FINANCIAL INTEGRITY NETWORK

Financial Integrity Network Policy Alert
Executive Order 13810 Intensifies U.S. Sanctions Targeting North Korea
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Summary

The United States last week dramatically expanded the scope of its North Korea sanctions, making financial institutions that participate in North Korea-related trade vulnerable to losing their access to the U.S. financial system. Executive Order 13810, which President Donald Trump issued on September 21, 2017, authorizes the Treasury Secretary to impose sanctions on:

- Any non-U.S. financial institution that knowingly facilitates a "significant transaction" with any person designated under previous North Korea-related executive orders or any person designated under Executive Order 13382 for helping North Korea;
- Any non-U.S. financial institution that knowingly conducts or facilitates any "significant" trade transaction involving North Korea;
- Any person or entity that has engaged in at least one "significant" importation from or exportation to North Korea of any goods, services, or technology;
- Any North Korean person; and
- North Korean port operators.

Executive Order 13810 also authorizes the Treasury Secretary to identify non-U.S. bank accounts that are controlled by North Korean persons or used to transfer funds for a North Korean person. Once a foreign account is identified, U.S. persons will be required to block any funds that have passed through those accounts. In addition, the new executive order expands sectoral sanctions and prohibits aircraft and vessels that call on North Korean ports from calling on U.S. ports within six months of their port calls in North Korea.

Executive Order 13810 is part of a growing set of financial and economic measures that are intended to increase the pressure on North Korean financial and commercial networks and motivate China to pressure Pyongyang. Both the U.S. Congress and the United Nations have passed stricter sanctions measures within the past two months, and the Treasury Department has used existing sanctions and anti-money laundering (AML) authorities to tighten the net around North Korea. On June 29, 2017, the Treasury Department determined that China's Bank of Dandong was a "primary money laundering concern" because it facilitated prohibited North Korean financial transactions and sanctions evasion.[1] On September 11, 2017, the U.N. Security

[1] See "Proposal of Special Measure against Bank of Dandong as a Financial Institution of Primary Money Laundering Concern," June 29, 2017.

Council adopted Resolution 2375, which curbs North Korea's energy imports, prohibits the issuance of new work authorizations to North Korean laborers, and bans North Korean textile exports. After the resolution was adopted, Treasury Secretary Steven T. Mnuchin told CNBC "If China doesn't follow these sanctions, we will put additional sanctions on them and prevent them from accessing the U.S. and international dollar system."[2] President Trump said on September 21, 2017, that the People's Bank of China (PBOC) has ordered its banks to stop doing business with North Korea.[3]

The sanctions and financial regulatory and enforcement attention on North Korea is likely to increase in the weeks and months following the issuance of the executive order. We expect the U.S. government to use the new authorities in Executive Order 13810 aggressively as it also urges countries to implement the recently enacted UN resolution, because the North Korean weapons of mass destruction (WMD) program and proliferation threatens the United States, its territories, and its allies and partners.

North Korea-related sanctions and AML risks extend well beyond the Korean Peninsula and mainland China. So far this year, the Treasury Department has designated people and companies under North Korea sanctions authorities in Russia, Hong Kong, and Singapore, in addition to China and North Korea. In the face of intensifying sanctions, North Korea is likely to continue employing deceptive practices to maintain access to the international financial system and find new ways to finance their procurement and commercial operations. While continuing to maintain robust sanctions screening systems, financial institutions should review and adjust their AML programs with an eye toward detecting possible North Korea-related activity and conducting enhanced due diligence on unusual transactions.

Designation Criteria and Prohibitions

Executive Order 13810 contains six new designation criteria, one expanded designation criterion, and two new prohibitions. The United States has maintained a full trade embargo on North Korea since March 2016, so additional designations of North Korean people and entities have little impact on U.S. financial institutions. However, when any new designations under this executive order are paired with the powerful, sweeping sanctions authorized by the new executive order, the new designations will send ripples worldwide, particularly in the financial services sector.

New Designation Criteria

Criterion 1: Authorizes sanctions against any non-U.S. financial institution[4] that knowingly conducts or facilitates any significant transaction on behalf of any person or entity that is

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[2] "CNBC Exclusive: CNBC's "Squawk Box" Interviews Treasury Secretary Steven Mnuchin from CNBC Institutional Investor Delivering Alpha Conference Today," September 12, 2017.

[3] "Remarks by President Trump, President Moon of the Republic of Korea, and Prime Minister Abe of Japan Before Trilateral Meeting," September 21, 2017.

[4] We use the term "non-U.S." instead of "foreign" throughout for the convenience of readers outside the United States. The executive order uses "foreign financial institution" and defines a "foreign financial institution" as "any foreign entity that is engaged in the business of accepting deposits, making, granting, transferring, holding, or brokering loans or credits, or purchasing or selling foreign exchange, securities, commodity futures or options, or procuring purchasers and sellers thereof, as principal or agent. The term includes, among other entities, depository institutions; banks; savings banks; money service businesses; trust companies; securities brokers and dealers; commodity futures and options brokers and dealers; forward contract and foreign exchange merchants; securities and commodities exchanges; clearing corporations; investment companies; employee benefit plans; dealers in precious metals, stones, or jewels; and holding companies, affiliates, or subsidiaries of any of the foregoing." See Executive Order, Section 8(e).

designated under Executive Order 13551, Executive Order 13687, Executive Order 13722, the new executive order, or Executive Order 13382, if the person or entity was designated in connection with North Korea-related activities. Under this criterion, the Treasury Secretary may impose full blocking sanctions or prohibit the maintenance of correspondent accounts in the United States.

Implications: This designation criterion attaches secondary sanction penalties to financial facilitation for individuals or entities designated for aiding North Korea-related weapons proliferation and those designated under executive orders targeting the North Korean government and North Korean malicious cyber activity. Of all the designation criteria, this one is likely to have the greatest immediate impact in the financial services sector. Non-U.S. financial institutions *knowingly* conducting *significant* transactions involving North Korea-related specially designated nationals (SDNs) risk losing their access to U.S. correspondent accounts and having their U.S. assets blocked.

- "Significant" is not defined in Executive Order 13810. However, this provision is similar to the secondary sanctions provision in the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA).[5] Under CISADA, two non-U.S. banks, China's Bank of Kunlun and Iraq's Elaf Bank, were found to have conducted "significant" transactions with designated Iranian banks.[6] Both banks conducted transactions with designated Iranian banks worth tens of millions of dollars. Thus, transactions worth tens of millions of dollars appear to satisfy the "significant" threshold, judging from prior designations in a separate program, but we do not know whether smaller transactions could also meet the "significant" threshold or whether the "significant" threshold could be met by a qualitative assessment of how important a transaction is to North Korea.

- While uncertain, it is likely that "significant" transactions do not include normal account maintenance fees, because the Treasury Department has licensed those transactions for U.S. financial institutions. However, financial institutions should be exceedingly cautious in conducting any such business, because the Treasury Department's Office of Foreign Assets Control (OFAC) has significant discretion in determining what constitutes "significant."

- "Knowingly" is defined in Executive Order 13810: "Knowingly, with respect to conduct, circumstance, or a result, means that a person has actual knowledge, or should have known, of the conduct, the circumstance, or the result."[7] The public nature of U.S. designations makes satisfying the knowledge bar easy for OFAC when a transaction involves an SDN. However, because the definition of "knowingly" also includes "should have known," OFAC could also apply sanctions to financial transactions involving people and entities not on the SDN list. "Should have known" implies an expectation of some level of due diligence, so secondary sanctions also could attach to transactions involving entities not on the SDN list, including those owned 50 percent or more by SDNs, which are commonly

[5] See the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010.
[6] See "Treasury Sanctions Kunlun Bank in China and Elaf Bank in Iraq for Business with Designated Iranian Banks," July 31, 2012.
[7] See Executive Order, Section 8(f).

called “shadow SDNs.” “Knowingly” was given the same treatment in previous secondary sanctions legislation and regulations.[8]

- The Treasury Department’s June 29, 2017, finding that the Bank of Dandong was a “primary money laundering concern” also illuminates factors that the Treasury Department may consider when determining whether a non-U.S. financial institution has knowingly conducted a significant transaction with a North Korea-related SDN. According to the finding, the Bank of Dandong conducted transactions with Kwangson Banking Corporation (KKBC), a North Korean bank designated by the United States and listed by the United Nations for providing financial services in support of North Korean WMD proliferators. With respect to knowledge, KKBC had a representative embedded at the Bank of Dandong. With respect to significance, between May 2012 and May 2015, at least 17 percent of the transactions that the Bank of Dandong conducted through the United States involved companies that had transacted with or on behalf of sanctioned North Korean entities.[9]

Criterion 2: Authorizes sanctions against any non-U.S. financial institution that knowingly conducts or facilitates any “significant” trade transaction involving North Korea. Like Criterion 1, this criterion authorizes the Treasury Secretary to impose full blocking sanctions or prohibit the maintenance of correspondent accounts in the United States.

Implications: This provision carries tremendous risk for non-U.S. financial institutions, because of its broad reach and because North Korea engages in deceptive financial practices. Under the definition of “knowingly” in Executive Order 13810, a financial institution that processes a trade transaction with a clear nexus to North Korea is at high risk of being sanctioned. Because the definition of “knowingly” also includes “should have known,” a financial institution that fails to conduct proper due diligence on a trade transaction and does not identify a North Korean nexus may also be at risk of being sanctioned, reinforcing the message that financial institutions need to anticipate sanctions risk and even future designations. What was previously indirect sanctions exposure through client and counterparty risk is now direct sanctions exposure, because this designation criterion looms over every financial institution that participates in a trade transaction involving North Korea. Notably, this designation criterion in effect appears to prohibit transactions related to North Korea’s procurement of refined petroleum products, which are explicitly permitted by U.N. Security Council Resolution 2375.[10]

Criterion 3: Authorizes the Treasury Secretary to identify non-U.S. bank accounts that are owned or controlled by a North Korean person or entity or that have been used to transfer funds in which any North Korean person or entity has an interest. All funds that originate from, pass through, or are destined for an account identified by the Treasury Secretary must be blocked if they come under the control of a U.S. person or entity.

Implications: This criterion effectively allows the Treasury Secretary to designate non-U.S. bank accounts and impose full blocking sanctions on funds associated with those accounts. That the

[8] See the Hizballah International Financing Prevention Act of 2015 and the Countering America’s Adversaries Through Sanctions Act of 2017.
[9] See “Proposal of Special Measure against Bank of Dandong as a Financial Institution of Primary Money Laundering Concern,” June 29, 2017.
[10] UNSCR 2375 allows North Korea to import 500,000 barrels of refined petroleum products from October 1, 2017, until the end of the year and 2,000,000 barrels of refined petroleum products in 2018, and each subsequent year.

money touching these accounts will be blocked upon reaching the United States is an obvious outcome of this measure. However, non-U.S. financial institutions that refuse to block funds associated with sanctioned accounts could be at risk of causing their employees who are U.S. persons[11] to violate U.S. sanctions, regardless of the currency in which the funds are denominated. This would expose such non-U.S. financial institutions to civil and criminal liability in the United States.

Criterion 4: Authorizing sanctions against owners and operators of seaports, airports, and land ports in North Korea.

Implications: Anyone helping to operate a North Korean port or providing financial services to a North Korean port is instantly at risk, because the defined universe of possible targets is both clear and finite. In addition, Criterion 2, which authorizes sanctions against non-U.S. financial institutions that conduct significant trade transactions involving North Korea, creates a sanctions risk for non-U.S. financial institutions that conduct transactions with North Korean port operators.

Criterion 5: Authorizes sanctions against any North Korean person[12] or entity, including a North Korean person who has engaged in commercial activity that generates revenue for the North Korean government or the Workers' Party of Korea.

Implications: This criterion is extremely broad, but the focus appears to be on North Koreans who are providing support to the government and the ruling party. The wording of this criterion, however, does not require the Treasury Department to make a showing that a person has supported the government or ruling party before it can carry out a designation, so it provides the Treasury Department with the flexibility to develop a list of sanctioned individuals and entities quickly. Like Criterion 4, this criterion will not have a practical effect until the Treasury Department designates people and companies. After new designations, financial institutions will be at risk of being sanctioned for doing business with the designated entities, though Criterion 2, which authorizes sanctions against non-U.S. financial institutions that conduct significant trade transactions involving North Korea, already creates a sanctions risk for non-U.S. financial institutions that conduct transactions with North Koreans.

Criterion 6: Authorizes sanctions against any person or entity that has engaged in at least one "significant" importation from or exportation to North Korea of any goods, services, or technology.

Implications: This criterion creates sanctions liability for people and companies who trade with North Korea, in addition to the sanctions liability for financial institutions created by Criterion 2. This criterion will make it easier for the Treasury Department to designate companies trading with North Korea, which could result in a flood of designations of Chinese entities. As with Criterion 2, this designation criterion in effect appears to prohibit shipments to North Korea of refined

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[11] "'U.S. person' means any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction within the United States (including foreign branches), or any person in the United States." See Executive Order, Section 8(c).

[12] "'North Korean person' means any North Korean citizen, North Korean permanent resident alien, or entity organized under the laws of North Korea or any jurisdiction within North Korea (including foreign branches). For the purposes of section 1 of this order, the term "North Korean person" shall not include any United States citizen, any permanent resident alien of the United States, any alien lawfully admitted to the United States, or any alien holding a valid United States visa." See Executive Order, Section 8(d).

petroleum products, which are explicitly permitted by U.N. Security Council Resolution 2375.[13]

Expanded Designation Criterion

Expanded Criterion 1: Expands sectoral sanctions by authorizing sanctions against entities operating in the construction, energy, fishing, information technology, manufacturing, medical, textiles, or transportation industries in North Korea, building on previous executive orders that subjected entities in the metals, minerals, transportation, mining, energy, and financial services in North Korea to U.S. sanctions.

Implications: This criterion expands the sectors of the North Korean economy subject to U.S. sanctions. Because the United States already has a full trade embargo against North Korea, the expansion will not have a practical effect for U.S. financial institutions. Like Criteria 4 and 5, this criterion will not have a practical effect for non-U.S. financial institutions until the Treasury Department designates entities. After new designations, financial institutions will be at risk of being sanctioned for doing business with the designated entities, though Criterion 2, which authorizes sanctions against non-U.S. financial institutions that conduct significant trade transactions involving North Korea, already creates a sanctions risk for non-U.S. financial institutions that conduct transactions with North Korean companies.

New Prohibitions

Prohibition 1: Bans aircraft in which a foreign person has an interest from landing in the United States if it has landed in North Korea within the past six months.

Prohibition 2: Bans vessels in which a foreign person has an interest from calling on U.S. ports if the vessel has called on a North Korean port in the past six months or engaged in a ship-to-ship transfer with such a vessel in the past six months.

Implications: These criteria are designed to pressure the airline and shipping industries to end service to North Korea. They also put pressure on intermediaries and facilitators to track transport to, from, and around North Korea more closely. Notwithstanding North Korea's 880-mile land border with China and 11-mile land border with Russia, these prohibitions could curtail North Korean sanctions evasion by making the physical delivery of goods more difficult.

Recommendations

The illicit finance risks associated with North Korea are not new, but Executive Order 13810 dramatically increases the regulatory exposure for North Korea-related customers and transactions. Before this executive order was issued, clients trading with North Korea created indirect sanctions exposure for financial institutions. Now, that exposure is direct, because financial institutions can be designated for facilitating trade with North Korea.

[13] UNSCR 2375 allows North Korea to import 500,000 barrels of refined petroleum products from October 1, 2017, until the end of the year and 2,000,000 barrels of refined petroleum products in 2018, and each subsequent year.

Financial institutions should review their policies and procedures governing clients with North Korea-related exposure and reassess their risk appetite for any North Korea-related exposure. Even when banks have decided to eliminate all North Korea-related exposure, they will still need to maintain robust counter-illicit finance programs, particularly for transactions involving China and Russia, because North Korea has a history of engaging in deceptive financial practices to evade sanctions. Avoiding running afoul of the new sanctions will require financial institutions to ensure that their screening systems are sound and monitoring measures robust to address North Korea-related risk.

- Non-U.S. financial institutions should immediately terminate relationships with any North Korea-related SDNs and any customers involved in unlicensed North Korean trade. They also should make sure that all North Korea-related SDNs are in their screening filters, and implement policies to ensure that all transactions involving North Korea-related SDNs or unlicensed North Korean trade are rejected or blocked, regardless of the currency in which the transactions are denominated.

- Financial institutions should consider terminating relationships with all North Korean nationals and entities. In the event that a financial institution decides to retain a relationship with a North Korean national, the institution should conduct enhanced due diligence on every transaction involving the North Korean national to ensure that the transaction does not put the financial institution at risk of being sanctioned. North Korean port operators, government officials, and businesses that provide financial support to the government or the North Korean Workers' Party are particularly high-risk clients and counterparties, because they have been specifically identified in the executive order as targets for designation.

- Financial institutions should conduct enhanced due diligence on any customer with ongoing or recent exposure to North Korea and reevaluate whether they should maintain those relationships, even if North Korean trade through such relationships is licensed.

- Financial institutions should strongly consider reporting all attempted transactions involving North Korea to their domestic authorities and directly to the U.S. government when permissible under local law. Treasury Assistant Secretary Marshall Billingslea earlier this month called on financial institutions around the world to help the U.S. government identify North Korea-related financial activity, saying, "[i]t is incumbent on those in the financial services industry who might be implicated in the establishment of shell or front companies for the DPRK, and anyone who is aware of such entities, to come forward with that information now, before they find themselves swept up in our net."[14] The clear implication is that institutions that are helpful will be viewed differently by U.S. authorities from those that remain silent.

- Screening the SDN and UN lists is insufficient to protect financial institutions from North Korea-related risk, because North Korea has engaged in deceptive financial practices to

[14] "Testimony of Assistant Secretary Marshall S. Billingslea Before House Foreign Affairs Committee on Threat Posed by North Korea," September 12, 2017.

evade sanctions in the past. Therefore, financial institutions should consider enhancing monitoring systems to detect possible North Korea-related activity. Possible red flags include the appearance of new counterparties in China, particularly in Dandong Province, which borders North Korea. Financial institutions should consider conducting enhanced due diligence on new Chinese counterparties, especially those that appear to be shell companies.

- The U.N. Panel of Experts and C4ADS, a nonprofit organization that provides data-driven analysis on global conflict, both have issued reports documenting North Korean sanctions evasion typologies.[15] These reports can serve as the basis for enhanced business intelligence on North Korean facilitation networks.

- Although China has long been a financial stronghold for North Korea, China should not be the sole focus of efforts to discover North Korea-related risk. In the past year, the United States has also designated people and entities in Russia, Singapore, and Hong Kong. A particular focus should be identifying shell company accounts that are actually shadow correspondent accounts for North Korean banks. Common red flags include missing or incomplete information in payment messages, high account turnover, and a large amount of third-party payments, particularly with counterparties suspected of trading with or otherwise related to North Korea.

[15] See "Midterm Report of the Panel of Experts Established Pursuant to Resolution 1874 (2009)," U.N. Panel of Experts, August 4, 2017, and "Risky Business: A System-Level Analysis of the North Korean Proliferation Financing System," C4ADS, 2017.