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U.S. Firms with Supply Chain components or Exporting to China now run the risk of being ensnared in the Russia Sanctions

Image Credit: South China Morning Post

As more Chinese firms are hit with violations of the U.S. sanctions imposed on Russia, many unsuspecting U.S. and other Western firms face the risk of being caught as well.

Overview of the Russia Sanctions Regime

Once the Russian attacks upon Ukraine commenced this past February, the United States, the EU, and a large number of other countries began applying sanctions with the aim of crippling the Russian economy. These sanctions were wide-ranging, targeting individuals, banks, businesses, monetary exchanges, bank transfers, exports, and imports. If you recall, those sanctions also included cutting off major Russian banks from SWIFT, the global messaging network for international payments, although, at that time, there would still be limited accessibility to ensure the continued ability to pay for oil and gas shipments. As the Ukraine war progressed, the sanctions were ratcheted up to include asset freezes on the Russian Central Bank which holds some $630 billion in foreign exchange reserves to prevent it from offsetting the impact of sanctions. By March 1st of this past year, the total amount of Russian assets being frozen by sanctions amounted to $1 trillion.

Turning to the private sector, major multinational companies including Apple, IKEA, ExxonMobile, and General Motors, among others, have independently elected to apply their own sanctions on Russia, acting as international law enforcers on behalf of the sovereign governments. A number of other multinational companies followed suit and have disengaged from Russia to comply with sanctions and trade restrictions imposed by their home governments. Even if the respective sovereign governments did not explicitly require full "disengagement," this was undertaken in many instances to avoid the economic and reputational risk associated with maintaining commercial ties with Russia.

The reputational risks for the private sector have now increased exponentially as allegations of "war crimes" are being leveled at the Russian military following the initial Russian occupation of and then withdrawal from the town of Bucha and elsewhere in Ukraine.[1]

As the war progressed and the months have dragged on this Spring into Summer, we have seen more and more nations join the sanctions regime and the sanctions themselves broadened out in an unprecedented manner. As the situation presently sits, the United States, along with some 30 other countries, have jointly imposed onerous sanctions and export controls in an attempt to punish and squeeze the Russian government. The White House has flatly stated that its intent is to restrict Russia access to critical technology that it needs to fund its war machine and turn Russia into a global financial pariah.

One view is that the Russian economy is staggering under the weight of financial and trade sanctions, export controls, and the exodus of approximately 1000 U.S. and multinational businesses.[2] Some analysts are projecting a double-digit decline in Russian GDP in 2022. Soaring inflation is now estimated at near 20% in 2022. The Ukraine war is projected to wipe out the last 15 years of economic gains in Russia. That is one view on sanctions projected by the U.S. government.

The other side of the coin is that the sanctions have <u>not</u> been all that effective. Far from collapsing, the Russian ruble has increased in value since the invasion. In addition, Russia continues to profit enormously from the oil prices and its ability to shift oil and gas sales to China and India, among others.

Setting aside the issue of effectiveness of the sanctions, there is little doubt of the enhanced challenges they have placed on the private sector. The wide ranging and comprehensive nature of the Russian sanctions regime and its related compliance, export controls and licensing requirements have imposed an onerous burden upon U.S. firms doing business with Russia or have had portions of their supply chains anchored

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[1] The type of atrocities that we are seeing in this Ukraine war pose an additional risk for businesses that get ensnared with the Russia sanctions regime. The potential for being associated with "war crimes" reputational risk is something to be seriously considered.

[2] There is also the enormous "brain drain" exiting Russia which should not be overlooked.

in Russia. However, the numbers of American firms doing business in Russia pales in comparison with the numbers of U.S. firms engaged with China. One of the concerns discussed during a recent NADEC trade policy committee meeting was the potential for Chinese firms to be swept up in the Russia sanctions regime and, given the sheer numbers of US firms continuing to do business with the Peoples Republic of China, that concern carries with it the potential that U.S. and other Western firms would be ensnared in the process along with their Chinese counterparts. That concern is now closer than we are comfortable with.

Chinese Companies now Being Swept up in the Russian Sanctions Regime

When the Ukraine war commenced, and for some weeks thereafter, China outwardly maintained an appearance of neutrality despite the "partnership that has no limits." More recently, China's support for Russia is now becoming more overt. In addition to purchasing energy, China is now a providing support for Russia's war effort in a number of other direct ways. In line with the concerns and prediction of NADEC's Trade Policy Committee some weeks ago, in late June of this year, the Department of Commerce even placed five Chinese companies on its entity list for providing support to Russia's military and defense industrial base.[3] According to the Commerce Department, these five targeted companies had supplied items to Russian "entities of concern" and that "they continue to contract to supply Russian entity-listed and sanctioned parties."

We need to be clear about one thing. It is not just these five Chinese firms that have been sanctioned. The Commerce Department also added another 31 firms to its blacklist from countries that include the UAE, Lithuania, Pakistan, Singapore, United Kingdom, Uzbekistan and Vietnam—in addition to Russia. Of the total 36 companies just added to the blacklist, 25 of them had China-based operations. We believe that there are a number of additional Chinese firms that are about to be sanctioned in the very near future.

What are some of the Practical Strategies you can Employ?

If you are exporting into China[4] or have some components of your firm's supply chains still located in China, here are some practical suggestions for consideration:

(1) Know your supply chain (audit, if you are not absolutely sure) and any distributors or customers for your products in either country.

(2) You will need to be careful of the "middleman" problem (see below).

[3] These 1st 5 Chinese firms are Connec Electronic Ltd., Hong Kong-based World Jetta, Logistics Limited, King Pai Technology Co, Ltd, and Winninc Eletronic. You should note that since Beijing's crackdown on Hong Kong's autonomy, Hong Kong is considered part of China for purposes of U.S. Export Controls.

[4] The same is true, of course, if your firm deals with Russia.

(3) Be sure to frequently check the Treasury Department's Specially Designated Nationals and Blocked Persons (SDN) maintained by the Office of Foreign Asset Control (0FAC) to make sure your firms is not dealing with any of these blacklisted persons or entities.[5]

(4) If you export products or services, look at the recent Export Controls issued by the Commerce Department list to see if any licenses are potentially needed.

(5) If your firm has had previous or currently has dealings with either Russia or China in the oil and gas sectors, undertake a review of what specific product or technology that your firm has been providing. In addition, you will then need to check the SDN Treasury list and be on the lookout for new Export Controls coming out of the Commerce Department.

(6) Constantly monitor the Commerce Department Entity List and the Treasury Department 0FAC for new sanctions and export controls. In this connection, you need you need to be aware of that additional sanctions and export controls are likely to be imposed before the Ukraine situation changes to any significant degree.

(7) If your firm is currently doing business by way of exporting to China or imports components of its supply chain from China, you need to be aware that the United States already has an extensive sanctions regime already in place against the Peoples Republic of China which your business or firm potentially runs the risk of running afoul of:

- Ban on Huawei Huawei and ZTE equipment (August, 2018)
- Currency manipulator (August, 2019)
- Sanctions under the Uyghur Human Rights Policy Act (July, 2020).[6]

[5] As part of its enforcement efforts, OFAC publishes a list of individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also lists individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. Collectively, such individuals and companies are called "Specially Designated Nationals" or "SDNs." Their assets are blocked and U.S. persons are generally prohibited from dealing with them.

[6] This new law has just gone into force and is sometimes referred to as the "Slave Labor Act." Among other things, this new set of sanctions prohibits any supply chain components being imported into the United States which are believed to have been created in Xinjiang province, China.

- Prohibition of investment in companies linked to China's military (PLA) (November, 2020).[7]

(8) If you sell to a 3rd party or parties, the "middleman defense" is not going to protect your firm. The legal standard is whether you knew or had reason to know where your products are going.[8] You should consider creating an "End User Certificate" from any 3rd parties which will disclose whom they are, in turn, selling your products to, and that such persons or entities are not violative of any Russian sanctions.[9]

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Finally, it is worth noting that the mood on Capitol Hill suggests that in the next several months we are likely to see further sanctions levied against China. If your firm continues to be involved in that market in some fashion, it behooves you to pay close attention to the coming developments.[10] Likewise, it is important to note that the ambivalent attitude taken by India towards the Ukraine war has been coupled with extensive Russian energy imports. The same can be said for Vietnam. It is also worth watching both of these two countries closely as firms operating there may likewise run afoul of the comprehensive Russia sanctions regime. Just like those in China already have.

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[7] As of January 14, 2020, 144 Chinese companies were identified and five of those companies are scheduled to be delisted by the New York Stock Exchange.

[8] This imposes an obligation on your firm to undertake such due diligence as may be appropriate to check out any potential connections with and any support for the Russian military and same for the military industrial base in Russia.

[9] There have already been instances in the Middle East and India of firms being sanctioned and sanctions levied against firms who claimed they did not know that their products were being used in violation of the Russia sanctions regime. You should know that any products going to Russia are going to be flagged for careful scrutiny. Likewise, products being shipped to Eastern Europe, the Middle East, India, and certain other allies (like Turkey) are also going to be scrutinized carefully. The "End User Certificate" is a certification by your middleman as to where your products are going and where they (the 3rd party or middleman) are shipping them to.

[10] The mood is sufficiently dark such that a number of U.S. Senators have called for sanctions on Russian oil sales to China. There is a draft measure pending on the Hill with penalties for the shipping and insuring of Russian energy. The effect of this Bill would be to sanction China's purchases of oil and other energy supplies from Russia to cut off funding for Russia's war efforts.