions involving North Korea illustrate this point well.

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