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# Navigating the Currents of US and PRC Sanctions: Compliance and Best Practice for Financial Institutions

Mini vandePol, Gerald Lam and Andrea Kan of Baker McKenzie and Vivian Wu of FenXun Partners set out the framework of the various U.S. and PRC sanction regimes, and discuss best practices for financial institutions to consider and implement

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As current tensions between the PRC and the U.S. have evolved beyond mere contradictions to a deep distrust, geopolitical considerations have been thrust to the forefront of compliance concerns for multinational businesses and financial institutions operating across Asia Pacific and globally. The U.S. has demonstrated its commitment, during the Trump and Biden Administrations, to utilize economic and trade sanctions as a way to further its foreign policy objectives; to protect its national security; and to defend against what it deems to be threats to international peace and stability.

Other countries and international organizations (such as the United Nations Security Council) also have well-established sanctions regimes to target human rights violations, international terrorism; nuclear proliferation; and drug trafficking. However, the U.S. stands out in its use of "long arm" jurisdiction to impose sanctions upon foreign countries, entities, and individuals. More recently, the COVID-19 pandemic has deepened the resolve of the Biden Administration to utilize such policy measures to protect U.S. supply chains, and to restrict the export and re-export of its sensitive technologies to strategic competitors such as the PRC.

> … the various U.S. sanctions imposed against the PRC, as well as the countermeasure sanctions issued by the PRC against the U.S., have since 2019 become a prominent feature of the global geopolitical landscape

In this context, the various U.S. sanctions imposed against the PRC, as well as the countermeasure sanctions issued by the PRC against the U.S., have since 2019 become a prominent feature of the global geopolitical landscape. This has directly affected multinational financial institutions (and PRC financial institutions with international operations), and have left them to wonder how to navigate the increasingly frequent, expansive, and complex sanctions laws and regulations.

**U.S. sanctions imposed against the PRC**

U.S. sanctions are enforced by the Treasury Department's Office of Foreign Assets Control (OFAC), while U.S. export controls are enforced by the Department of Commerce's Bureau of Industry and Security (BIS). Although OFAC administers a number of different sanctions programs, which can range from comprehensive or selective, these are accomplished through the blocking of assets and through trade restrictions to accomplish the U.S.'s foreign policy and national security goals.

OFAC's sanctions *vis-à-vis* the PRC selectively target various areas of U.S. concern, ranging from the activities of the so-called "Communist Chinese Military Companies" (CCMCs) and potentially its subsidiaries, individuals and entities connected with alleged abuses against ethnic minorities in Xinjiang Province. OFAC's Xinjiang-related sanctions are under its Global Magnitsky Sanctions regime, which targets human rights abuses globally. The UK and EU have also implemented their own sanctions under their respective human rights sanctions regimes against certain PRC individuals and entities in relation to the alleged abuses in Xinjiang specifically. The sanctioned parties are subject to various restrictions such as asset freezes, travel bans, and transacting with UK/EU persons. More recently, OFAC's sanctions have also targeted government officials in charge of enforcing Hong Kong's National Security Law.

The Trump Administration also issued various Executive Orders restricting or prohibiting certain transactions with PRC software and technology giants. For example, Executive Order 13971 Addressing the Threat Posed By Applications and Other Software Developed or Controlled By Chinese Companies (Jan. 5, 2021). These sanctions selectively target certain entities and individuals by restricting (in varying degrees) the ability of U.S. persons to deal with them. In the case of CCMCs, U.S. persons are restricted from purchasing, selling or being in possession of the publicly traded securities of CCMCs (see Executive Order 13959 Addressing the Threat From Securities Investments That Finance Communist Chinese Military Companies (Nov. 12, 2020) amended by Executive Order 13974 (Jan. 13, 2021)).

All U.S. persons, including U.S.-incorporated entities, their foreign branches (including non-U.S. entities owned or controlled by a U.S. person that are also subject to U.S. sanctions with respect to certain sanctions programs, such as the U.S.'s Iran, Cuba, and North Korea sanctions programs) and employees, are prohibited from transacting with sanctioned parties. However, OFAC has traditionally taken an expansive view on U.S. jurisdiction, and held that non-U.S. persons may also be subject to sanctions restrictions based on various jurisdictional hooks. For instance, OFAC has held in a number of cases that a jurisdictional nexus exists where the conduct involved the use of the U.S. financial system and commenced enforcement action against non-U.S. parties based solely on the use of U.S. dollars in transactions with a sanctioned party. For example, OFAC's settlement with CSE Global Limited (CSE) and CSE TransTel Pte. Ltd. (Transtel) (July 15, 2017) and OFAC's settlement with Union de Banques Arabes et Françaises (UBAF) (Jan. 4, 2021) CSE and its wholly-owned subsidiary Transtel, both non-U.S. entities, maintained U.S. dollar bank accounts at non-U.S. financial institutions, but transferred money from those accounts to multiple third party vendors that supplied goods or services to Iran. UBAF, also a non-U.S. entity, operated U.S. dollar bank accounts on behalf of Syrian financial institutions and processed internal transfers on behalf of these entities that were followed by corresponding transfers through a U.S. bank.

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The danger with non-U.S. parties transacting in U.S. dollars is that this process necessarily involves clearing funds through U.S. correspondent banks, which in turn "causes" U.S. persons to engage in prohibited activity. OFAC has also established jurisdictional nexus where the connection was even more tenuous—for example, where the non-U.S. entity was involved in bankruptcy proceedings in the U.S. when the suspect transaction occurred (see OFAC's Finding of Violation against B Whale Corporation (Feb. 3, 2017)).

The U.S. *Hong Kong Autonomy Act* (HKAA), enacted in July 2020, is of particular significance, as it expressly targets "foreign financial institutions", which knowingly conduct a significant transaction with individuals who have "materially contributed" to the PRC Government's "failure to meet its obligations under the *Sino-British Joint Declaration* or the *Hong Kong Basic Law*". Any such financial institution would be subject to a range of secondary sanctions that would effectively exclude it from the U.S. financial system, U.S. financial products, and U.S. investors. Importantly, the senior officers of these financial institutions may also be subject to the same restrictions. Furthermore, the consequences of non-compliance with the HKAA could significantly affect a financial institution's existing relationships with other financial institutions, customers, and counterparties, and may also affect its ability to operate in other jurisdictions. At present, no financial institution is designated under the HKAA (see Treasury Department's Dec. 11, 2020 Report to the Congress and May 18, 2021 Report to the Congress pursuant to Section 5(b) of the HKAA). Although the HKAA does not define what constitutes a significant transaction, previous Treasury Department guidance indicates that the totality of facts and circumstances would be taken into account in determining whether transactions are significant, including the size, nature and frequency of the transaction; the level of awareness of management; and whether the transaction is part of a pattern of conduct (see Treasury Department's FAQ No. 850).

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OFAC is increasingly active in the enforcement space, and fines of hundreds of millions of U.S. dollars have been imposed. The risk for banks and other financial institutions is particularly acute, given their operations routinely involve processing of monetary transactions between international parties. Some of the aggravating factors affecting OFAC penalty decisions also disproportionately apply to large financial institutions. Factors such as commercial sophistication, size of operations, financial condition, as well as the volume of transactions that an institution undertakes on an annual basis with the sanctioned party have been factors that were taken into account by OFAC in assessing fines (see OFAC's Enforcement Guidelines). In the last decade, OFAC imposed nearly US$4.9 billion in civil penalties for violating U.S. sanctions. The ten largest penalties from this period, accounting for nearly US$4.3 billion of the US 4.9 billion, were all imposed on multinational financial institutions.

OFAC also impose non-monetary penalties, including designation on its "Specially Designated Nationals and Blocked Persons" (SDN) List and mandatory compliance remediation measures. A key consequence of being designated as an SDN is that all property (and interest in the property) belonging to the designated party *or any entity that is owned, directly or indirectly, 50% or more by them, individually or with other sanctioned persons*, are "blocked". As such, under this so-called "50 Percent Rule", any entity that is owned 50% or more in the aggregate by one or more SDNs would in effect be "tainted" and treated as an SDN, even if they are not specifically listed. Unless authorized by OFAC or otherwise exempt, all transactions by U.S. persons (or those that are within or transiting the U.S.) that involve any such blocked property is prohibited. Therefore, the risk of violation and enforcement has significant commercial and reputational ramifications for U.S. and non-U.S. financial institutions.

**PRC sanctions**

Although the PRC does not yet have a fully developed sanctions regime, it has recently advanced its legislative and supervisory efforts in response to sanctions and other restrictions imposed by the U.S, EU, UK, Canada and other countries.

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First, the PRC Ministry of Foreign Affairs announced "retaliatory" sanctions against specified foreign entities and individuals who were deemed as seriously infringing the PRC's sovereignty and interests. For example, the PRC Ministry of Foreign Affairs announced sanctions on various U.S., UK, and EU individuals and entities in late March 2021, days after the U.S., UK, and EU imposed new Xinjiang-related sanctions. These sanctions subjected the relevant individuals and entities to certain prohibitions, including from entering the PRC, Hong Kong, and Macau and the freezing of their property in the PRC. The sanctions do not, however, proscribe penalties for non-compliance by third parties such as finance institutions who may transact with the sanctioned individuals.

Second, the PRC Ministry of Commerce (MOFCOM) announced the Unreliable Entity List (UEL) regime in May 2019, and in September 2020 introduced specific principles for its implementation (UEL Regulations) (see the *Provisions on the Unreliable Entity List* (不可靠实体清单规定]). The UEL Regulations set out various blacklisting considerations, including actions that endanger the PRC's national sovereignty, security, or development, or damage the legitimate rights and interests of PRC individuals and entities. The potential consequences include fines and other broad restrictions on travel, investment, and trade. As at the time of writing, no foreign company has been designated under the UEL.

In January 2021 MOFCOM also announced the *Rules on Counteracting Unjustified Extra-territorial Application of Foreign Legislation and Other Measures* (阻断外国法律与措施不当域外适用办法] also known as the *PRC Blocking Rules* to counteract the impact on PRC companies and citizens of "unjustified extra-territorial application" of foreign legislation and other relevant measures. It includes a new reporting obligation on PRC individuals and entities to disclose when they have been restricted from engaging in normal economic or trade activities with a third country entity or individual due to foreign regulations. If an "unjustified extra-territorial application" can be established, such as through the impact of U.S. sanctions, MOFCOM may issue a prohibition order that the relevant measure should not be accepted or complied with by PRC citizens and entities. Following the issue of this order, any PRC citizen or entity may also institute legal proceedings and claim for compensation in a Chinese court, unless an exemption has been granted.

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**Impact of U.S. and PRC sanctions**

U.S. and PRC sanctions have significantly impacted, and will continue to significantly impact, the way financial institutions conduct business. At a very basic level, these measures will affect *who* they can transact with, *how* they should transact with these parties and *if* they should transact at all.

U.S. financial institutions are prohibited from dealing with any U.S. sanctioned parties, whether directly or indirectly, or formally or informally. To avoid so-called "secondary" sanctions under the HKAA, non-U.S. financial institutions must also ensure that they do not transact with any of the individuals designated under the legislation. Currently, 34 individuals have been designated under the HKAA, including Carrie Lam, the Chief Executive of Hong Kong. The State Department designated 10 individuals on Oct. 14, 2020, and another 24 individuals on March 16, 2021. All of the designated individuals were already sanctioned under Executive Order 13936 on Hong Kong Normalization.

HKAA considerations aside, non-U.S. financial institutions should also avoid dealing with sanctioned parties. Given the significant financial and reputational risks associated with non-compliance, and the substantial risk of enforcement by OFAC through secondary sanctions, it would not be advisable for non-U.S. financial institutions to ignore U.S. sanctions requirements on the basis that there appear to be no obvious U.S. jurisdictional nexus. OFAC has stated in its May 2019 Framework for OFAC Compliance Commitments (OFAC Compliance Manual) that it "strongly encourages organizations subject to U.S. jurisdiction, as well as foreign entities that conduct business in or with the United States, U.S. persons, or using U.S.-origin goods or services" to adopt a compliance program to comply with OFAC standards. Additionally, compliance with OFAC requirements would also avoid any potential violation of sanctions-related contractual provisions with other counterparties, such as insurers.

Finally, for financial institutions operating in the PRC and Hong Kong, a growing concern remains on complying with competing sanctions requirements. The U.S. sanctions regime is broadly applicable to, and is strictly enforced against, U.S. and potentially non-U.S. financial institutions alike. In contrast, although the competing PRC sanctions regime continues to be developed, the possibility that compliance with U.S. or other foreign sanctions may lead to designation as an Unreliable Entity, or a penalty under the Blocking Rules, cannot be discounted.

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**Best practices: What financial institutions need to know and do**

The most important and effective way to ensure compliance with sanctions laws and regulations around the world is to implement a comprehensive risk-based sanctions compliance program. It is insufficient to simply rely on off-the-shelf screening products or one-size-fits-all solutions—the compliance program needs to be tailored to the business-specific and region-specific risks that are faced. From a U.S. sanctions perspective, for example, particular attention should be paid to parties that operate in one of the targeted industries, or parties that have strong government connections.

The OFAC Compliance Manual lists five essential elements of a successful compliance program. OFAC expressly states that it will "consider favorably" companies that had effective compliance programs at the time of an apparent violation. OFAC has also broadly adopted the same compliance framework in a recent settlement agreement with a non-U.S. enforcement subject (see, for example, [OFAC's settlement with UniCredit Bank AG] (April 15, 2019)):

(1) Management commitment to and support of the risk-based compliance program.

(2) Adopting a risk-based approach to designing or updating the compliance program, including conducting a routine and ongoing "risk assessment" to identify potential sanctions issues.

(3) Having in place effective internal controls, including policies and procedures, in order to identify, escalate, report, and keep records of activities that may be prohibited under U.S. sanctions. Two important controls include: (i) sophisticated sanctions screening capabilities and (ii) robust due diligence measures, which we further elaborate on below.

(4) Assessing the effectiveness of the internal controls implemented and checking for inconsistencies between these and day-to-day operations.

(5) Communicating compliance standards to all employees and personnel on a periodic basis through a structured and tailored training program.

**Sanctions Screening and Diligence**

Sanctions screening against international sanctions lists (including OFAC's SDN lists) should be conducted at the outset of any client relationship or transaction with a new counterparty and at regular intervals throughout the course of the relationship/transaction to take into account any new updates to restricted party lists. It is insufficient to simply rely on manual desktop searches against the name of a client or counterparty, which would be highly inefficient and will likely result in false negatives, given the OFAC's "50 Percent Rule" (as explained above). It has been observed that an increasing number of financial institutions are outsourcing this function to external sanctions experts, like law firms and risk advisory companies, which have the technological capabilities and sanctions knowledge and experience to carry out this work efficiently and effectively.

Due diligence is a process that both supplements and informs basic sanctions screening. Financial institutions' core Know-Your-Client (KYC) and other diligence processes allow them to gather more substantive information about the identity and background of its customers and counterparties, including their subsidiary entities and affiliates. This will suggest additional sanctions searches where necessary from a risk-perspective. It is important to request responses to broad questions covering all types of dealings, all geographical areas, and all restricted party lists during this process to ensure that relevant information is provided.

After the screening and due diligence processes have been carried out, contractual and other documentary protections should be utilized. This includes mandatory sanctions declarations in account opening forms, as well as sanctions representations and warranties and covenants in financing and other agreements. Other contractual protections, such as a broadly drafted "material adverse change" and termination clauses, may also allow the financial institution to mitigate its risks by allowing unilateral termination of its relationship (or a transaction) with a newly sanctioned party.

Contingency measures should also be put in place to actively identify, flag and address any newly-designated customer or counterparty. The protocol should contain practical guidance and standard operating procedures from a legal, commercial, and reputational point of view, to escalate and review sanctions lists and media findings on potentially sanctioned parties.

Ultimately, the current web of U.S. and PRC sanctions will only get more complex going forward. Any decision on compliance with competing sanctions requirements will require careful consideration of both legal and commercial concerns. It will be vital for financial institutions to keep up to date with political, legal, and economic developments in this space, and seek specialist sanctions advice to adequately mitigate the attendant risks.

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