The ANTI-CORRUPTION REPORT
Formerly the FCPA Report
An Acuris Company

www.anti-corruption.com October 3, 2018

Preparing for a Sanctions Crackdown on Apparel Companies With Operations in China

By Ryan Fayhee, Ashley Hodges, *Hughes Hubbard*

During August 2018, the United States Department of the Treasury's Office of Foreign Assets Control (OFAC) added eight entities (including one bank), six vessels and two individuals to the Specially Designated Nationals and Blocked Persons List for violating U.N. sanctions against North Korea. The violations resulting in the designations included facilitating illicit shipments to North Korea, ship-to-ship transfers, a significant transaction and financial activity on behalf of North Korea. This spate of designations is demonstrative of OFAC's aggressive use of its authority to express its dissatisfaction with North Korea's lack of progress on denuclearization. It also signals that the agency will continue to target the shipping and financial services sectors in order to penalize and deter Chinese and Russian facilitation of North Korean government activities.

Notably, the August designations all came within one month after the U.S. Department of State, along with the U.S. Department of the Treasury and the U.S. Department of Homeland Security, issued a joint advisory titled, "Risks for Businesses with Supply Chain Links to North Korea" (Supply Chains Advisory). The Supply Chains Advisory details deceptive tactics employed by North Korea to evade U.S. and U.N. sanctions that "prohibit trade with North Korea and the use of North Korean labor," and it places special emphasis on risks in the apparel industry.

If recent Department of the Treasury enforcement actions and advisories targeting the financial services and shipping industries serve as a guide, the North Korea Supply Chains Advisory signals an impending crackdown on apparel companies with operations in China. As underscored in the North Korea Supply Chains Advisory, businesses must conduct rigorous, risk-based due diligence not only on third parties with whom they do business, but also on all stages of these third parties' supply chains – lest these businesses violate North Korean sanctions themselves.

This article analyzes the advisories and provides practical steps companies can take to mitigate sanctions risks.

See "Five Ways a Company Can Leverage Its Anti-Bribery Compliance Program to Facilitate Sanctions Compliance" (Sep. 14, 2016).

Recent Crackdown on Financial Services and Shipping Industries

Over the past year, the U.S. Department of the Treasury has designated various individuals and entities in the financial services and shipping industries for violating North Korea-related sanctions. The recent August 2018 designations were imposed in three iterations. First, on August 3, 2018, OFAC designated the Russian bank, Agrosoyuz Commercial Bank, for "knowingly facilitating a significant transaction on behalf of an individual designated for weapons of mass destruction-related activities in connection with North Korea" as well as "one individual and two entities for facilitating North Korean illicit financial activity."

Then, on August 15, 2018, OFAC issued designations directed at China-based company Dalian Sun Moon Star International Logistics Trading Co., Ltd. along with its affiliate SINSMS Pte. Ltd., as well as Russia-based Profinet Pte. Ltd. and its Director General, Vasili Aleksandrovich Kolchanov, for "facilitating illicit shipments on behalf of North Korea."

Finally, on August 21, 2018, OFAC imposed sanctions on the Russian shipping companies Primorye Maritime Logistics Co. Ltd. and Gudzon Shipping Co. LLC along with six related vessels in connection with "ship-to-ship transfers of oil for the benefit of North Korea."

Notable designations from 2017 include the Chinese Bank of Dandong, two Chinese citizens affiliated with Chinese banks, and Dalian Global Unity Shipping Company. Each of the 2017 designees was found to have facilitated transactions on behalf of North Korea or otherwise operated in the North Korean economy. Around the same time these notable designations in the financial services and shipping industries were made, the U.S. Department of the Treasury also issued two advisories addressing North Korean sanctions risks unique to these sectors. Further context for the previous advisories and corresponding designations is included below.

November 2017 FinCEN Advisory Targeting Financial Institutions

A November 2, 2017, Financial Crimes and Enforcement Network (FinCEN) "Advisory on North Korea's Use of the International Financial System" (the November Advisory), reinforces that financial institutions must not only concern themselves with OFAC sanctions, but should also be mindful of actions initiated by FinCEN under section 311 of the U.S. Patriot Act, which allows the Secretary of the Treasury to "take special measures" against an entity of primary money-laundering concern. "Special measures" could include, for instance, specific recordkeeping, reporting and information collection requirements, as well as prohibitions or conditions on correspondent or payable-through accounts.

The November Advisory highlights North Korean use of Chinese banks "to facilitate the movement of illicit funds on behalf of the North Korean government" and explains how "the North Korean government continues to use state-owned entities and banks, as well as bulk-cash smuggling and trade, to access the international financial system" using deceptive tactics. The November Advisory cautions that covered financial institutions "must take reasonable steps to not process a transaction for the correspondent account of a foreign bank in the United States if such a transaction involves a North Korean financial institution," advises that institutions apply special due diligence to foreign correspondent accounts to avoid processing transactions involving North Korean financial institutions or other designated banks, and summarizes reporting obligations.

The November Advisory further warns banks that facilitating transactions for the North Korean government not only puts them at risk for being designated, but also can cause other institutions to avoid doing business with them and thus serve as a de facto exclusion from the international financial system. The November Advisory, which was issued four months after the Department of the Treasury designated the Bank of Dandong as an entity of primary money laundering concern and various individuals connected with Chinese banks for violating North Korean sanctions, signaled an increase in targeting the financial services sector.

February 2018 Advisory Targeting Shipping Companies

A February 23, 2018, Advisory on "Sanctions Risks Related to North Korea's Shipping Practices" (February Advisory) issued by OFAC, the U.S. Department of State and the U.S. Coast Guard, warned of "deceptive shipping practices used by North Korea to evade sanctions" which could "create significant sanctions risk for parties involved in the shipping industry, including insurers, flag registries, shipping companies and financial institutions." Deceptive practices cited in the February Advisory include physically altering a vessel's identification, North Korean ship-to-ship transfers, falsifying cargo and vessel documents and disabling or manipulating automatic identification systems. In addition to describing penalties for violating sanctions measures (pursued on a strict liability basis), the February Advisory provides guidance for mitigating risks of violating North Korean sanctions measures.

The February Advisory, which provided key insights to help companies avoid violating North Korean sanctions, was issued in connection with OFAC's designation of dozens of shipping companies and vessels and was published approximately eight months after OFAC designated Dalian Global Unity Shipping Co. Ltd. for facilitating transactions between China and North Korea. As referenced above, numerous shipping industry designations related to North Korean sanctions were made as recently as August 21, 2018.

See "How Anti-Corruption Compliance Can Springboard Sanctions Compliance" (Feb. 15, 2017).

The Supply Chains Advisory's Focus on the Apparel Industry and China

In line with the previous advisories and contemporaneous designations, the Supply Chains Advisory indicates forthcoming enforcement actions targeting the apparel industry in China. For background, various U.S.- and U.N.-imposed North Korea sanctions prohibitions relate to supply chains. Generally, however, businesses face two primary supply chain risks that put them in danger of violating North Korea-related sanctions:

1. inadvertent sourcing of goods, services, or technology from North Korea; and
2. the presence of North Korean citizens or nationals in companies' supply chains and the generation of revenue for the North Korean government.

The Supply Chains Advisory details areas of heightened risk and potential related indicators, due diligence best practices, penalties for violating sanctions and enforcement actions, specific activities that could result in designation by OFAC, as well as other North Korea sanctions compliance resources

Heightened Sourcing Risk for the Apparel Industry

The Supply Chains Advisory is particularly relevant to apparel companies. Three of the five heightened risks and potential indicators of goods, services and technology with a North Korean nexus detailed in the Supply Chains Advisory include specific examples related to apparel or garments. For instance, the Advisory states that subcontracting or consignment firms are at heightened risk for having a North Korean nexus because third-country suppliers may "shift manufacturing or sub-contracting work to a North Korean factory without informing the customer or relevant parties." The Supply Chains Advisory illustrates this risk by providing the example of a Chinese factory that "sub-contracts with a North Korean firm to provide embroidery detailing on an order of garments."

Additionally, mislabeled goods, services or technology are heightened risks and potential indicators of a North Korean nexus. The Supply Chains Advisory explains that the origin of goods produced in North Korea can be disguised by affixing a country-of-origin label for a country other than North Korea and notes cases "in which garments manufactured in North Korea are affixed with 'Made-in-China' labels."

Further, the Supply Chains Advisory states that joint ventures are at heightened risk and attaches an annex of all "known North Korean joint ventures," and details that "North Korean firms have established hundreds of joint ventures with partners from China and other countries in various industries." First among the industries listed is the "apparel" industry.

Moreover, North Korean exporters incentivize the purchase of North Korean raw materials and goods by selling them to intermediaries and other traders at artificial, below-market prices, and North Korean firms sell various information technology products and services abroad using aliases, involving non-North Korean facilitators and exploiting the anonymity of freelancing websites. Such IT products and services include website and app development and could be used by various industries, including the apparel industry.

Heightened Labor Risk for Companies Operating in China

The Supply Chains Advisory also highlights more generalized supply-chain risks for North Korean overseas labor, revealing that "[t]he North Korean government exports large numbers of laborers to fulfill a single contract." According to the Supply Chains Advisory, China and Russia hosted more North Korean laborers than all other countries and jurisdictions combined in 2017 to 18. Notably, a sectoral breakdown of high-risk countries for North Korean overseas labor lists China as the sole country in the textile and apparel sectors.

There are several potential indicators that an entity is using North Korean overseas labor:

- laborers hired under two-to-five-year contracts that require a large upfront payment;
- laborers reside in isolated, unsafe and unsanitary collective housing;
- employers retain laborers' passports, destroy their visas and personal documents, give laborers little to no time off and require laborers to attend self-criticism sessions;
- laborers have government-issued passports and official documentation (unlike refugees and asylum-seekers who typically do not have such documentation); and
- there is a lack of transparency, including financial transactions which obfuscate the ultimate beneficiary, hidden contract details, prevention of third-party worksite inspections and prohibition on interviewing laborers without a "minder" present.

Due Diligence and Mitigation of Supply-Chain Risks

Companies must conduct due diligence to ensure North Korean laborers are not involved in their supply chains or the supply chains of their business partners, joint venture partners, customers, suppliers or other third parties with whom they do business. The Supply Chains Advisory cautions that "[b]usinesses should closely examine their entire supply chain(s) for North Korean laborers and goods, services, or technology, and adopt appropriate due diligence best practices," placing special emphasis on businesses that operate in high-risk countries, such as China, or high-risk industries, such as the apparel industry. Robust due diligence is not only important to mitigate the risk of an enforcement action in the first place, but it can also be a key factor in mitigation should an action be brought.

As outlined by the U.S. Department of Homeland Security, due diligence best practices that exporters can implement include:

- issuing policy statements demonstrating a commitment to human and labor rights;
- conducting rigorous, continuous assessments of human and labor impacts or risks of the company's activities and relationships in consultation with stakeholders;
- integrating these commitments and assessments into internal controls, operations and supply chains oversight systems; and
- tracking and reporting risk areas.

Importers are also obliged to exercise "reasonable care" to ensure supply chains don't run afoul of North Korea-related sanctions programs. Generally, training materials and policies specific to North Korean labor prohibitions along with evidence that the company meaningfully implemented these polices and shared them with suppliers, subcontractors and stakeholders (including workers and trade unions) can demonstrate reasonable care. Moreover, reasonable care can involve labor impact assessments, evidence of a high-level company commitment to human and labor rights due diligence, supply chain audits and transparency regarding facilities, workforce composition, wage payment and recruitment.

See "Anti-Corruption Provisions in Third-Party Contracts in China" (Jun. 7, 2017).

Ryan Fayhee leads the sanctions, export controls and anti-money laundering practice group at Hughes Hubbard & Reed and previously served as the national export control coordinator at the Department of Justice.

Ashley Hodges is an associate at the firm in the Paris and New York offices.