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Keynote Address -- Emerging Sanction Complexity in the Private Sector

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KEYNOTE ADDRESS – EMERGING SANCTION COMPLEXITY IN THE PRIVATE SECTOR

CHRISTOPHER SANDS: Thank you very much, Rick. That was a masterclass in economic sanctions. One of the best things about being here at the Wilson Center is not only the chance to hear such good, insightful food for thought, but also to have great colleagues.

Although the Canada Institute gets all the credit here, I have to say, my colleague, Mark Kennedy, who is the Director of the Wahba Institute for Strategic Competition, very much fits in this frame. This is something that he works on all the time. With no further ado, let me introduce you to the Honorable Mark Kennedy.

MARK KENNEDY: Thank you, Chris. Thanks to everybody for being here today. I lead the Wahba Institute for Strategic Competition. In fact, we do focus on things like sanctions and the economic statecraft that we are implementing more aggressively, as we just heard from our illustrious speaker.

It's getting to be a more complicated world out there. I thought I wanted to be a lawyer when I grew up. I ended up being in business. As a businessperson first, then a congressman, then a university president, I listened to everything we just heard and say, "Wow, it's tough to do business out there." That's why you need good lawyers to help you navigate through this. That's why we need these types of situations and conferences to talk through some of the complexity.

At the beginning of the remarks of our previous speaker, he said, "this only happens if you have an effective implementation of a regime within a country." Well, I would suggest it also really only happens if you have that effective regime with other partner countries. Those partner countries begin with Canada, and that's why this conference is important.

To take us to the next step of understanding how these sanctions work, and how U.S. and Canada work together, we are pleased to have Stephen Alsace with us, the Global Head of Economic Sanctions at the Royal Bank of Canada (RBC), who has the ideal background to help us understand this even further.

Stephen Alsace is RBC's Global Head of Economic Sanctions. In this role, Stephen is accountable for leading and implementing RBC's global economic sanctions program and is a member of the Financial Crimes Operating Committee. He has been dealing with sanctions issues since 2010.

Prior to joining RBC in 2022, Stephen was a Director of the Global Investigations and Compliance Practice of Guidehouse, a McLean, Virginia-based consulting firm, where he was the Canadian Practice Lead for financial crime, fraud, and investigative services. He also worked nineteen years for CIBC, first in their legal department, and later as the Global Head of Sanctions and Terrorist Financing. Stephen frequently speaks at conferences on sanctions matters in Canada, the U.S., U.K., and Europe, and has provided sanctions and terrorist financing instruction to the Royal Canadian Mounted Police, the FBI, and MI5.

Stephen has also appeared twice as a sanctions expert before Canadian Parliamentary and Senate committees. He holds law degrees from the University of Windsor and University of Detroit Mercy, as well as a Master's degree in European Studies from the University of Strasbourg in France. Please welcome Stephen Alsace as our next speaker.

STEPHEN ALSACE: Thanks, Mark, for those kind words. Let me just say it's an honor to actually be invited to the Wilson Center to be able to deliver a keynote address. In a way, Rick, it's almost like being able to meet one of my heroes. I have to say, congratulations for all the work that you've done in building the OFAC sanctions program and the framework, of course, with the government. Clearly, it is the preeminent guide to sanctions, and the influence it has worldwide is incredible. I'll speak to that a little bit further in my presentation.

In terms of sanctions compliance, I'm going to approach it from more of a business aspect in our interactions with legal counsel and maybe talk a little bit about the emerging complexity of sanctions and talk a little bit about friction, especially when we're looking at the evolution of financial services and where we're going today. I'll also talk about the need to continue with collaboration because it is so important.

I'll start with what I've seen in my seventeen years or so of dealing with sanctions. I need to preface this by saying, these are comments from me personally, and they don't necessarily reflect my employer.

When I started working as a lawyer in the legal department for a bank, I really wasn't an expert in sanctions. I started working in the financial transactions group supporting commercial banking. On the side, they said, "Oh, hey, well, the AML lawyer just kind of quit. So, can you do AML? By the way, you're also getting sanctions."

I went, "Okay, great, fine." I knew what AML actually was, but not so much sanctions. I thought, "Yeah, it's kind of trade-related. So that's fine."

As it evolved, I would go home, and I'd see my mother. She'd say, "Oh, what are you doing?"

I'd say, "I moved to a different department."

She'd say, "What do you do now?"

I'd say, "I do sanctions."

She's like, "Oh, that's nice, dear."

She would go on, knowing that she didn't really know what sanctions really were.

Coming to 2022, and following the Russian invasion of Ukraine, it was fascinating because she came over to me, excited. She said, "You work in sanctions. I actually know what that is now!" It's funny because she's a very tiny Jewish-Japanese woman, which was interesting growing up. Have you ever had ramen in matzah ball soup? It's an interesting combination.

She said it very excitedly, and she was truthful about this. She's like, "I was talking to my friends, and you may want to consider . . ." and she actually drew up a list of Russian individuals that she thought were sketchy. She thought she was helping me. I mean it doesn't work like that Mom. But okay, sure, thank you, thank

you. I'll go talk to some of my colleagues in global affairs, maybe it'll come up in conversation sometime, right?

It just shows you how I think sanctions have come to the forefront of everyday parlance. People you run into on the street now know what sanctions are, and how important they are. I actually credit that to the work that OFAC has done and from an enforcement perspective, but it also shows how important it is for Western nations to actually continue collaboration in this regard. Collaboration is key for us to be able to bring sanctions to the next level. What I mean by that is really being able to operationalize sanctions beyond just the tight group of major financial institutions because that's actually where it's going next.

So just to bring it back, 2014 was a very significant event. When you saw the first Russian invasion of Crimea, a new type of sanction emerged: sectoral sanctions.

Now, going from the comprehensive and the targeted sanctions, we could deal with that right? From an operationalization perspective, again, you can do list reviews. You make sure that you've got screening filters that are in place, you have controls that you can implement, but this was new—the sectoral—because it was targeting certain industries. When you look at being able to implement those types of sanctions for payments . . . let's take swift wire payments, right? This is liquidity, this is the way money moves around the world—it was a challenge. I remember when they first dropped, being in my office and reading them.

The first thing I did was get on the phone with our external counsel. I asked, "What is this? Have you seen this?" And I remember, for a 24-hour period, it was frantic. I reached out to our counsel in New York saying, "Are you aware of this?" They said, "Yep". So, we had a series of transactions involving Russia. The question was, "Can we actually make these?" The answer was, "We don't know, we need to look at this". I said, "Well, we need to answer this fast, because we actually have to be able to clear transactions daily to be able to maintain liquidity."

Let's call our counsel in Washington. They weren't sure. Let's call our counsel in London. Let's call our counsel in Belgium. We actually were on the phone with lawyers from around the world. I reached out to all my colleagues in Canada. I reached out to our correspondent colleagues for correspondent banks in the U.S.

Transactions actually stopped globally for a 24-hour period. I'm not sure if people are aware of that. Right after the sanctions actually dropped, there was a huge impact on liquidity. Within the next day they continued again, but it just goes to show you the power of sanctions and the power of ambiguity related to sanctions, because everyone was so concerned about violating them – primary and secondary.

From a Canadian perspective, obviously, secondary sanctions are important, but so are primary. Why? Because most of the big banks operate in the United States. As Rick stated, global currency is the U.S. dollar, so that means that pretty much any type of international settlement is in U.S. dollars, including foreign currency transactions, which usually will end up settling in U.S. dollars. That means you have a U.S. nexus now to a U.S. correspondent, which makes it very complicated for Canadian companies, when they're operating even within the law,

when you have someone that's on a U.S. sanctions list but they're not on a UK or Canadian sanctions list, and there are quite a few of them.

It's a very fine line that we have to tread to decide, can we actually clear these transactions? If they're in U.S. dollars, no. If they're in pounds sterling or euros, possibly. But then we get into the very complicated assessment of whether or not we have a U.S. nexus to the transaction based on personnel that are involved and where it's actually cleared.

What ends up happening? Banks de-risk from those markets because it's too complicated. When you have complications, you also see an increase in the cost of compliance. Compliance is essential. You need controls in place to be able to manage this risk, but it's getting more and more complicated, especially when you start looking at issues like sectoral sanctions, where they're actually impacting certain sectors. So, it is a challenge.

2014 also saw a lot of enforcement actions. This is really where you see, I'm going call it, the power of OFAC, because really at that time—I'll say the power of Ben Lawsky from the New York Department of Financial Services—you start seeing fines in the range of \$9 billion levied against foreign banks mostly. BNPP was first. You got Standard Chartered, Deutsche Bank, Danske Bank, Credit Suisse, one after the other. From a Canadian perspective, we all just went, "Whoa, holy cow." In one respect, it was great. Not for stress, but great, in the sense that it gave leverage to compliance departments and compliance professionals like me to be able to say, "This is the impact if you do not follow sanctions." Obviously, in those situations, or most of those situations, you had other factors involved like [asset] stripping, et cetera. And in other instances, you had repeat offenses. But still, you are talking about a strict liability regime when you're talking about U.S. sanctions.

In Canada, it is not strict liability. For Canadian sanctions under the Special Economic Measures Act, you need to actually formulate intent. And perhaps that's why there's such a stark difference between the two countries. I'm only aware of one successful prosecution by Canadian authorities against a company for contravening Canadian sanctions—Lee Specialties. This was back in 2014. It was a Red Deer, Alberta company. They shipped O-rings, valued at about \$15 [each], to Iran, in contravention of Special Economic Measures Act regulations, resulting in a \$90,000 fine. That's the only one that I'm aware of in Canada. Somebody else might be able to come up with another one, but there are very few. That's not to say that Canadian firms aren't subject to sanctions enforcement. There have been at least three of the Big Five Canadian banks that have entered into deferred prosecution agreements because of enforcement actions by OFAC for their operations in the United States. It's really weird that the two banks that haven't been caught are the two banks where I was head of the sanctions program. I'm just saying that maybe it's a coincidence. I don't like to think so, but anyway. Knock on wood.

In some respects, it could just be luck, because I have to say, banks are trying to do their best. It's a challenge just because of the complexity, again, involved in implementing effective sanctions programs.

Rick mentioned the importance of doing certain things like KYC (Know Your Client). Let's look at Customer Due Diligence KYC. In the United States, it's much easier because you actually have the 50 percent-plus-one rule. Canada doesn't. In Canada, up until just last year, we didn't actually know what it was. We didn't really have any guidance around it. In Bill C-47, that passed and was in effect as of June 22nd of this past year, clarified the beneficial ownership rule for Canada under SEMA. The challenge is that it's not fifty plus one, it includes indirect or direct control. Okay, so it's a control test. Interesting.

It indicates if the individual has the ability to influence or appoint directors of the board of directors. Okay, how do you make that determination? What documentation do you now need to be able to prove that that shareholder may or may not be able to appoint a member of the board of directors, or actually its ability to influence or change the board of directors, or a member of a committee of the board? So, a whole level of complexity now has been added to this assessment. For financial institutions that have millions of clients where you've already done your due diligence on them, how do you actually refresh your files now?

Well, perhaps, we could take a risk-based approach. Again, I'm pointing to the guidance of OFAC. So, outside of the some-odd 1300 FAQs, somewhere around there, we do not have any guidance around this in Canada. We don't have any published guidance that we've been asking for. I've been at this since 2010. Since then, we've been asking Global Affairs Canada to publish guidance around the interpretation of sanctions. They're working on it, which is great. This is the importance of being able to collaborate with the Department. Today, we don't have anything published.

So that's just one area where it makes it challenging, not just for financial institutions and other firms to be able to interpret the requirements for sanctions, but it makes it difficult for our legal counsel to be able to provide advice on this. Many times, we've asked legal counsel, "Okay, well, how should we proceed?" The answer tends to be, "Well, we're not exactly sure. The only way you can be sure if this transaction or this party is okay to proceed with is to ask for a specific permit from Global Affairs Canada." Which is what we do.

The challenge about that is that, let's look at some of the transactions that we're facing – we have them in the hundreds. Again, so the major difference between Canada and the United States, in the United States you have general licenses that can be applicable, so where you actually are carving out certain exceptions. You also have a period of time before they're actually implemented in force. Canada doesn't. When new sanctions drop, they're effective that day. In some cases, they're actually backdated. So, when they're published, they're effective three days before they're actually published, which is confusing and challenging.

But, in speaking to the Department of Finance around that, the rationale was they knew that most of the banks use service providers that generate the lists that we ingest to actually do our screening and that's why they did that, to be able to account for it. It's still not clear to the banks whether the expectation is that you're going to actually re-review your transactions, so you have to do a look back every time that the new regulations drop. A lot of us are doing that anyway, or we pick

it up as soon as we see it on a website to make sure that it gets implemented the same day to be able to avoid that risk. Again, these are ongoing challenges. So, with respect to the permit applications, it can take upwards, we have some that have been in queue, for over a year. Operationally, it can be a challenge day-to-day.

There are some good things, though. In terms of the Canadian approach, for a long time under the Russia SEMA sanctions, Canada actually had more listings than the United States did. Canada is taking a very aggressive position when it comes to sanctions deployment. But the reality is, we look to the U.S. or allies from an enforcement perspective.

Canada, today, doesn't actually have a sanctions regulator. We have the RCMP that will press charges, and they seek guidance from Global Affairs Canada. Global Affairs Canada is the one that actually publishes the sanctions. But there is no oversight branch for sanctions because it doesn't fall within FINTRAC (Financial Transaction and Reports Analysis Centre of Canada). FINTRAC is our financial intelligence unit, they actually regulate all the banks. FINTRAC's authority is limited to AML [Anti-Money Laundering], it doesn't actually extend the sanctions.

So, there's a gap that's been in place since 2017 since the Office of the Superintendent of Financial Institutions (OSFI) actually backed out of this area in Canada because you had two regulators that were regulating the banks—OSFI and FINTRAC—and they were kind of going head-to-head in exams and it was causing a lot of friction. The Department of Finance said, "Oh, we'll just get rid of OSFI." They didn't get rid of them, they're still a prudential regulator, but they don't do examinations for financial crime anymore.

Consequently, there's been a hole since 2017. Now, I've been speaking to Global Affairs and the Department of Finance, and we know that there are plans in place to be able to remedy that. But the reality is, since that date, we really haven't had anyone to actually oversee sanctions compliance.

So, what do you do in Canada? Well, in Canada, we're all very polite, we're nice. We do the right thing, right? Usually, yes, we do. We don't have to worry about it because most of the big, large financial institutions have to comply with sanctions and have robust sanctions because we're constantly being assessed by U.S. regulators for our programs. So, it's covered.

I remember attending conferences in Europe and I was having a conversation with my counterpart in Holland. One of the regulators for Holland was there too and I asked about this. I said, "Does Holland have a sanctions regulator?" "No, we rely on OFAC," is what he told me, which I found actually very curious. That's the reality of the world that we're in today. I'm going to talk a little bit about where we're actually going and why it's important to continue this dialogue around sanctions, and the implementation of sanctions, and being able to address the complexity of sanctions.

We're seeing a lot of pressure, whether it's in Europe, Canada, North America, in open banking. You're seeing a lot more payment rails, cross-border, being person-to-person. You're seeing fintech being introduced into this world where they're allowing payments to travel from one country to the next. It's actually

outside of SWIFT. When you look at SWIFT (Society for Worldwide Interbank Financial Telecommunications) all the members of SWIFT have robust sanctions screening in place. Fintechs, I'm not so sure, it depends on their jurisdiction and who actually has regulatory oversight over them.

In Canada, it's a bit of a debate. In Canada, there is some oversight from FINTRAC, but the problem is they only have to be registered with FINTRAC, meaning they have to report AML requirements. Nothing in Canadian legislation expressly stipulates that they have to have a sanction screening in place. If they're operating mostly in Canada but they don't have a U.S. presence per se, but they may be settling transactions in U.S. dollars, that potentially becomes a problem.

The other pressures that you have around the real-time payments, particularly of small value payments, not only is the fact that they may or may not have sanction screening enabled for their clients or for the transaction itself, but there is also increasing pressure to actually enable faster payment processing. That's the notion of friction.

Sanctions cause friction of payments. Why? Because you have to screen. Well, when you screen, you get false positive alerts. Your false positive alerts have to be actioned somehow; you take it out of the queue, and you have to work it separately. You have to have a mechanism to be able to move it off of the rail. You have to have a mechanism to be able to issue an RFI (Request for Information). You have to have a mechanism to obtain additional information, especially when you look at sectoral sanctions, or you're looking at the sanctions that might be connected to someone more than just an SDN (Specially Designated Nationals), but it could be to the underlying purpose of the transaction.

So, although we are seeing movement to an ISO 20022 standard – richer payment information will flow with the payment—you won't necessarily have the purpose of the transaction and the data quality may be questionable.

What does that result in? It means friction. It means potentially, companies won't do it. It means you have to have a mechanism to be able to address that, especially for transactions that are expected to clear in not a minute but 300 microseconds or less that is the standard. That's far below a minute. These are almost real time payments. How do you implement not just sanctions, but other compliance controls against that kind of traffic? That's the challenge that we face today. And that's the reality not just in Canada or the United States, it's global.

Collaboration and communication—we need to come up with better ways of complying with requirements from multiple jurisdictions. Alignment is crucial. where you get hiccups, are where you actually have differences between lists. Because you have one country that says, oh, this person is sanctioned and then the other country says, Nope, they're not. We're seeing better alignment, particularly between the G7. You saw that recently with Myanmar. You actually have alignment now with the G7 around who's actually going to be listed. That's great, right? More of that is crucial.

Collaboration also is important with regulators in multiple jurisdictions, not just the United States and Canada—and I'm talking about not just the sanctions regulators, or in the banking or whoever controls the rails for financial payments—it's with any privacy advocates and privacy department.

When you look at being able to reduce friction, part of the causes of friction is the fact that multiple points along the way in processing that transactions are being rescreened by each entity over and over again. This results in enormous inefficiencies and delays. As a bank, when we initiate a transaction, we screen it. Then if the transaction involves another currency, the intermediary bank screens it, before passing it on to the next beneficiary bank, who gets it, and screens it along the way. Why do we do that? Well, we don't really trust each other because we think we have different standards.

We've started collaborating with a consortium service provider that's comprised of forty other banks globally, to look at doing things differently. We're saying hey, how about we use an ODFI model? Meaning, it's a reliance model where the originating depository financial institution screens both legs of the transaction or if there are multiple legs, they screen all of them at once. But all the participants agree to that standard, setting a baseline standard that way can actually make sanction screening more efficient, more effective.

It also helps with enforcement and making sure that we are in compliance with sanctions requirements. Getting agreement to allow the sharing of the information necessary along the pathway is critical. That's why privacy departments for respective nations need to be engaged in this discussion. The more banks that can actually hop on board, again, we're not talking about anti-competitive behavior here. This is really efficiencies for compliance. We're all in the same boat. We've been involved in those discussions, and we've had a lot of success. So, I think that's going to be the key to moving forward. And it also provides an avenue or at least a solution for fintechs, money services business, and non-banks to actually follow the same standards that banks have been following for the last two decades.

So, to me, that's the future we're seeing. It's something that Canada is trying to lead. We're being very forceful on this. We'd like to see a bit more traction from participants in the United States, but we have to move in that direction because the costs of compliance are becoming excessive. The difficulties and the challenges with compliance are also becoming more and more apparent. Part of the solution is also leveraging the use of generative AI to help improve sanctions and alert resolution—so critically important.

The next trend we're also seeing as we talk about complexity, is the bleeding of the definition of what constitutes sanctions into the world of export controls. Before, we used to see a clear division between those two areas. You'd have OFAC do their thing; BIS do their thing. They're now seeing collaboration—which is great from a departmental level, very challenging from an implementation perspective. Why? We don't have as rich information, when a payment processes as you might have on an export. You don't have the same level of documentation. Now, you might argue that you have that for documentary letters of credit if you're doing trade finance transaction, but it's a very unique niche. When you start looking at the payments end of it, which are actually separate, they're bifurcated. You've usually got the trade documents, and the settlement happens somewhere else, you don't necessarily have the same level of detail.

We're finding in both the U.S. and Canadian legislation, the regulations, in particular in Canada, when you look at the SIMA schedules, they started,

including harmonized codes. HS codes is the description of some of the items and included in that is chapter eighty-five. If you ever look at HS, chapter eighty-five, it's massive. It's basically electronics. It's so broad that we understand the intent, but the problem is the application. We need some guidance around it, because that means we have to actually stop any type of payment that actually references, electronics involving Russia.

Now we lead back to the complexity and possibly de-risking, it's actually perhaps easier to just de-risk and not process any transactions with certain countries, because of the level of complexity now that you have to implement.

That's a challenge. It is a challenge, especially when you look at the unintended consequences. Because you still have people, ordinary citizens who do want to be able to complete transactions that stay in Russia, pension payments, it could even be we've got hockey teams that we've seen, where it's just a question about their payroll that it's being interrupted. Humanitarian aid is the next piece of it right? When you start looking at countries like Iran and Syria, right, and unintended consequences, we may start interrupting humanitarian aid to some of these countries. Simply, it's too difficult to be able to implement adequate controls because it's not acceptable anymore to be able to do everything manually. Thank you, I'm at time. I appreciate all of you listening. I think we're going to have great discussions later on this morning. Thank you.

CHRISTOPHER SANDS: Ladies and gentlemen, thank you very much. For those of you watching on screen as well as those in the room, we're going to break.