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Understanding and Navigating Iran and Russia Sanctions- related risk

Hogan Lovells and Kharon
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- Introduction
- 50% rule, “shadow” SDNs and control vs ownership
- Secondary sanctions
- Blocking laws – compliance perspectives and strategies
- Due diligence and shipping – sector-specific commentary
- Q&As

Speakers



Joshua Shrager

SVP, Kharon
New York City
Email: shrager@kharon.com
Phone: +1 646 921 8631



Howard Mendelsohn

Chief Client Officer, Kharon
Washington, D.C.
Email: mendelsohnh@kharon.com
Phone: +1 (202) 517-0711



Thomas Mounty

Account Executive, Kharon
London
Email: mountyt@kharon.com
Phone: +44203 868 3815



Jamie Rogers

Partner, Hogan Lovells
London
Email: jamie.rogers@hoganlovells.com
Phone: +44 20 7296 5795



Aleksandar Dukic
Partner, Hogan Lovells
Washington, D.C.
Email:
aleksandar.dukic@hoganlovells.com
Phone: +1 202 637 5466



Ellie Rees
Associate, Hogan Lovells
London
Email: ellie.rees@hoganlovells.com
Phone: +44 20 7296 5929



Magnus Burrough
Chief Counsel – Global Regulatory,
Koch International
London
Email:
magnus.burrough@kochps.com
Phone: +44 20 7260 3019

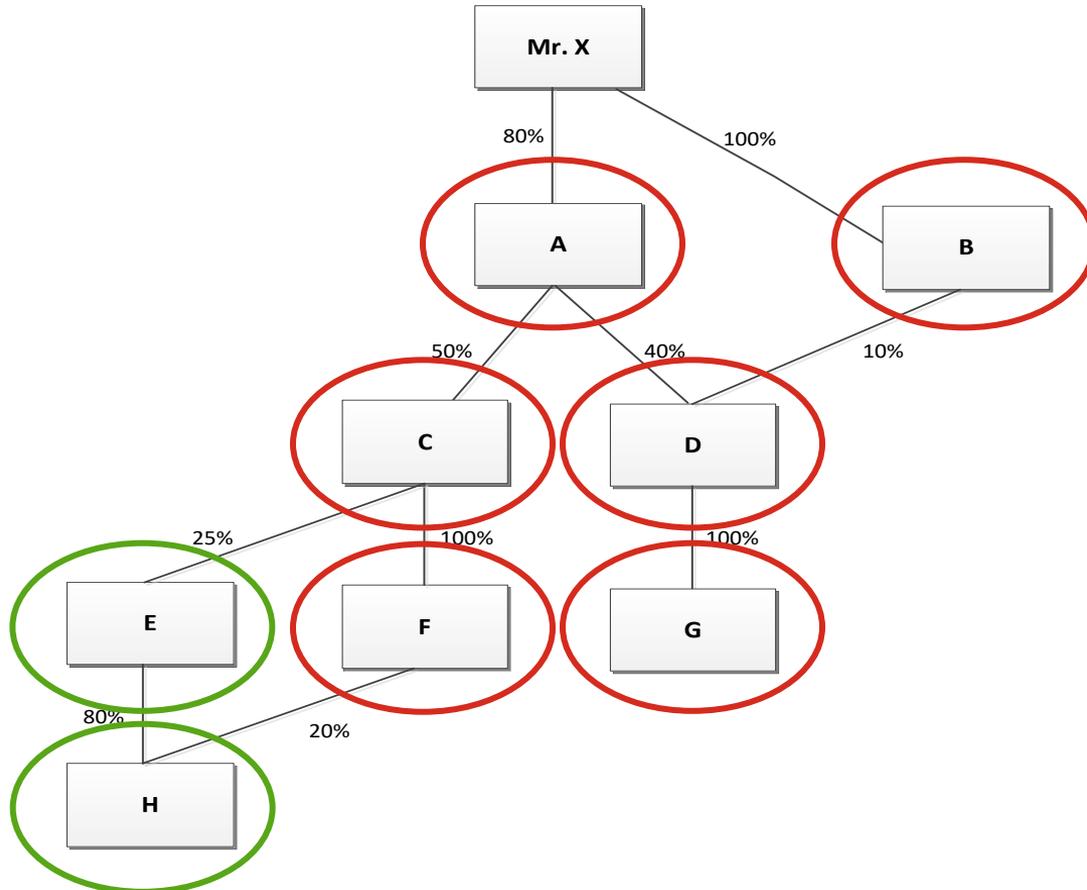


Chris Po-Ba
Compliance and Financial Crime,
Corporation of Lloyd's
London
Email:
chris.po-ba@lloyds.com
Phone: +44 20 7327 5473

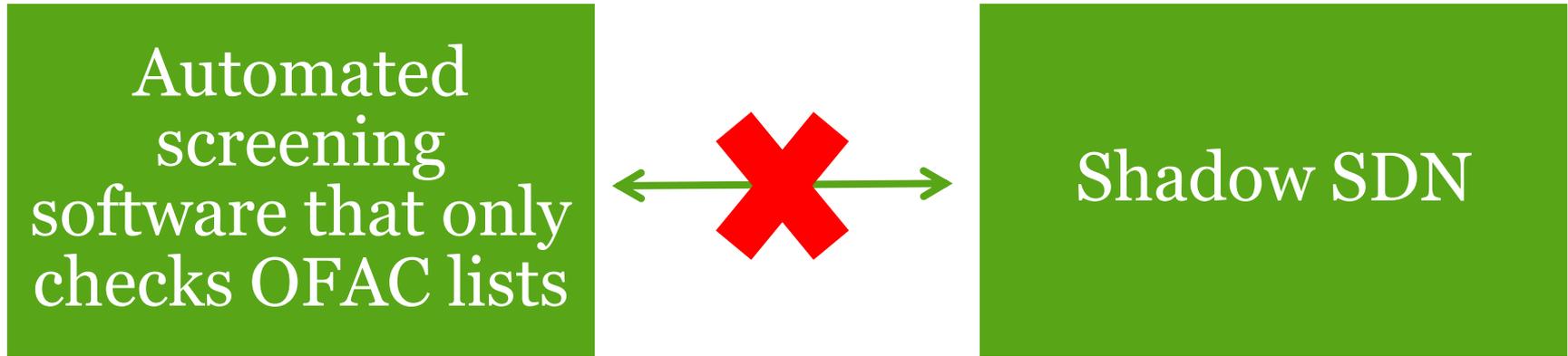
A photograph of a person silhouetted against a sunset over a body of water. The person is standing on a beach, holding a hat. The sky is a mix of blue and orange, with mountains visible in the distance. A green trapezoidal shape is overlaid on the right side of the image, containing white text.

50% rule,
“shadow” SDNs
and control vs
ownership

Featured image from Hogan Lovells 2018 *Capture* Photography Competition



- Apply “cascading” (waterfall) analysis, going step-by-step down the corporate ladder, with no dilution of interest
- Apply “aggregation” principle by combining interest held by sanctioned parties targeted by the same type of sanctions (e.g., combine interest of two SDNs)



- The challenge:
 - Shadow SDNs are not on the SDN List
 - Compliance obligations remain

What can you do beyond checking OFAC lists?

Use an enhanced screening tool

Research UBOs using public sources

Use certificates/written representations about ultimate ownership

Use a sanctions contract clause

Visit office, facility in person

Meet board/senior management

Validate previously communicated information

Approach US government for guidance

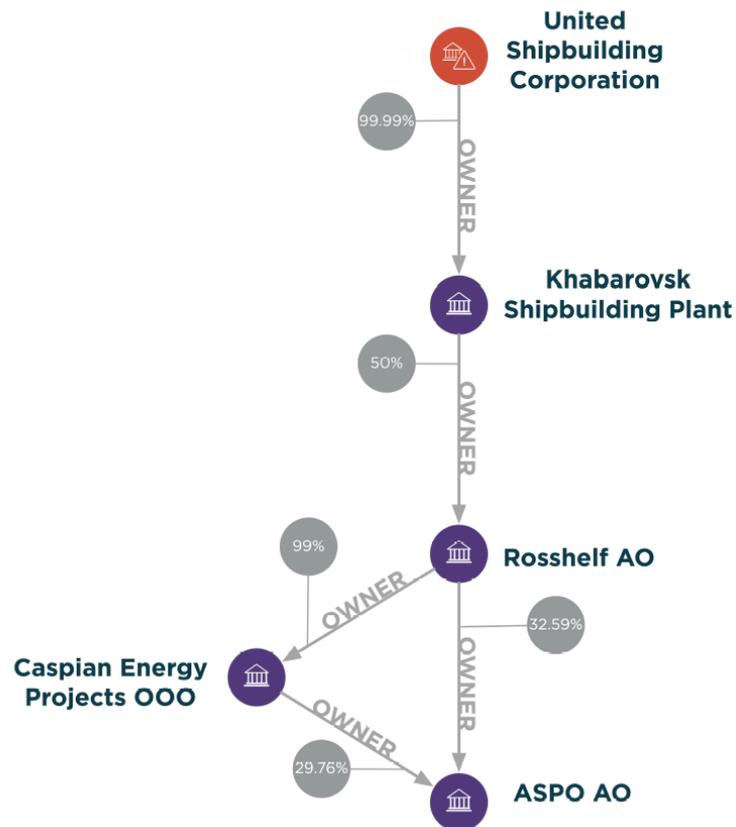
- US Embassy in country
- OFAC

- “50% rule” – ownership/equity interest determines if entity is automatically treated as sanctioned
- “Control” by an SDN does not automatically taint an entity in which the SDN holds a minority interest (FAQ 398), but:
 - OFAC “urges caution” by US persons where SDN has “a significant ownership interest that is less than 50 percent” or “may control by means other than a majority ownership interest”
 - US persons cannot deal with an SDN acting on behalf of non-sanctioned entity
 - OFAC can use “control” as a factor leading to a future SDN designation of that entity

- “Control” is also part of the definition of “Government of Iran”, “Government of Venezuela” etc.
 - Entity that is “owned or controlled” by such sanctioned governments must be treated as sanctioned whether or not the entity is on SDN List
- 50% rule applies to listed SDNs (and SSIs and FSEs)
- For a sanctioned government, have to look at control, not just ownership
- “Control”: is entity sanctioned due to control exercised by a sanctioned country government?
 - No uniform definition of control

- Entities owned and controlled by designated persons may need to be treated as if designated themselves
- No legal rule on what the test is for ownership and control
- Case by case evaluation
- EU Guidance:
 - Ownership: “*possession of more than 50% of the proprietary rights of an entity or having majority interest in it*”
 - Control:
 - a) having the right or exercising the power to appoint or remove a majority of the members of the administrative, management or supervisory body of such legal person or entity;
 - b) having appointed solely as a result of the exercise of one's voting rights a majority of the members of the administrative, management or supervisory bodies of a legal person or entity who have held office during the present and previous financial year;
 - c) controlling alone, pursuant to an agreement with other shareholders in or members of a legal person or entity, a majority of shareholders' or members' voting rights in that legal person or entity;

- d) having the right to exercise a dominant influence over a legal person or entity, pursuant to an agreement entered into with that legal person or entity, or to a provision in its Memorandum or Articles of Association, where the law governing that legal person or entity permits its being subject to such agreement or provision;
 - e) having the power to exercise the right to exercise a dominant influence referred to in point (d), without being the holder of that right;
 - f) having the right to use all or part of the assets of a legal person or entity;
 - g) managing the business of a legal person or entity on a unified basis, while publishing consolidated accounts;
 - h) sharing jointly and severally the financial liabilities of a legal person or entity, or guaranteeing them.
- HMT Guidance largely follows EU Guidance



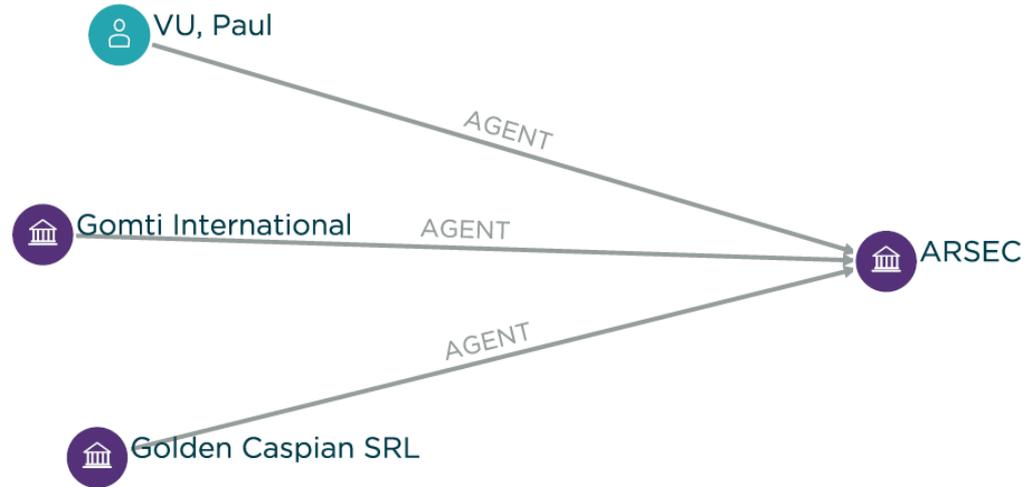


Secondary
sanctions

- “Secondary” US sanctions can create exposure for non-US companies to adverse action (e.g., SDN designation) even if the underlying activity has no US nexus
- Depends on the sanctions program
- Conduct
 - “Significant” transactions with an SDN
 - “Material support” for an SDN
 - Other activities targeted by secondary sanctions (even where no SDNs are involved)
- Not limited to SDNs – have to look beyond
 - Entities that would be considered blocked by the same Executive Order under which the SDN was designated
 - In the case of Russia, those covered by the broad phrase describing a Russian sanctioned person in section 228 of CAATSA (including family members)

- Similar steps as for dealing with Shadow SDNs
- Ensure counterparty is not owned by a sanctioned party such that dealings with it could create exposure if they are “significant” or if they are viewed as “material support”
 - No specific monetary threshold for what would be considered “significant” or what would constitute “material support”
 - OFAC guidance provides seven broad factors that would be considered in determining whether a transaction is significant, and the same likely would be applied in assessing whether there is “material support”
- Terms can be broadly interpreted: last year OFAC designated a company from Slovakia as an SDN for essentially engaging in a transaction with an SDN that involved an attempted facilitation of a payment valued at approx. \$20,000

- Certain types of activities can create exposure
 - Not just SDNs or shadow SDNs but activity based:
 - “Operating in” the Crimea region
 - Several sectors of Iranian and Venezuela economy are targeted
 - Diligence focus
 - Counterparty and determining its UBO
 - Whether particular activities are targeted by secondary U.S. sanctions
- For example, non-U.S. persons engaging in certain transactions involving Iranian automotive sector can face exposure even if there are no sanctioned parties involved





Blocking laws –
compliance
perspectives and
strategies

Featured image from Hogan Lovells 2018 *Capture* Photography Competition

- 8 May 2018: US announces withdrawal from the JCPOA
- Consequences:
 1. Two-tiered schedule for re-introduction of US extraterritorial sanctions previously lifted under JCPOA (*7 August and 5 November 2018*)
 2. 'Government of Iran' or 'Iranian financial institution' entities re-designated as SDNs (5 November 2018) (ca 250 entities)
 3. Wind-down of various licences:
 - **General License H (entities owned/controlled by US persons): expired 5 November 2018 – now subject to full scope of US primary embargo against Iran** (*Note: US embargo never lifted so US persons could not engage in transactions related to Iran even during JCPOA*)

- Remainder of EU3+3 confirm their commitment to JCPOA and sanctions relief; 6 June 2018: European Commission announces update of Council Regulation 2271/96 (the "**EU Blocking Regulation**")
- Update effective 7 August 2018
- What is the EU Blocking Regulation?
 - Originally adopted in 1996 in response to US extraterritorial sanctions against Cuba, Libya and Iran (still relevant for Cuban and Iranian sanctions)
 - Sovereignty legislation – designed to protect the Single Market from foreign laws
 - Nullifies the effects *within EU* of certain listed US sanctions
 - Limitations: no protection outside EU; no protection from US measures (eg, asset seizure, criminal charges, loss of access to US financial system); negligible enforcement
 - A bargaining chip? EU aiming for exemptions from US secondary sanctions for EU companies

- Application ("EU Operators"):



Member state nationals (wherever located)



Any other natural person resident in the EU (except in their country of nationality)



Natural persons within the EU

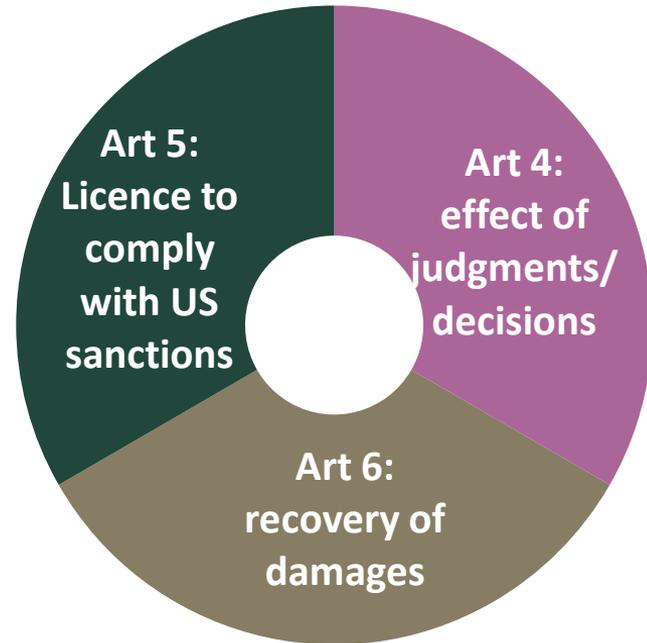


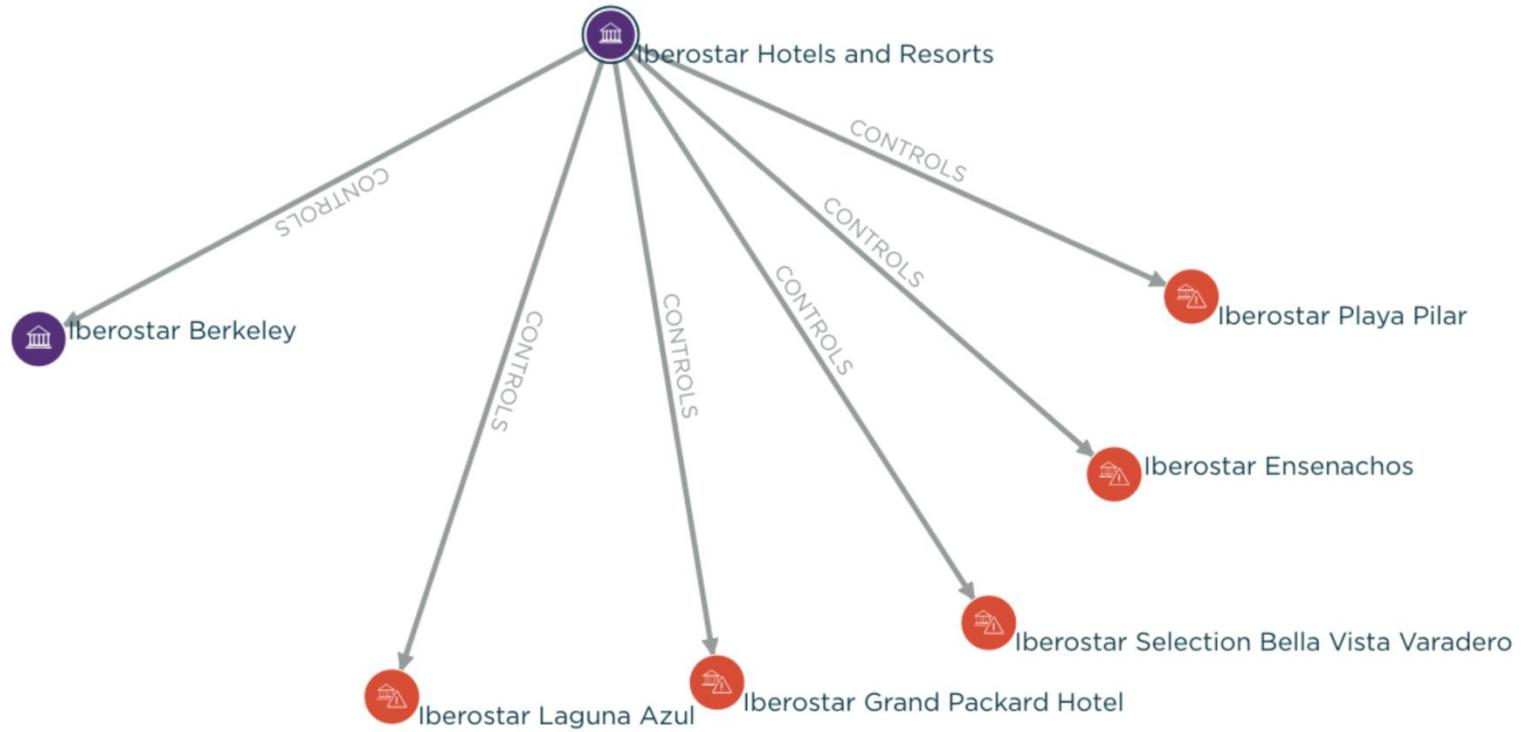
Legal entities incorporated within the EU

- US – EU Groups

Entity Type	Blocking Regulation Applicable?
EU subsidiaries of US companies	Yes
EU branches of US companies	No
US subsidiaries of EU companies	No
US branches of EU companies	Guidance silent – yes?

- **Core Principle 1 (Article 5):**
No person shall comply with blocked US sanctions
- **Core Principle 2 (Article 2):**
Must report to Commission within 30 days if financial interests are affected by blocked US sanctions or by actions of others based thereon
- List of blocked US sanctions in Annex (inc. sanctions re-introduced after US JCPOA withdrawal)







Due diligence and
shipping – sector-
specific
commentary

- **21 March 2019** – State and OFAC - North Korea Sanctions Advisory
 - Focused on exports of refined petroleum to, and imports of coal from, North Korea, including illicit practices by N. Korea such as STS transfers
 - List of 28 N. Korean tankers capable of STS transfers and list of ports visited before and after STS transfers
- **25 March 2019** – OFAC Advisory to the Maritime Petroleum Shipping Community – *“Sanctions Risks Related to Petroleum Shipments Involving Iran and Syria”*
 - Petroleum shipments to the Govt. of Syria (including from Russia and Iran) or oil shipments from Iran create *“significant sanctions risks”* for entities
 - Those who *“in any way facilitate the financial transfers, logistics, or insurance associated with these or other petroleum shipments are at risk of being targeted”* by US sanctions
 - Described deceptive shipping practices (falsifying cargo/vessel documents, STS transfers, disabling AIS, vessel name changes) and contained a list of vessels found to have been engaging in sanctionable conduct
 - Listed risk mitigation measures:
 - Strengthen AML/CFT compliance by adopting *“appropriate due diligence policies and procedures”* and *“promoting beneficial ownership transparency for legal entities”*
 - Ship registries, insurers, charterers, vessel owners or port authorities should *“consider investigating vessels that appear to have turned off their AIS while operating in the Mediterranean and Red Seas”*
 - Review all applicable shipping documentation (documents related to STS transfers should demonstrate that the underlying goods were delivered to the port listed on the shipping documentation)
 - KYC diligence – researching IMO numbers in addition to researching vessel owners, operators, and their practices
 - Incorporate publicly available resources into diligence processes (e.g., commercial shipping data)

- **May 2020** – New State Dept. Guidance
- Directed at “*persons subject to U.S. jurisdiction, as well as foreign persons that conduct transactions with or involving the United States or U.S persons*” BUT: (i) covering advisory not limited in this way; and (ii) many of the measures to which advisory/guidance are relevant derive from secondary sanctions
- Guidance is sectoral:

Insurance Companies	Financial Institutions (Bank Secrecy Act Compliance)
Flag Registry Managers	Ship Owners, Operators and Charterers
Port State Control Authorities (High risk areas)	Classification Societies
Shipping Industry Associations	Vessel Captains
Commodity Trading Companies	Crewing Companies

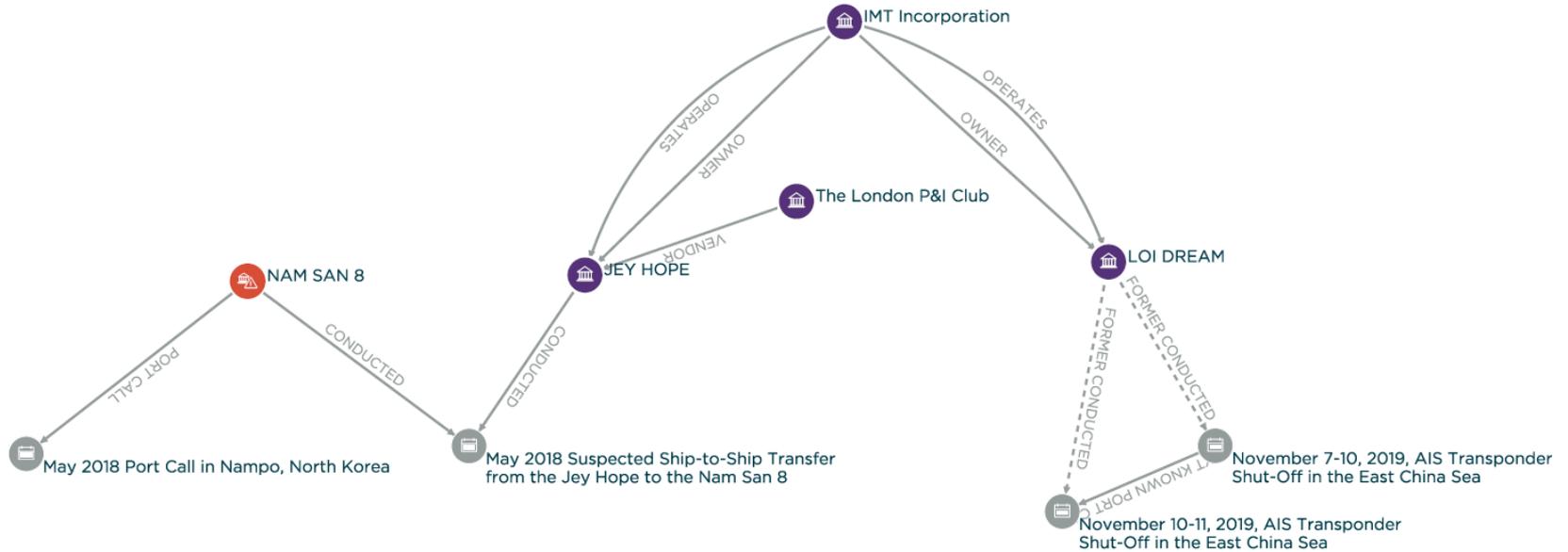
- Identifies 7 core deceptive shipping practices:
 - A. Disabling/manipulating Vessel AIS
 - B. Physically altering Vessel ID
 - C. Falsifying Vessel/Cargo documents
 - D. Ship-to-ship transfers
 - E. Voyage irregularities
 - F. False Flags and Flag Hopping
 - G. Complex Ownership/Management
- Risk-sensitive approach recommended: recognises programs will vary depending on company size, products/services, counterparties and geography
- General business practices set out in the advisory “*are not intended to be...comprehensive, [or] as imposing any specific requirements under U.S. law...*”

Example sector-specific guidance recommendations:

- For Insurers:
 - Monitor/investigate AIS irregularities; research AIS history for all vessels under common ownership/control
 - Due diligence documents to contain colour copies of passports, names, business and residential addresses, phone/email of all individual vessel owners including IMO numbers of all vessels in the fleet (applicable to ships operating in high risk areas)
 - Incorporate historical ship location, registry and flagging information (plus information available from U.S. authorities) into due diligence processes
- For commodity trading companies:
 - Requesting and reviewing complete and accurate shipping documentation, including bills of lading identifying the origin of cargo where individuals and entities are processing transactions pertaining to shipments potentially involving products to or from Iran, North Korea, or Syria
 - Incorporating data into due diligence practices from several organizations that provide commercial shipping data, such as ship location, ship registry information, and ship flagging information, along with available information from the U.S. Department of the Treasury, the UN, and the U.S. Coast Guard
- For financial institutions:
 - Risk factors that financial institutions may wish to consider as part of their internal risk assessments for customers in the maritime industry:
 - Results from an assessment of the nature of each client's business, including the type of service(s) offered and geographical presence
 - Client acquisition or sale of vessels to determine that the client's assets do not include blocked property

- **Striking the right balance: RISK ASSESSMENT**
 - Relevant factors (not comprehensive):
 - 1) Area of operation
 - 2) Jurisdiction of entity (and related parties)
 - 3) Vessel type and activities (what goods will it lift and any history of AIS anomalies)?
 - 4) Flag registry (is it open or a flag of convenience?) and history of vessel
 - 5) Known complexities in vessel ownership or operational structure
 - 6) Red flags in standard screening (limited trading history, lack of information or inconsistencies in it)?
- **Document your approach: what enhanced screening will be performed, when and by whom?**

Case study





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