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Do U.S. States Have Authority to Enforce OFAC Economic and Trade Sanctions Against Banks?

In recent years the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) and other federal authorities have robustly enforced OFAC-administered sanctions against banks, particularly U.S. branches of foreign banks. Notable for their number, successiveness, and monetary penalty amounts imposed—often for U.S. sanctions and related violations, such as of the Bank Secrecy Act—these federal enforcement actions have nevertheless been overshadowed by state enforcement, in particular by the New York State Department of Financial Services (NYDFS).

About This Document

This document summarizes key issues discussed in a forthcoming publication by Hdeel Abdelhady. It stems from ongoing work on key issues in U.S. law and its extraterritorial reach. For information about the issues discussed herein or MassPoint's services, please contact Hdeel Abdelhady at habdelhady@masspointpllc.com or +1 202 630 2512.

The NYDFS is the New York State agency with licensing, supervisory, and enforcement authority over, among others, New York branches of foreign banks. In 2012, the NYDFS made headlines when it, reportedly without coordinating with federal authorities, sharply enforced OFAC-administered sanctions against a New York branch of a European bank. This and other NYDFS OFAC sanctions enforcement actions have generated ample commentary, much of it focused on case facts, law *as applied by* the NYDFS, and enforcement style.

Beyond case recitations and optics, the enforcement of OFAC-administered sanctions by a state agency—even against banks by a banking regulator operating in a dual banking system—raises fundamental constitutional and other legal questions. Chief among them is the overarching question of whether U.S. states have authority to directly or effectively enforce OFAC-administered sanctions, particularly independently and prior to enforcement by competent federal authorities—namely OFAC. This question and some of the legal issues and policy and practical considerations appertaining to it are discussed in detail in a forthcoming publication. This document provides a summary preview of some of the key legal issues discussed in that publication.

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AMERICAN FEDERALISM AND DUAL BANKING

American Federalism, Dual Banking and OFAC Sanctions

The American system of law and government is complex. Owing to federalism—a constitutional bedrock of American law and government—governing, lawmaking, and regulatory authority is divided primarily between the federal government and the states. Sources of U.S. law (*e.g.*, cases, statutes, administrative regulations) are manifold and vary in applicability and binding effect. These and other aspects of American federalism are evident in the American dual banking system, in which federal and state actors have legally distinct but sometimes intersecting authority over banks—intersecting such as where a state chartered bank is a member of the Federal Reserve System and thus subject to state and federal examination, principally with respect to bank safety and soundness.

Even in the dual banking system, the authority of state banking regulators to ensure safety and soundness, consumer protection, and other regulatory and oversight objectives does not by itself give rise to authority to enforce all non-state laws and regulations applicable to banks within state jurisdiction—including OFAC-administered sanctions programs, which are within the legal domain of the federal government.[1]

EXPRESS STATE AUTHORITY TO ENFORCE OFAC SANCTIONS

Lack of Express State Authority to Enforce OFAC Sanctions

Federal laws are generally enforced by federal agencies. U.S. states may not enforce federal laws without express federal statutory authorization to do so.[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, for example, expressly authorizes states (through states attorneys general or their equivalents) to directly enforce some of its consumer protection provisions.[3] In contrast, the core federal statutes that undergird OFAC-administered sanctions contain no such provisions. The absence of express state enforcement authority in such statutes is not at all surprising. As discussed below, OFAC sanctions and the core federal statutes that underpin them—*e.g.*, the International Emergency Economic Powers Act (IEEPA)—are concerned with decidedly national issues within the sphere of federal government authority, specifically foreign relations and national defense.[4]

OFAC SANCTIONS: LEGAL FRAMEWORK, FOREIGN AFFAIRS AND NATIONAL SECURITY

OFAC Sanctions Basic Federal Legal Framework

In the area of U.S. economic and trade sanctions, lawmaking, regulatory, and enforcement authority has generally been understood to lie with federal authorities. OFAC sanctions regulations are legally based on federal statutes and Presidential Executive Orders (OFAC also acts pursuant to the President's constitutional authority). Congress legislates and the President, pursuant to statutory and constitutional authority, executes U.S. sanctions through agencies and instrumentalities of the Executive Branch of the federal government, such as OFAC. The

Executive Branch (not U.S. states) is subject to Congressional oversight over its implementation of relevant federal statutes.

OFAC's Authority to Administer and Enforce OFAC Sanctions

As stated above, the core federal statutes that erect or authorize the President to devise U.S. sanctions programs do not expressly authorize U.S. states to enforce their provisions—they authorize the President to implement. OFAC, pursuant to authority delegated by the President to the Department of the Treasury (of which OFAC is a part), has administrative and civil enforcement authority with respect to sanctions programs widely and tellingly referred to as "OFAC Sanctions." In carrying out its mandate, OFAC coordinates with other federal agencies, including with the U.S. Department of State (the State Department's role underscores the foreign policy purposes of OFAC-administered sanctions discussed below).

OFAC also cooperates with relevant state regulators to buttress its administration and enforcement capacity, such as through information sharing. There is no indication that OFAC has ceded, expressly or impliedly, any of its enforcement authority to state agencies (in any case such power sharing would also have to be consistent with applicable law). For example, as discussed below, a Memorandum of Understanding between OFAC and a New York banking agency casts the state regulator in a supporting role—the MOU does not appear to contemplate an enforcement role for New York authorities.

OFAC's MOU with the New York State Banking Department Suggests a Mutual Understanding of OFAC's Enforcement Primacy

OFAC has in place memoranda of understanding with some U.S. state, commonwealth, and federal regulators, including with the New York State Banking Department, a predecessor agency of the NYDFS.[5] Many of these MOUs with states pertain to information sharing, the purpose of which is, in the case of the New York MOU, "to help OFAC in fulfilling its role as administrator and enforcer of economic sanctions and to assist the State Agency in fulfilling its role as a banking organization supervisor."[6] This language, which is consistent with the MOU's other language and overall meaning, distinguishes the state agency's more traditional role (prudential regulation, consumer protection, etc.) and cedes no sanctions enforcement authority to the New York state agency. More to the point, the MOU provides, under the heading "Civil Enforcement," that none of its provisions "is intended to affect the respective enforcement authorities of the State Agency, OFAC, or the [Federal Banking Agencies]."[7]

OFAC Sanctions Advance Federal Government Objectives: U.S. Foreign Policy and National Security

The conduct of foreign affairs is within the exclusive or nearly exclusive domain of the President and Congress. This power is not diminished if not exercised—the power lies dormant (referred to often as the "dormant foreign affairs doctrine"). As the U.S. Supreme Court once put it:

> Power over external affairs is not shared by the States; it is vested in the national government exclusively. It need not be so exercised as to conform

> to state laws or state policies, whether they be expressed in constitutions, statutes, or judicial decrees. And the policies of the States become wholly irrelevant to judicial inquiry when the United States, acting within its constitutional sphere, seeks enforcement of its foreign policy in the courts.[8]

OFAC's role within this framework is clear and borne out by its history. As OFAC itself explains:

> The Office of Foreign Assets Control (OFAC) of the US Department of the Treasury administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States. OFAC acts under Presidential national emergency powers, as well as authority granted by specific legislation, to impose controls on transactions and freeze assets under US jurisdiction. Many of the sanctions are based on United Nations and other international mandates, are multilateral in scope, and involve close cooperation with allied governments . . . OFAC is the successor to the Office of Foreign Funds Control . . ., which was established at the advent of World War II following the German invasion of Norway in 1940 . . . OFAC itself was formally created in December 1950, following the entry of China into the Korean War, when President Truman declared a national emergency and blocked all Chinese and North Korean assets subject to U.S. jurisdiction.[9]

Affirmation of Federal Foreign Affairs Powers: Preemption of State Sanctions Law

Some U.S. states have enacted sanctions laws, such as laws prohibiting investment by state pension funds in targeted foreign countries (*e.g.*, Iran). Where these laws have been challenged, some have been deemed unconstitutional encroachments on federal power and preempted by federal statutes. For example, in 2000, the Supreme Court agreed with a lower court that a Massachusetts law "restricting the authority of its agencies to purchase goods or services from companies doing business with Burma" was "invalid under the Supremacy Clause of the National Constitution owing to its threat of frustrating federal statutory objectives."[10]* The Court found that, *inter alia*, the Massachusetts law conflicted with the federal statutory scheme providing for "mandatory and conditional sanctions" against Burma (Myanmar).[11]

It is worth noting, as an aside for now, that some NYDFS enforcement orders and press releases indicate that the agency has predicated violations of New York Banking law on violations of OFAC sanctions against Burma. Some of these violations, presumably, have legal roots in the same federal statute that preempted the Massachusetts sanctions law.[12] Of course, state regulation of foreign affairs is distinct from state enforcement of foreign affairs-related laws and regulations. Nevertheless, cases reaffirming the federal government's foreign affairs primacy are relevant to questions about state enforcement authority.

NYDFS ENFORCEMENT (OR EFFECTIVE ENFORCEMENT) OF OFAC SANCTIONS

NYDFS Enforcement: New York State Law Violations Predicated on Apparent OFAC Violations

Many news articles and observers have remarked on the NYDFS's enforcement style in cases involving OFAC sanctions. More notable is the content and structure of some NYDFS enforcement orders. NYDFS enforcement orders involving OFAC sanctions do not, as a technical legal matter, *directly* enforce OFAC sanctions or the federal statutes underlying them. Instead, NYDFS enforcement orders directly enforce New York laws and regulations, such as those requiring banks to maintain accurate books and records and to report to the NYDFS fraud, dishonesty, or the making of false entries immediately upon discovery.[13]

The nature of the New York law provisions that have been directly enforced by the NYDFS in OFAC sanctions cases is noteworthy. These and similar kinds of provisions can be triggered by a vast range of antecedent legal violations. In OFAC sanctions cases, for example, a bank's omission of the name of a sanctioned party or country in a SWIFT message ("stripping") would not only violate applicable law (*e.g.*, OFAC sanctions or other) but also the books and records and reporting requirements provisions of state and/or federal laws and/or regulations.[14]

The Operation of Two Distinct Legal Frameworks in NYDFS Enforcement Orders Illustrates Lack of *Direct* Enforcement Authority

The operation of two distinct legal frameworks—one federal (OFAC sanctions) and one state (New York Banking Law and NYDFS Regulations)–in some NYDFS OFAC sanctions enforcement orders (and related press releases) is striking. For example, in a 2015 Consent Order with Deutsche Bank AG and its New York branch, 25 of the Order's 53 numbered paragraphs describe facts ("Factual Background") apparently giving rise to OFAC sanctions violations (without citations of specific OFAC sanctions provisions).[15] Three of the Order's 53 paragraphs set forth violations of New York laws and regulations ("Violations of Law and Regulations"), 22 paragraphs detail settlement provisions, and three paragraphs pertain to perfunctory matters (notices and standard interpretive clauses). While the structure of the Order is not by itself a reliable gauge of legal substance, the structure of the Deutsche Order and other NYDFS OFAC sanctions enforcement orders is nevertheless worth considering in light of their impacts.

Moreover, the fact that NYDFS enforcement orders do not *directly* enforce OFAC sanctions—*i.e.*, by basing legal liability on violations of OFAC sanctions provisions in, *e.g.*, a "Violations of Law and Regulations" section of an order—is important. Such binary orders illustrate the NYDFS's lack of authority to *directly* enforce OFAC sanctions (such as a state attorney general would directly enforce Dodd-Frank Act provisions or regulations pursuant to the express statutory enforcement authority conferred upon states in that federal law (see above)). Findings of legal liability under state law books and records, reporting, and similar (catch-all type) provisions is therefore necessary for the NYDFS or another state agency lacking express enforcement authority to, in effect, enforce OFAC sanctions while technically enforcing state law.

NYDFS Authority to *Effectively* Enforce OFAC Sanctions or Make Findings of OFAC Sanctions Violations is Also Questionable

As to whether the NYDFS may *effectively* enforce OFAC sanctions, as it apparently has, this too seems beyond the bounds of a state banking regulator's authority. NYDFS enforcement, even if technically not direct enforcement, is nevertheless a kind of enforcement that, *inter alia*, has immediate and longer-term legal, policy, and compliance impacts. As a general practical matter, NYDFS cases involving OFAC sanctions are not viewed by banks, lawyers, or even other regulators as "New York books and records law" cases. They are viewed as OFAC sanctions cases and studied as such.

Also, the nature of NYDFS enforcement in some cases is pervasive and ongoing, such as where the agency has required banks to, for example: install monitors for one year, incorporate monitors' recommendations, terminate employees, provide NYDFS access to outside services providers within and outside of the United States,[16] make specified management and governance changes, and adopt remedial and other measures that incorporate monitors' recommendations[17] and/or reflect NYDFS experience gained in its own prior OFAC sanctions cases. Such enforcement is not enforcement of New York banking laws and regulations, it is OFAC sanctions enforcement (and, arguably, regulation by enforcement). It is worth noting that the NYDFS recently issued a final rule on transaction monitoring and filtering that involves OFAC sanctions and is a result of its OFAC (and AML) enforcement experience and "examinations for safety and soundness . . . .") (as stated at note 18, this rule might also raise legal authority questions).[18]

It is not at all clear that a state banking regulator like the NYDFS has authority to effectively enforce OFAC sanctions. Related to this is an unaddressed question of whether the NYDFS or other state agencies have authority to make findings (or apparent findings) of OFAC sanctions violations, particularly independently or in advance of such findings by competent federal authorities, namely OFAC.

NYDFS Invocation of U.S. Foreign Policy and National Security as Rationale for State Enforcement (of New York Law) is Incongruous with States' Roles

Some NYDFS enforcement orders (and related press releases) contain language explicitly invoking national policies and interests. The preamble of the Deutsche Order, for example, states that the bank's "conduct ran counter to U.S. foreign policy and national security interests, constituted violations of New York and federal laws and regulations, and raises substantial safety and soundness concerns."[19]

While, again, state banking regulators have an interest in ensuring that banks subject to their jurisdiction comply with all applicable laws and regulations and are effectively supervised and made accountable for legal breaches, it does not follow that state regulators are properly positioned to redress or appear to redress injuries to U.S. foreign policy or national security. The promulgation and implementation of OFAC sanctions involves legal, policy, political, economic, and other factors that are currently and appropriately managed at the federal government

level. In any case, as stated above, OFAC has in place an MOU with the New York Banking Department (a predecessor agency of the NYDFS), which facilitates information sharing between the NYDFS and OFAC to assist OFAC in its sanctions enforcement. State agencies having such MOUs or other arrangements with OFAC have a defined role in advancing OFAC sanctions enforcement, but that role is subordinate to and supportive of OFAC.

CONCLUSION

The foregoing discussion highlights some of the key features of the U.S. system of law and government. Legal and governing authority is primarily divided between the federal government and the states (vertical federalism) and between and among the states (horizontal federalism). While federal and state authorities have roles in the American dual banking system, these roles are legally distinct, even where federal and state banking regulation intersects in practice. The power of states to charter and regulate banks within their borders does not mean that states have authority to directly or effectively enforce all laws applicable to banks within their jurisdiction. Given that OFAC sanctions are rooted in federal laws that do not apparently authorize state enforcement of their provisions, reflect and advance U.S. foreign policy and national security matters within the constitutional purview of Congress and the President, and are multilateral in scope and effect (with some based on multilateral commitments, such as UN mandates), the legality of state enforcement of OFAC sanctions is doubtful. These and related issues deserve, in any case, consideration and clarification.

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NOTES

[1] The declared policy of New York State with respect to the supervisory and regulatory powers of the NYDFS appears to suggest a more traditional role for the NYDFS. The New York Banking Law provides that it is the

> policy of the state of New York that the business of all banking organizations shall be supervised and regulated through the department of financial services in such manner as to insure the safe and sound conduct of such business, to conserve their assets, to prevent hoarding of money, to eliminate unsound and destructive competition among such banking organizations and thus to maintain public confidence in such business and protect the public interest and the interests of depositors, creditors, shareholders, and stockholders.

N.Y. BANKING LAW § 10 (Superintendent of Financial Services, Supervisory and Regulatory Powers, Declaration of Policy) (Consol. 2016). This declaration of policy typifies traditional state banking law and regulatory purposes, which do not include national security, foreign affairs, or other federal government specialties. Although terms like "safety and soundness" could, on their face, be interpreted broadly to include ensuring compliance with all applicable laws, the nature, history and conduct of bank regulation by U.S. states does not support such a broad interpretation.

[2] States may also sue on behalf of their inhabitants in some cases, where such suits are authorized by relevant federal statutes (*e.g.*, authorized specifically for state attorneys general or for individual parties on whose behalf a state may sue). *See, e.g*., 15 U.S.C. § 15c, §15c(a)(1) (LexisNexis 2016) (authorizing states attorneys general to sue as *parens patriae* on behalf of state inhabitants).

3 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–20, 124 Stat. 1383, § 1042 (2010) (§ 1042 codified at 12 U.S.C. 5552) (LexisNexis 2016).

[4] The IEEPA, 50 U.S.C. §§ 1601 et. seq., is codified at Title 50 of the United States Code, the subject of which is "War and National Defense." Other federal statutes underpinning OFAC sanctions are codified at Title 22 of the U.S. Code, "Foreign Relations and Intercourse."

[5] Memorandum of Understanding between the U.S. Department of the Treasury, Office of Foreign Assets Control and the New York State Banking Department, December 2006, *available at* https://www.treasury.gov/resource-center/sanctions/Documents/ofacnymou.pdf (last accessed July 15, 2016) [hereinafter the "MOU"]. The NYDFS "was created by transferring the functions of the New York State Banking Department and the New York State Insurance Department into a new department. This transfer of functions became official on October 3, 2011." NYDFS, About Us, http://www.dfs.ny.gov/about/dfs_about.htm. It is assumed here that the OFAC MOU with the New York State Banking Department remains in place with the NYDFS.

[6] MOU at Section I.A.

[7] *Id*. at Section V.

[8] *United States v. Pink*, 315 U.S. 203, 233-34 (U.S. 1942)

[9] OFAC, About OFAC, *at* https://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx (last accessed July 15, 2016).

[10] *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 363 (2000). The Supremacy Clause of the U.S. Constitution provides that: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bond thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const. art. VI, § 1, cl. 2. *See also Zschernig v. Miller*, 389 U.S. 429 (1968) (finding unconstitutional an Oregon statute requiring, *inter alia*, non-resident alien heirs or successors prove that the laws of their country would allow their use or control of inherited property without government "confiscation" (*i.e*., in communist countries). The Court explained: "It seems inescapable that the type of probate law that Oregon enforces affects international relations in a persistent and subtle way. The practice of state courts in withholding remittances to legatees residing in Communist countries or in preventing

them from assigning them is notorious. The several States, of course, have traditionally regulated the descent and distribution of estates. But those regulations must give way if they impair the effective exercise of the Nation's foreign policy . . . Where those laws conflict with a treaty, they must bow to the superior federal policy." *Id.* at 440-41 (internal citations omitted). *Zschernig* is noteworthy as it involves a state law that furthered traditional state prerogatives (regulation of inheritance) but crossed a constitutional line between state and federal authority by touching foreign affairs. In the case of state enforcement of OFAC sanctions, the analogous issue is whether state actors cross constitutional lines when they assert traditional state bank objectives to enforce federal laws and regulations that, like OFAC sanctions, reflect and advance U.S. foreign affairs.

*Note also that state sanctions laws targeting foreign governments or government conduct also trigger questions under the Foreign Commerce Clause of the U.S. Constitution, which grants Congress the power to "regulate commerce with foreign nations . . . ." U.S. Const. art. I, § 8, cl. 3. The Foreign Commerce Clause is not discussed in this summary.

[11] *Crosby*, 530 U.S. at 368 (discussing the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1997 enacted by the Omnibus Consolidated Appropriations Act, 1997, Pub. L. No. 104-208 (1996) (imposing, *inter alia*, mandatory and conditional sanctions against Burma/Myanmar). In reaching its decision, the Court in *Crosby* determined that the state law impeded the objectives and mechanics of the federal statute, including by limiting the President's ability to negotiate with allies and others. The Court stated: "We need not get into any general consideration of limits of state action affecting foreign affairs to realize that the President's maximum power to persuade rests on his capacity to bargain for the benefits of access to the entire national economy without exception for enclaves fenced off willy-nilly by inconsistent political tactics." *Id.* at 381.

[12] The Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1997 is one of the legislative bases for OFAC-administered Burma/Myanmar sanctions, pursuant to Exec. Order No. 47 (Prohibiting New Investment in Burma), 62 Fed. Reg. 28,299 (1997). The NYDFS has made findings of Burma/Myanmar U.S. sanctions violations. *See, e.g.*, NYDFS press releases and consent orders with Deutsche Bank AG and Crédit Agricole and their respective New York branches, *available at* http://www.dfs.ny.gov/about/dfs_press_2015.htm.

[13] *See, e.g.,* Consent Order Under New York Banking Law §§ 39 and 44, between the NYDFS and Deutsche Bank AG and Deutsche Bank AG New York Branch, paras. 26-28 (Nov. 3, 2015) (finding violations of books and records provisions at New York Banking Law §§ 104 and 200-c, false reporting provisions at New York Regulations § 3.1, and reporting provisions at New York Regulations § 300.1) [hereinafter "Deutsche Order"].

[14] Such provisions are similar to the books and records provisions of the U.S. Foreign Corrupt Practices Act of 1977, as amended, 15 U.S.C. §§ 78dd-1, et seq. (LexisNexis 2016).

[15] Deutsche Order.

[16] Access to outside services providers and consultants conceivably may include outside legal counsel. Access to outside legal counsel may raise attorney-client privilege issues in some cases, particularly where outside counsel is located in a jurisdiction in which attorney-client privilege is limited or not available under applicable law.

[17] *See, e.g.,* Deutsche Order, paras. 30-44.

[18] Banking Division Transaction Monitoring and Filtering Program Requirements, 38 N.Y. St. Reg. 13 (June 20, 2016) at § 504.1. The final rule, which takes effect on January 1, 2017, states: "The . . . [NYDFS] . . . has been involved in investigations into compliance by Regulated Institutions . . . with applicable . . . [OFAC] requirements implementing federal economic and trade sanctions. As a result, the Department has determined to clarify the required attributes of a Transaction Monitoring and Filtering Program . . . ." *Id.* at § 504.1. The NYDFS rule on OFAC monitoring and filtering raises a distinct but related question of whether the rule constitutes direct state regulation of OFAC sanctions, and therefore foreign affairs. The similarity of the rule and its implementation to OFAC regulations and enforcement and compliance guidance may be relevant to determining whether the rule is a regulation of foreign affairs that frustrates existing sanctions frameworks. Nevertheless, the issuance of a such a rule by a state regulator raises, or should raise, questions of legal authority. As previously noted, this matter is discussed in the forthcoming publication partially summarized here.

[19] Deutsche Order at pg. 2.