

Steering Clear of the Spectre of Secondary Sanctions

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Residents of Hong Kong will doubtless be aware that current Chief Executive, John Lee Ka-chiu, receives his salary in cash. He has the same problem former Chief Executive, Carrie Lam Cheng Yuet-Ngor, often talked about. Ms Lam has even suggested that in the future her pension may even have to be paid in cash. All this is a result of being the subjects of US unilateral sanctions. But why?

On the face of it, unilateral sanctions seem to only apply to the persons of the issuing country. A country puts a person or an entity on their sanctions lists, therefore blocking that person or entity's assets and generally prohibiting the issuing country's citizens, residents, and incorporated companies from dealing with them. These are called primary sanctions. Main sanctions issuers include the United Nations Security Council, the European Union, Australia, Canada, Japan, Switzerland, the United Kingdom, and, of course, the United States.

Let's start with a quick rundown of US sanctions in general. The United States Office of Foreign Asset Control (OFAC) has 38 sanctions programs from Afghanistan to Zimbabwe, from rough diamond trade control to cybersecurity. They are broadly divided into two categories: specially designated nationals ("SDNs") and everything else, known as Non-SDN.

The SDN list is the list of blocked persons, i.e. persons (natural and legal) whose assets are blocked and with whom US persons are generally prohibited from dealing although there are usually certain exemptions, for example, being able to travel to and use transport of a country subject to a sanctions regime, or provision of humanitarian aid. The list includes over 6,300 individuals and entities, and the list of entities is not exhaustive.

The Non-SDN list is a smaller and more mixed bag of individuals and entities and US Persons are prohibited from activities ranging from purchasing listed securities of entities on the list, to being prohibited from engaging with them in certain sectors but not others. This list runs to around 450 individuals and entities, and again the list of entities is not exhaustive.

Why is the list of entities not exhaustive? This is a result of the so-called 50% rule when any individual holding equal to or greater than 50% of any entity, whether directly or indirectly (including on an aggregate basis), causes that entity to also be blocked. Since OFAC cannot possibly know all the entities which a sanctioned individual may hold a 50% or greater stake, the list comprises only those they know of. This highlights the importance of understanding who the beneficial owner of an entity is.

But all this only applies to US persons, right? So as a non-US person we can still do business with these people and companies? That's where it gets tricky. The United States also adopts a system of so-called secondary sanctions.

Secondary sanctions risk is founded upon one of the key principles of imposing sanctions in the first place: to effect a change in the behaviour of a country or regime that is violating human rights, waging war, or endangering international peace and security. Sanctions can become fairly blunt tools if people can (legally) work around them, and, despite understandable cries of overreach, this is something the US government has sought to punish. Therefore, it has identified individuals and entities which, even though they are not US persons, engage with SDNs and provide material assistance in helping those sanctioned individuals or entities not feel the intended effect of the block on interaction with the United States.

For this reason, no matter how unjustified the HKMA and the banks themselves may feel the sanctions are, no bank would currently allow Carrie Lam or John Lee to be a customer, and therefore accept salary payments from the Hong Kong government, because they would potentially incur the wrath of OFAC and a place alongside the incumbent and erstwhile Chief Executive of Hong Kong.

A place on the US sanctions list would see any bank frozen out of the US dollar market. It would mean many other banks would no longer transact with them. It would absolutely affect the shareholder value, would probably cause a run on the bank, and lead to insolvency and the bankruptcy courts. All very good reasons for Hong Kong banks to observe and obey US sanctions, regardless of whether they are applicable to them or not, even though it severely impacts some very senior Hong Kong politicians.

Simply put, if you help someone on OFAC's SDN list, OFAC could decide you're threatening their policy and they'll put you on the list as a secondary sanctions risk.

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