ALERT MEMORANDUM

Navigating Conflicts of Law: U.S. Sanctions and China's National Security Law

August 19, 2020

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

WASHINGTON

Paul Marquardt
+1 202 974 1648
pmarquardt@cgsh.com

Chase D. Kaniecki
+1 202 974 1792
ckaniecki@cgsh.com

Samuel Chang
+1 202 974 1816
sachang@cgsh.com

Following the enactment of the Hong Kong Autonomy Act (**HKAA**),[1] the issuance of Executive Order 13936,[2] which implemented sanctions authorities under the HKAA and other statutes, and other recent U.S. sanctions designations and enforcement actions, many multinational entities based or operating in Hong Kong are concerned with how to navigate the new landscape. Financial institutions subject to regulation by the Hong Kong Monetary Authority (**HKMA**) are in a particularly difficult position given the recent circular guidance from the HKMA reminding regulated institutions that "unilateral sanctions imposed by foreign governments are not part of the international targeted financial sanctions regime and have no legal status in Hong Kong" and that their policies should be "informed by a thorough assessment of any legal, business and commercial risks involved and based on a balanced approach. In assessing whether to continue to provide banking services to an individual or entity designated under a unilateral sanction which does not create an obligation under Hong Kong law, boards and senior management of [regulated institutions] should have particular regard to the treat customers fairly principles."[3]

This task is complicated not only by the obvious political sensitivities of sanctions targeting senior Chinese and Hong Kong officials, but by Article 29(4) of the new National Security Law governing Hong Kong, which provides that it is a criminal offense for any person to "conspire[] with a foreign country or an institution, organisation or individual outside the mainland, Hong Kong and Macao of the People's Republic of China, or directly or indirectly receive[] instructions, control, funding or other kinds of support from a foreign country or an institution, organisation or individual outside the mainland, Hong Kong and Macao of the People's Republic of China, to…impos[e] sanctions or blockade, or engag[e] in other hostile activities against the Hong Kong Special Administrative Region or

[1] Pub. L. 116-149. See our prior blog post at https://www.clearytradewatch.com/2020/07/united-states-enacts-additional-hong-kong-related-sanctions-impact-remains-unclear/.

[2] 85 Fed. Reg. 43413 (July 17, 2020). See our alert memorandum at https://www.clearygottlieb.com/-/media/files/alert-memos-2020/executive-order-eliminates-differential-treatment-for-hong-kong.pdf.

[3] HKMA Circular "Financial Sanctions (For AIs)" (Aug. 8, 2020), available at https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200808e2.pdf.

the People's Republic of China."[4] Press reports indicate significant uncertainty regarding how this provision will affect sanctions compliance efforts.[5]

The purpose of this memorandum is not to predict how the National Security Law will be interpreted and enforced. Rather, assuming that there is at least some risk of a conflict of laws between U.S. sanctions and Chinese law, and bearing in mind the HKMA's admonition to take a balanced, risk-based approach, we look to other circumstances in which multinational institutions have addressed the uncertainty created by potentially conflicting legal obligations, most notably so-called "blocking statutes,"[6] to examine how these institutions have navigated conflicting legal obligations.

A nuanced understanding of the underpinnings and effects of U.S. sanctions is critical to navigating this minefield. While it is impossible to make the issues disappear entirely, it is possible to understand and moderate the risks.

I. U.S. Sanctions Govern U.S. Dollar Clearing Transactions

Any transaction involving a person whose assets are blocked under U.S. sanctions must not take place within U.S. jurisdiction; this is simply a direct application of U.S. law. Many U.S. jurisdictional triggers are obvious, such as involvement of U.S. legal entities or individuals (including citizens, dual citizens, and "green card" holders) or activities physically within the United States. Less obvious, but clearly established in U.S. law and familiar to international financial institutions, is the prohibition on exporting goods or services from the United States for the direct or indirect benefit of a sanctioned person. Critically, this includes most U.S. dollar interbank transfers and foreign exchange transactions, even those involving non-U.S. financial institutions.[7] Ultimately, a transfer of U.S. dollars from one foreign person to another involves a transfer of U.S. dollars from one bank to another. As a practical matter, interbank U.S. dollar transactions are generally settled by transfers of funds between the banks' respective correspondent accounts in the United States. The same is true of foreign exchange transactions involving the U.S. dollar, which require a payment of U.S. dollars settling through the same mechanism. Thus, U.S. dollar transactions generally involve the use of the U.S. financial system, which is considered an export of services from the United States in which any sanctioned person benefiting from the transaction in question has an interest.

Blocking statutes purporting to prohibit compliance with U.S. sanctions by non-U.S. institutions have no influence on U.S. enforcement action against prohibited transactions clearing through the U.S. financial

[4] The Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region, available at http://english.scio.gov.cn/topnews/2020-07/01/content_76223722.htm.

[5] *See, e.g.*, Nikkei Asian Review, "The Hong Kong national security law: Five articles to know" (July 10, 2020), available at https://asia.nikkei.com/Politics/The-Hong-Kong-national-security-law-Five-articles-to-know; South China Morning Post, "Foreign firms in Hong Kong face 'huge uncertainty' over national security law" (July 7, 2020), available at https://www.scmp.com/news/china/diplomacy/article/3092229/foreign-firms-hong-kong-face-huge-insecurity-over-national.

[6] *See, e.g.*, Council Regulation 2271/96, as amended (European Union); Foreign Extraterritorial Measures Act, R.S.C. ch. F-29 (1985), as amended (Canada).

[7] There is a dollar clearing facility within Hong Kong, overseen by the HKMA, that may settle U.S. dollar transactions between two Hong Kong institutions. OFAC has, in some enforcement actions, looked through intermediary banks settling interbank transactions on their own books and then transferring U.S. dollar payments on to third parties, and it is unclear to what extent they would attempt to exercise jurisdiction over U.S. dollar transactions using the Hong Kong facility.

system. From the U.S. perspective, this is not an extraterritorial exercise of jurisdiction. All of the parties to the transaction may be physically outside the United States, but if they use the U.S. financial system to clear the transaction they must, in the U.S. view, comply with U.S. law. Engaging in such a transaction passing through the U.S. financial system on behalf of a sanctioned person, even if it involves a Chinese bank acting on behalf of a Chinese official, constitutes a civil and, if willful, criminal violation of U.S. law, and U.S. authorities will give no deference to what Chinese law may say about the use of correspondent accounts in the United States in assessing their enforcement response, which will be viewed as a law enforcement matter purely within the competence of the United States.

As a result, even where the risk of blocking statute enforcement is real, international financial institutions generally will not engage in U.S. dollar transactions (or transactions involving securities issued or held in the United States, which raise similar issues) on behalf of or involving U.S.-sanctioned persons. This is a fairly bright line, and when it is crossed the institutions in question violate U.S. law and take a significant risk of civil or criminal enforcement action. However, this is not the same as refusing all transactions with U.S.-sanctioned persons.

II. Secondary Sanctions Are a Question of Politics, Not Law

The picture is quite different when it comes to secondary sanctions, which threaten the imposition of U.S. sanctions against parties that engage in specified transactions outside U.S. jurisdiction. Of course secondary sanctions are rooted in law. There are laws that provide authority to impose secondary sanctions, provide guidance on when they are meant to be imposed, and even purport to mandate their imposition. However, the process that determines whether secondary sanctions are in fact imposed on any particular individual or institution is entirely political. There is no judicial or administrative adjudicative proceeding, there are no civil or criminal penalties imposed, and properly speaking one cannot “violate” secondary sanctions. They are not an exercise of U.S. jurisdiction over the target. Rather, the question is whether the United States will use its authority to order persons who are within its jurisdiction to cease trading with the target by placing the target on a sanctions list. Unless and until the relevant political officials take the additional step of exercising that authority, the secondary sanctions have no legal effect.

This may seem a matter of semantics; after all, the imposition of U.S. sanctions has severe and possibly catastrophic economic consequences, and it would be cold comfort indeed to a sanctioned party to hear that at least it hadn’t been convicted or fined. The risk of adverse consequences is real. However, understanding the discretionary nature of secondary sanctions is critical to understanding the possibility and legitimacy of taking a risk-based approach to addressing and moderating the threat of those sanctions. The actual imposition of secondary sanctions is relatively rare, and there are many entities engaged in sanctionable activity that are not in fact added to sanctions lists. This is not to say that the risk of secondary sanctions is not real or not important, but rather that it is not as simple as “permitted” versus “prohibited.”

In a sense, secondary sanctions are more a matter of new presentation than new law. Boilerplate language in nearly every modern Executive Order imposing sanctions under U.S. law (including those that have been used to target various Chinese parties) has long stated that any person found “to have materially assisted, sponsored, or provided financial, material, or technological support for, or goods or services to or in support of” a person or entity blocked under that order may in turn be sanctioned.

However, beginning with sanctions on Iran and continuing with an ever-growing number of programs, the threat that U.S. sanctions will be imposed on those dealing with blocked persons has been made more explicit and specific (and, in some cases, broadened). More specific secondary sanctions language underlines the threat, increases political pressure to in fact impose sanctions, and is intended to serve as a deterrent. In the case of the HKAA, the statute calls for the imposition of sanctions on any foreign financial institution that "knowingly conducts a significant transaction with" a person or organization sanctioned under the HKAA.[8]

The question becomes, then, what sorts of activities are most likely to result in the imposition of secondary sanctions. This is a matter of judgment and risk appetite; there are no guarantees. However, there is some formal guidance available, which aligns with practical experience. U.S. officials have no interest in providing a clear roadmap to which transactions will or will not be considered "significant," but they have issued general statements with respect to similar sanctions programs making clear that both qualitative and quantitative factors will be considered as part of the totality of the circumstances. These factors include (a) the size, number, and frequency of the transactions; (b) the nature of the transactions, including their type, complexity, and commercial purpose; (c) the level of awareness of management and whether the transactions are part of a pattern of conduct; (d) the nexus of the transactions, financial services, and financial transactions to blocked persons; (e) the impact of the transactions, financial services, and financial transactions on program objectives; (f) whether the transactions, financial services, and financial transactions involve deceptive practices; and (g) any other factors deemed relevant.[9] The Departments of Treasury and State have also indicated publicly that in general they expect to engage with potential targets of secondary sanctions to discuss their concerns prior to actually imposing sanctions; this has often, though not always, been the case, particularly where the potential target is a significant entity. The HKAA explicitly contemplates a warning mechanism, providing for the listing of banks engaged in "significant transactions" a year prior to the mandatory imposition of sanctions, with a process for discontinuing the activities and being removed from the list.

Like any political decision, the imposition of secondary sanctions can be unpredictable, and the risks are not subject to quantification. It plainly is the case, however, that the proportion of entities engaged in transactions of any kind with U.S.-sanctioned persons that could, in theory, result in the imposition of secondary sanctions that are in fact sanctioned is quite small, and in most of those cases the transactions go directly to core policy concerns of the United States.

III. A Risk-Based Approach

As noted, this is not the first time that non-U.S. financial institutions have had to navigate between aggressive U.S. sanctions enforcement and national statutes purporting to prohibit enforcement and compliance. A number of those principles and lessons may be useful, and consistent with HKMA guidance, in addressing the current situation.

First, in our experience, sophisticated multinational institutions will not violate direct U.S. sanctions. After a long string of bank enforcement actions, it is quite clear that the United States views the use of the U.S. dollar clearing system as being within its jurisdiction even if both parties to the transaction are

[8] HKAA, §§ 5(b), 7.

[9] *See* 31 C.F.R. §§ 561.404, 562.407 (interpreting "significant transaction" for purposes of Iranian secondary sanctions).

outside the United States, and it will no more hesitate to bring civil or criminal enforcement actions than if a price-fixing cartel or financial fraud were agreed outside the United States. Moreover, as a practical matter, it is not possible to conduct transactions involving sanctioned parties through the U.S. financial system without making misrepresentations to the financial institutions involved, which often both constitutes a separate offense in itself and endangers critical commercial relationships. In the end, the use of the U.S. financial system to conduct transactions on behalf of sanctioned persons is a clear violation of U.S. law against which a successful defense is unlikely.

Other transactions involving U.S.-sanctioned persons are different in kind, and many institutions have balanced commercial risks (including credit risk), reputational risks (including risks to international financing), and regulatory risks in deciding which transactions the institution is willing to pursue in light of blocking statutes. We have also seen institutions document the multiple considerations that go into managing the relevant relationships to make clear that the institution is not simply mechanically refusing all transactions with U.S.-sanctioned persons solely because they have been designated. Secondary sanctions risks are really just a variation on this theme, and many of the factors in the guidance on which transactions are likely to be considered "significant" (qualitative nature of the transaction, size of the transaction, etc.) are those we have seen institutions consider in assessing the commercial, reputational, and compliance risks of the transaction. Transactions subject to secondary sanctions are not illegal; they are outside the jurisdiction of the United States. They do, however, present additional risk, which must be accounted for and weighed against other risks.

Seen in this light, the choice for institutions operating in China is less stark than whether to refuse or accept all transactions with U.S.-sanctioned persons. An institution might, for example, reasonably conclude that a new significant commercial loan to a company controlled by a sanctioned person presents a different type and magnitude of risk, for credit and reputational reasons, than maintaining a retail checking account for that person – which in turn presents a different level of risk than processing a customer payment to that person. Similarly, such an assessment may be more consistent with the HKMA circular's guidance to take a "balanced approach" in assessing legal, business and commercial risks. While there will be no guarantee that either authority will accept the path an institution chooses to walk, historical experience is that a path toward balancing competing risks and considerations exists and is wider than might seem to be the case.

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