

Latest U.S. Sanctions Developments Show Focus on Mainland China and Hong Kong

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The U.S. government is sending a series of signals that it intends to focus on Chinese banks and corporate entities as potential points of additional pressure on North Korea. Close U.S. scrutiny could lead to enforcement actions by U.S. authorities. As Sigal Mandelker, Under Secretary for Terrorism and Financial Intelligence of the U.S. Department of the Treasury (“**TFI**”), recently stated, the U.S. government is “resolved to use our economic authorities to take action against foreign banks that disregard anti-money laundering safeguards and become conduits for widespread illicit activity, including activity linked to North Korea’s weapons program.”¹

Over the last year, the Office of Foreign Assets Control of the U.S. Department of the Treasury (“**OFAC**”) has designated more than 100 North Korean-related individuals and entities.² Under Secretary Mandelker recently testified to Congress that TFI has been warning financial institutions both within and outside the United States about North Korean abuses of the international financial system, explaining that TFI is focused on “depriving North Korea of its ability to earn and move revenue through the international financial system.”³ The Under Secretary noted that she raises these concerns in “virtually every engagement I have with my foreign counterparts and with many financial institutions” and emphasized that TFI is “laser-focused on detecting and disrupting these networks as part of the Administration’s strategy to impose maximum pressure on North Korea.”⁴

Following the Congressional hearing, Under Secretary Mandelker traveled to Asia with stops in Beijing, Hong Kong, Seoul, and Tokyo. In an interview after the meetings, Mandelker characterized meetings with Chinese Officials in Beijing as productive but also stressed that China’s efforts were “critical” to maximizing pressure on Pyongyang.⁵ She said she urged Chinese officials in Beijing to comply with obligations under United Nations Security Council (“**UNSC**”) sanctions and underscored the importance of expelling what the U.S. government calls North Korean “financial facilitators.”⁶ She also suggested that failure to act could make Chinese banks targets for future sanctions, stating that “[w]hile we seek to work

¹ U.S. Treasury Department Statements & Remarks, Sigal Mandelker Speech before the Securities Industry and Financial Markets Association Anti-Money Laundering & Financial Crimes Conference (February 13, 2018) <https://home.treasury.gov/news/press-release/sm0286>.

² Testimony of Sigal Mandelker, U.S. Senate Committee on Banking, Housing, and Urban Affairs (January 17, 2018) https://www.banking.senate.gov/public/_cache/files/2b674112-beb0-42e0-a3cf-4bc68e7d2e5f/61873D5CBBA50D993383F57700AAAD4E.mandelker-testimony-1-18-18.pdf.

³ *Id.*

⁴ *Id.*

⁵ The Washington Times, It’s “Complicated:” China’s NKorea envoy on lack of visit (January 26, 2018) <https://www.washingtontimes.com/news/2018/jan/26/its-complicated-chinas-nkorea-envoy-describes-rela/>.

⁶ The Wall Street Journal, U.S. Urges China to Kick Out North Korea’s Money Men (January 24, 2018) <https://www.wsj.com/articles/top-u-s-sanctions-envoy-presses-china-to-expel-north-korean-agents-1516788506>.

very cooperatively with our Chinese counterparts we won't hesitate to take unilateral action where we think such unilateral action is warranted.”⁷

During Under Secretary Mandelker's visit to Hong Kong, she met with the Hong Kong Monetary Authority, Financial Services and Treasury Bureau, and the Commerce and Economic Development Bureau to discuss cooperation between the United States and Hong Kong on combating the North Korean threat. Following these meetings, she noted to the press that registering a company in Hong Kong is “extremely easy” and said “[Hong Kong] shouldn't be a place where companies can establish themselves to help [with] smuggling [or] ship-to-ship transfers.”⁸ She reportedly also stressed to the Hong Kong government the importance of having the appropriate mechanisms in place to enforce UNSC resolutions and other regulations prohibiting activities that facilitate financial transactions with North Korea.⁹

In a recent speech in New York City, Under Secretary Mandelker reiterated that “there is no more urgent problem than the grave threat posed by North Korea” and advised that financial institutions around the world need to be “extraordinarily vigilant” in ensuring that North Korea is not overtly or covertly moving money through their financial institutions.¹⁰ She further warned that the U.S. government “will target not only companies that actually know they are being exploited, but also those that *should know*.”¹¹ In describing her trip to Asia, the Under Secretary stated that she delivered the message to counterparts in Asia that the U.S. government expects “100% implementation of sanctions against North Korea.”¹²

Both Beijing and Hong Kong have vowed to implement sanctions against North Korea. In September 2017, the People's Bank of China reportedly issued instructions to Chinese banks to strictly implement sanctions against North Korea shortly after (i) the UNSC passed resolution 2375 expanding financial sanctions and imposing further restrictions on North Korea's oil and gas, textile, and overseas labor sectors and (ii) President Trump signed Executive Order 13810 expanding U.S. sanctions on North Korea, as discussed below.¹³ The Hong Kong Secretary for Commerce and Economic Development stated that the city has been staying highly vigilant about activities and suspected cases that may violate UNSC sanctions.¹⁴ The Secretary stated that Hong Kong would keep a close watch on reports of the UNSC in relation to sanctions against North Korea in which Hong Kong persons are alleged to be involved and follow up diligently on suspected violations.¹⁵

⁷ The Washington Times, It's “Complicated:” China' NKorea envoy on lack of visit (January 26, 2018) <https://www.washingtontimes.com/news/2018/jan/26/its-complicated-chinas-nkorea-envoy-describes-rela/>.

⁸ The Standard, “SAR told to tighten lines on N Koreans” (January 25, 2018) <http://www.thestandard.com.hk/section-news.php?id=192140>.

⁹ *Id.*

¹⁰ U.S. Treasury Department Statements & Remarks, Sigal Mandelker Speech before the Securities Industry and Financial Markets Association Anti-Money Laundering & Financial Crimes Conference (February 13, 2018) <https://home.treasury.gov/news/press-release/sm0286>.

¹¹ *Id.*

¹² *Id.*

¹³ South China Morning Post, “Top Chinese bank vows to strictly apply UN sanctions on North Korea” (September 25, 2017) <http://www.scmp.com/news/china/diplomacy-defence/article/2112760/top-chinese-bank-vows-strictly-apply-un-sanctions-north>.

¹⁴ HKSAR Commerce and Economic Development Bureau, “Legislative Council Question 13: Implementation of United Nations Security Council's sanctions against North Korea” (November 22, 2017) <http://www.cedb.gov.hk/speech/2017/pr22112017b.htm>.

¹⁵ *Id.*

Types of North Korea-Related Evasive Practices

In their official reports and public statements, the United Nations and the U.S. government have alleged that North Korea has employed a number of methods and practices to evade the toughened sanctions.¹⁶ According to published UN documents and media reports, these measures, demonstrating increasingly sophisticated nature, include:

- a. Smuggling, or ship-to-ship transfers such as supplying fuel by transferring cargoes at sea;
- b. Bartering of goods, such as exchanging its coal and other minerals and agricultural/fishing products for weapons components and other goods it needs;
- c. Using financial facilitators to act as representatives for North Korean banks;
- d. Using overseas workers and infrastructure projects to help fund North Korean state military programs;
- e. Using shell companies or diplomatic cover to open accounts and transact with Chinese or Hong Kong Financial Institutions; and
- f. Direct arms sales to countries in Africa.

Companies operating in industries such as shipping, fishing, agriculture, mining and coal, construction, weapons, and ammunition, and the financial institutions who serve them, must be mindful of those evasive practices and develop proper surveillance systems to avoid knowingly or inadvertently becoming part of or playing any role in them.¹⁷

Current U.S. Sanctions Against North Korea

The current U.S. sanctions against North Korea include (among others) the following recently enacted or implemented authorities:

- The North Korea Sanctions and Policy Enhancement Act of 2016 (“**NKSPEA**”), which became law in February 2016, expanded U.S. sanctions on North Korea. Among other things, NKSPEA provides for both mandatory and discretionary secondary sanctions against non-U.S. individuals or entities (“**Persons**”) determined to be engaged in certain activities with regard to North Korea.
- Executive Order (“**E.O.**”) 13722, “Blocking Property of the Government of North Korea and the Workers’ Party of Korea, and Prohibiting Certain Transactions With Respect to North Korea”

¹⁶ See S.C. Res. 2397, U.N. Doc. S/RES/2397 (Dec. 22, 2017) http://www.securitycouncilreport.org/atf/cf/%7B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%7D/s_res_2397.pdf; U.S. Department of Treasury FinCEN Advisory, Advisory on North Korea’s Use of the International Financial System (November 2, 2017) <https://www.fincen.gov/sites/default/files/advisory/2017-11-02/DPRK%20Advisory%20FINAL%20508%20C.pdf>; S.C., “Report of the Panel of Experts established pursuant to resolution 1874 (2009),” U.N. Doc. S/2017/150 (Feb. 27, 2017) http://www.securitycouncilreport.org/atf/cf/%7B65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9%7D/s_2017_150.pdf; S.C., “Report of the Panel of Experts established pursuant to resolution 1874,” U.N. Doc. S/2016/157 (Feb. 24, 2016) http://www.un.org/en/ga/search/view_doc.asp?symbol=S/2016/157; CNN, US official warns Hong Kong over North Korea smuggling, money laundering (January 25, 2018) <https://edition.cnn.com/2018/01/25/asia/hong-kong-north-korea-money-intl/index.html>; South China Morning Post, How North Korea evades UN Sanctions (September 17, 2017) <http://www.scmp.com/news/china/diplomacy-defence/article/2111440/how-north-korea-evades-un-sanctions>.

¹⁷ For further insight into U.S. government goals and targets, see the FinCEN advisory on North Korea’s Use of the International Financial System (November 2, 2017) https://www.fincen.gov/sites/default/files/advisory/2017-11-02/DPRK%20Financing%20Advisory%20FINAL%2011022017_0.pdf.

(March 18, 2016), implements provisions of NKSPEA. Among other things, the E.O. blocks the property of the Government of North Korea and the Workers' Party of Korea, prohibits the direct or indirect exportation or re-exportation of any goods, services (including financial services), or technology from the United States or by a U.S. Person to North Korea and any new investment in North Korea by a U.S. Person, wherever located, and authorizes blocking sanctions targeting Persons meeting new designation criteria, including Persons determined to operate in specified North Korean industries (such as financial services).

- The Countering America's Adversaries Through Sanctions Action of 2017 ("**CAATSA**") includes a number of new secondary sanctions provisions and other measures targeting sources of economic support for the North Korean Government, as we previously reported.¹⁸ Section 311 of CAATSA amends NKSPEA to provide for additional sanctions designation criteria with respect to North Korea and blocks the assets of persons determined to knowingly, directly or indirectly, (i) purchase or acquire from North Korea significant amounts of certain minerals; (ii) sell or transfer to North Korea significant amounts of rocket, aviation, or jet fuel; (iii) provide significant amounts of fuel or supplies, provide bunkering services, or facilitate a significant transaction or transactions to operate or maintain a vessel or aircraft that is identified as sanctioned or that is owned or controlled by a sanctioned person; (iv) maintain insurance for a vessel owned or controlled by the North Korean Government; or (v) maintain a correspondent account with any North Korean financial institution (unless specifically approved by the UNSC), among other things.

Section 311(b) of CAATSA authorizes (but does not require) blocking sanctions against Persons determined to knowingly, directly or indirectly, (i) facilitate a significant transfer of funds or property of the North Korean Government that materially contributes to a violation of an applicable UNSC resolution, or facilitate significant transfers of bulk cash, and certain precious metals, gemstones, or other stores of value to the North Korean Government; (ii) conduct a significant transaction in North Korea's transportation, mining, energy or financial services industries; or (iii) facilitate the operation of any branch, subsidiary, or office of a North Korean financial institution, among other things.

In addition, Section 312 of CAATSA amends NKSPEA to require U.S. financial institutions to prevent the indirect use of correspondent accounts maintained for a foreign financial institution to provide significant financial services to any person, foreign government, or financial institution sanctioned pursuant to NKSPEA, as amended.

- E.O. 13810, "Imposing Additional Sanctions With Respect to North Korea" (September 20, 2017), expanded OFAC's authority to target those who enable the North Korean regime's economic activity. Among other provisions, the E.O. authorizes the imposition of blocking sanctions on persons determined to: (i) operate in the construction, energy, financial services, fishing, information technology, manufacturing, medical, mining, textiles, or transportation industries in North Korea; (ii) own, control, or operate any port in North Korea; (iii) have engaged in at least one significant importation or exportation to North Korea of any goods, services, or technology; (iv) be a North Korean person, including a North Korean person who has engaged in commercial activity that generates revenue for the Government of North Korea or the Workers' Party of Korea; and (v) have materially assisted, sponsored, or provided financial, material, or

¹⁸ See Davis Polk Client Memorandum, The Countering America's Adversaries Through Sanctions Act Becomes Law (August 4, 2017) https://www.davispolk.com/files/2017-08-07_the_countering_americas_adversaries_through_sanctions_act_becomes_law.pdf.

technological support for, or are owned or controlled by, or have acted on behalf of any person whose property and interests in property are blocked pursuant to the E.O.

In addition, E.O. 13810 authorizes the imposition of sanctions, such as restrictions on correspondent or payable-through accounts or full blocking sanctions, on a foreign financial institution determined to have knowingly conducted or facilitated, on or after September 21, 2017, (i) any significant transaction on behalf of certain blocked persons or (ii) any significant transaction in connection with trade with North Korea, among other things.¹⁹

According to Treasury Secretary Mnuchin, E.O. 13810 puts foreign financial institutions on notice that, “going forward, they can choose to do business with the United States or with North Korea, but not both.”²⁰ Secretary’s Mnuchin’s stark language suggests that foreign companies that continue to engage in trade or financial transactions with North Korea going forward will face real exposure to targeted sanctions, and suggests that the U.S. government intends to make a sustained and comprehensive effort, backed by the threat of these sanctions, to push other countries to isolate North Korea economically with the end goal of eliminating nuclear weapons from the Korean peninsula.

The penalties for violating U.S. sanctions can be substantial, depending on the program. Violations are punishable by civil and criminal fines, as well as imprisonment. For civil penalties, OFAC has a “strict liability” standard. It should be noted that in several settlements involving non-U.S. persons, there have been no allegations of misconduct by a U.S. branch, U.S. nationals or U.S.-based personnel of the non-U.S. person.²¹ Enforcement actions have been brought even where a non-U.S. financial institution processed U.S. dollar payments that ultimately entered into the U.S. financial system.²²

Recent Enforcement Actions Involving Chinese Entities

Recent developments indicate that there is an increased likelihood of secondary sanctions against Chinese financial institutions and corporates. Consequently, Chinese banks should not only ensure that they do not have direct exposure to North Korea, but also that their services to third parties cannot expose the banks to U.S. primary or secondary sanctions. In the past two years, actions have been brought against various Chinese entities—Dandong Hongxiang Industrial Development, Mingzheng International Trading, Bank of Dandong, Beijing Chengxing Trading, and Dandong Jinxiang Trade—for breach of U.S. sanctions against North Korea.

¹⁹ Notably, E.O. 13810 does not define what constitutes a “significant” trade or financial transaction that would justify the imposition of sanctions. In other contexts, the Treasury Department has indicated that it may consider a number of factors in determining whether transactions are significant, including the nature, size, number, and frequency of transactions, the transaction’s nexus to sanctioned persons or sanctionable activity, the impact of the transaction on the objectives of the relevant sanctions program, the benefit conveyed to a sanctioned person or government by the transaction, whether the transaction is performed with the involvement or approval of management or is part of a pattern of conduct, whether the transaction involves deceptive practices, and any other factor deemed to be relevant in a particular case.

²⁰ U.S. Treasury Department Press Release, Remarks by Secretary Mnuchin on President Trump’s Executive Order on North Korea (September 21, 2017) <https://www.treasury.gov/press-center/press-releases/Pages/sm0162.aspx>.

²¹ See, e.g., Settlement agreement between CSE Transtel Pte. Ltd. & CSE Global Limited and OFAC (July 15, 2017) https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/transtel_settlement.pdf; Settlement agreement between Zhongxing Telecommunications Equipment Corporation and certain of its affiliates and OFAC (March 7, 2017) https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20170307_zte_settlement.pdf.

²² Settlement agreement between CSE Transtel Pte. Ltd. & CSE Global Limited and OFAC (July 15, 2017) https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/transtel_settlement.pdf.

- In September 2016, the U.S. Department of Justice unsealed criminal charges against and OFAC imposed sanctions on **Dandong Hongxiang Industrial Development**, a China-based trading company, and four Chinese company officials for allegedly conspiring to evade U.S. sanctions against North Korea, money laundering and the violation of U.S. regulations against the support of designated WMD proliferators.²³ The defendants allegedly used the trading company and various front companies around the world to conduct U.S. dollar transactions designed to evade U.S. sanctions against North Korea. The Justice Department also filed for civil forfeiture of all funds contained in 25 Chinese bank accounts that belong to the trading company.
- In the 2017 **Mingzheng International Trading** enforcement action, the U.S. Department of Justice alleged that Mingzheng conspired to evade U.S. sanctions by facilitating prohibited U.S. dollar transactions through the United States, on behalf of the Foreign Trade Bank, a sanctioned North Korean entity. The Justice Department sought civil forfeiture in the amount of \$1.9 million.²⁴
- In the 2017 **Bank of Dandong** action, the Financial Crimes Enforcement Network of the U.S. Department of the Treasury (“**FinCEN**”) found that Bank of Dandong acted as a conduit for North Korea to access the U.S. and international financial systems by facilitating millions of dollars of transactions for companies involved in North Korea’s WMD and ballistic missile programs. Using Section 311 of the USA PATRIOT Act, FinCEN labeled Dandong as an institution of “primary money laundering concern” and issued a rule to exclude Bank of Dandong from the U.S. financial system.²⁵
- On January 24, 2018, OFAC designated **Beijing Chengxing Trading** and **Dandong Jinxing Trade** pursuant to E.O. 13810. According to OFAC, between January 1, 2013 and June 1, 2017, the two companies cumulatively imported/exported over \$87 million worth of goods with North Korean companies, including those involved in the country’s WMD and missile programs.²⁶

How to Mitigate Sanctions Risks

In order to mitigate their U.S. sanctions risks, financial institutions and other companies must ensure that they have strong internal sanctions, anti-money laundering (“**AML**”) and other policies, procedures and controls, adequate training for employees to spot red flags and avoid violations, and mechanisms in place to monitor suspicious activity.

Customer due diligence is necessary to protect a company from being a conduit for illicit activity. Normal “know your customer” procedures may be sufficient for standard customers; however, enhanced customer due diligence should be conducted for higher risk customers. Customers can be classified as high risk based on a number of considerations, such as the regional risk of the origin of the customer,

²³ U.S. Department of Justice Press Release, Four Chinese Nationals and China-Based Company Charged with Using Front Companies to Evade U.S. Sanctions Targeting North Korea’s Nuclear Weapons and Ballistic Missile Programs (September 26, 2016) <https://www.justice.gov/opa/pr/four-chinese-nationals-and-china-based-company-charged-using-front-companies-evade-us>; U.S. Treasury Department Press Release, (September 26, 2016) <https://www.treasury.gov/press-center/press-releases/Pages/jl5059.aspx>.

²⁴ U.S. Department of Justice Press Release, United States Files Complaint to Forfeit More Than \$1.9 Million From China-Based Company Accused of Acting as a Front for Sanctioned North Korean Bank (June 15, 2017) <https://www.justice.gov/usao-dc/pr/united-states-files-complaint-forfeit-more-19-million-china-based-company-accused-acting>.

²⁵ U.S. Federal Register, Vol. 92, No. 215 (November 8, 2017) https://www.fincen.gov/sites/default/files/federal_register_notices/2017-11-08/Dandong%20Final%202017-24238.pdf.

²⁶ U.S. Department of the Treasury, Treasury Sanctions North Korean Overseas Representatives, Shipping Companies, and Chinese Entities Supporting the Kim Regime (January 24, 2018) <https://home.treasury.gov/news/press-releases/sm0257>.

whether there is any record of suspicious transactions or transactions processed by the customer that have been blocked for sanctions reasons, whether the customer is a non-resident or offshore company, whether the customer has set up multiple layers of accounts, etc. Enhanced due diligence includes obtaining information on the customer's source of funds, ultimate beneficial owner (if applicable), closer monitoring of the customer's transactions, and obtaining information and documentation on the underlying transaction. This due diligence should also include looking for any U.S. nexus, ranging from the involvement of U.S. persons, U.S. technology or goods, or a transaction or account containing U.S. dollars, all of which could be a basis for U.S. sanctions jurisdiction. Moreover, the risks related to North Korea extend beyond transactions with a U.S. nexus. Given the breadth of the designation authorities and the seriousness with which the U.S. views the situation, any dealing with North Korea carries risk.

In addition to due diligence, policies should include a process for suspicious transaction monitoring and reporting. Companies should also continue to monitor developments on U.S. and UNSC sanctions and update policies and procedures where necessary. Further, companies should expect Chinese and Hong Kong authorities to tighten scrutiny of sanctions and AML compliance, particularly customer due diligence, as both have vowed to comply with UNSC sanctions.

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