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INTERNATIONAL BANKING

Secondary Sanctions Against North Korea Place Global Financial Firms at Risk

BY DAVID HORN

As North Korea continues its provocative missile tests and nuclear activities, the United States appears poised to adopt secondary sanctions that would target Chinese and other firms conducting business with Pyongyang. Global firms operating in Asia or with direct or indirect exposure to North Korea should use the emerging consensus on North Korean secondary sanctions as an opportunity to weigh the lessons of the Iran secondary sanctions program and examine evolving sanctions compliance challenges.

A U.S. "secondary" sanctions program against North Korea will likely be modeled on the type of sanctions responsible for swiftly degrading Iran's economic relationship with non-U.S. firms around the world over the past decade. For example, U.S. Secretary of the Treasury Steven Mnuchin has called secondary sanctions a "very, very powerful" policy tool for North Korea.

The principal target, at least initially, would likely be Chinese firms perceived to be engaged in business with North Korea. As the U.S. ambassador to China, Terry Bransta, stated to Congress, secondary sanctions "may well be" deployed against Chinese companies. In this climate, Asian and other financial institutions with North Korean exposure will now be at increased risk of U.S. sanctions enforcement actions – or of becoming sanctioned parties themselves – if they do not understand and account for the legal, policy, and political framework of U.S. secondary sanctions.

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Secondary sanctions are not a new policy tool. Unlike most U.S. sanctions that apply only to U.S. firms or those operating in the United States, secondary sanctions effectively apply prohibitions extraterritorially even when a non-U.S. firm is engaged in activity that does not touch the United States.

Although they have been used by the United States in various forms to address a range of foreign policy or national security challenges, secondary sanctions are most lauded for their utility in confronting Iran. Over the past decade, secondary sanctions severely curtailed Iran's ties to the global financial system by threatening non-U.S. companies with significant penalties if they engaged in certain proscribed dealings in or with sensitive Iranian entities or sectors, such as defense, energy, and financial services.

Why do secondary sanctions work? There is a natural limit to the effectiveness of U.S. sanctions that apply only to U.S. companies and to those transactions that touch the United States. While these "primary" sanctions can have powerful extraterritorial effects due to the centrality of the U.S. dollar in international trade and finance, non-U.S. banks may generally continue to service sanctions targets without exposing themselves to U.S. sanctions liability, especially when trade fi-

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nance, lending, and other banking is carried out with non-U.S. dollar currencies that do not require clearing through U.S. correspondent accounts.

By contrast, secondary sanctions typically do not expose non-U.S. banks (or other non-U.S. firms) to direct civil or criminal liability, but rather threaten a third-country target's access to U.S. capital markets by specifically listing them as sanctioned parties after the U.S. government determines that they have engaged in proscribed dealings with the country of concern. As such, secondary sanctions act as a sword of Damocles over companies considering business with an embargoed country, creating an ever-present threat to their access not only to U.S. capital markets but also to their U.S. suppliers, customers, lenders, insurers, and vendors.

In practice, the Treasury Department formally levied U.S. secondary sanctions against Iran relatively infrequently, but their principal impact was to persuade firms to voluntarily exit Iran or deter future dealings. For example, from 1998 until 2013, the United States imposed secondary sanctions against various third-country energy and financial firms under the Iran Sanctions Act. In several of those cases, the Treasury Department waived or ''exempted'' the sanctions after the targeted firms committed to wind down their projects in Iran.

But after Congress passed the Comprehensive Iran Sanctions Accountability and Divestment Act (CISADA) in 2010, which significantly enhanced prior U.S. legal authority to impose secondary sanctions, global companies undertook a swift exodus from the Iran market.

By utilizing only a handful of formal designations – such as those on the Treasury Department's ''Part 561'' List – and engaging in global sanctions diplomacy, the United States caused firms around the world to carefully scrutinize their dealings in or with Iran and weigh the relatively modest benefit of such dealings against forfeiting relationships with U.S. financial institutions or other U.S. persons.

Now, the U.S. Congress and the Executive Branch have increasingly looked to the Iran paradigm to apply to North Korea. In early 2016, President Obama signed the North Korea Sanctions and Policy Enhancement Act of 2016 (NKSPEA). It provided for both ''mandatory'' and ''discretionary'' sanctions.

The President is required to designate any firm determined to have knowingly assisted with the development of North Korea's weapons of mass destruction program, exported luxury goods to North Korea, engaged in money laundering, counterfeiting, cyber-attacks or narcotics trafficking on behalf of North Korea, among other actions.

In the event of such a finding, the President must impose asset blocking requirements against the offending firm and prohibit all transactions involving its property and property interest.

Such an action would be dramatic and far-reaching. It would completely end the offending firm's access to the U.S. market, U.S. banks, and U.S. persons. Any funds or other property interests that come under the possession or control of a U.S. person would need to be blocked. This is the same treatment that designated terrorists, narcotics traffickers, and other bad actors receive from the U.S. government.

The NKSPEA also provides the President with ''discretionary'' authority to select from a menu of sanctions to impose against those who provide material assistance to certain North Koreans that are already the subject of United Nations sanctions; engage in bribery in North Korea; assist in the misappropriation of North Korean funds; or financially support such activities.

The menu of sanctions includes less draconian measures than under the mandatory prong of NKSPEA, such as the application of ''special measures'' for U.S. financial institutions to address money laundering; prohibitions on forex transactions; prohibitions on transfers of credit or payment through the U.S. financial system; and certain other measures related to procurement, travel, and shipping.

The U.S. House of Representatives recently passed the Korean Interdiction and Modernization of Sanctions Act (KIMS Act), which would broaden the NKSPEA's authorities.

The KIMS Act would expand the list of activities triggering mandatory sanctions under the NKSPEA to include the purchase of certain minerals from North Korea, the provision of goods and services to sanctioned North Korean vessels, and the maintenance of a correspondent account with a North Korean bank.

The KIMS Act would also expand the list of activities triggering discretionary sanctions to address purchasers of products from North Korea's key export sectors (such as coal, iron, seafood, textiles) and suppliers of telecommunications and online commercial services.

Third-country firms in Asia and elsewhere that engage in these activities with North Korea may soon face the same dilemma that companies around the world faced after the passage of CISADA in 2010. Such exposure can be direct, as in the case of Asian banks that facilitate North Korea trade or finance. It can also be indirect, as in the case of U.S. and other firms that rely on North Korean rare earth minerals and other material inputs.

Even if the activities are not covered by the new prohibitions, firms will need to further consider the risk and reputational implications as such activities may invite scrutiny by the U.S. Treasury Department, Congress, or the press.

One distinguishing factor from the Iran experience is the relative economic isolation of North Korea. While North Korea has trading partners besides China, its access to the global economy is substantially more dependent on China than Iran's economic access was on any one country at the time of CISADA.

The United States was reluctant to target Chinese entities in the Iran case and will face similar diplomatic terrain with Beijing in relation to an effective secondary sanctions program against North Korea. South Korean president, Moon Jae-in, has signaled his interest in reviving the ''sunshine policy'' to reverse the isolation of North Korea in favor of deepening economic ties. This, too, could complicate efforts to aggressively pursue secondary sanctions.

Ultimately, as with Iran sanctions, secondary sanctions against North Korea will likely be driven by numerous constituencies in Congress, the Executive Branch, the think-tank community, and the press, as well as the complex geopolitical dimensions introduced by China, South Korea, and others.

Firms with direct or indirect exposure to North Korea will need to closely monitor developments – and undertake appropriate de-risking measures – to account for the emerging North Korea secondary sanctions pro-

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gram that will likely remain a significant enforcement priority for the current U.S. administration.