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OFAC compliance in the securities and investment sector

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Abstract

Purpose – *The purpose of this paper is to highlight some of the most significant US sanctions risks faced by persons that operate in the securities and investment marketplace, in order to encourage firms to maintain comprehensive, risk-based compliance controls that will strengthen their ability to comply with US sanctions regulations.*

Design/methodology/approach – *The paper begins with a brief overview of the sanctions programs administered by the US Treasury Department's Office of Foreign Assets Control (OFAC), followed by examples of potential sanctions violations that emphasize the risks and challenges faced by the securities and investment sector with respect to sanctions. Finally, the paper describes how firms can develop measures intended to mitigate their OFAC risk and prevent the potentially costly monetary penalties associated with violations of US sanctions regulations.*

Findings – *The nature of the securities and investment sector can make identifying the often indirect sanctions implications of engaging in certain activity a challenging task; however, a well thought out, responsibly implemented OFAC compliance program can help mitigate sanctions risks in an effective manner.*

Originality/value – *The paper provides insight regarding OFAC compliance in the securities and investment sector directly from the government agency responsible for administering and enforcing US sanctions.*

Keywords *Sanctions, Treasury, Iran, United States of America, Securities markets*

Paper type *Technical paper*

Introduction

Sanctions have been much in the news of late. The President's ability to use sanctions against targets that pose threats to the nation's security, foreign policy, or economy is a powerful and effective way to further US foreign policy and protect the interests of the US. The success of sanctions, of course, depends on their effective implementation by the private sector. This article highlights some of the most significant US sanctions risks faced by persons that operate in the securities and investment marketplace, and it outlines steps that can be taken to mitigate exposure.

Background

The US Department of the Treasury's Office of Foreign Assets Control (''OFAC'') is charged with administering and enforcing US economic sanctions. Its programs are primarily implemented under the authority of the International Emergency Economic Powers Act (''IEEPA'')[1] and the Trading With the Enemy Act[2]. OFAC sanctions generally either target countries or regimes whose actions or policies are determined to constitute an unusual and extraordinary threat to the national security, foreign policy, or economy of the US, or they target specific individuals or entities involved in or contributing to activity determined to constitute such a threat (such as narcotics trafficking, weapons proliferation, and terrorism)

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regardless of geographic location. Currently, OFAC administers over 20 sanctions programs. Although each program is unique, they all generally involve cutting off sanctions targets' access to the US marketplace by prohibiting transactions in certain property or interests in property within the US or involving US persons[3], and/or requiring US persons to block (i.e. freeze) the property of sanctioned persons who are listed on OFAC's list of Specially Designated Nationals and Blocked Persons (''SDN List'') and entities that are 50 percent or more owned, directly or indirectly, by such persons. Any person listed as blocked on the SDN list or 50 percent or more owned by a person whose property is blocked is considered a ''blocked person''[4].

OFAC-related risks in the securities and investment sector

OFAC recently posted on its website a settlement relating to an apparent violation of US sanctions against Iran, in which OFAC had pursued an enforcement action against a US investment manager that had delegated its authority to carry out transactions to a third-party agent, where that authority had then been used to purchase shares in a company that invests exclusively in Iranian securities. An individual or entity that violates a sanctions program administered by OFAC is liable for that violation regardless of whether the violation occurred with the knowledge or intent of the violator[5]. Apparent ignorance of the law did not shield this investment manager from potential civil liability arising out of its investment in Iran, and will not absolve similarly situated individuals or entities from potential civil liability.

As this case highlights, OFAC will consider the totality of facts and circumstances surrounding apparent violations of the regulations it administers, and it is critical that an institution be able to identify and mitigate adequately the OFAC risks it faces. Failure to do so could lead to hefty civil monetary penalties for the violator (which are up to the greater of $250,000 or twice the value of each transaction under IEEPA), as well as considerable reputational damage[6]. When assessing OFAC risk and developing an OFAC compliance program, OFAC's Enforcement Guidelines[7] should be taken into account. OFAC's Enforcement Guidelines identify the range of responses OFAC may pursue and set forth the General Factors Affecting Administrative Action that OFAC considers when determining its response to apparent violations. As the Enforcement Guidelines make clear, an entity's policies and procedures intended to mitigate its OFAC risk are an important part of OFAC's calculus when it analyzes apparent violations.

At the most basic level, OFAC risk in the securities and investment sector stems from the possibility of engaging in prohibited business with a person or country subject to US economic sanctions. Opening a brokerage account for, or executing a trade involving, a blocked person or a person in a country subject to comprehensive sanctions would (unless authorized by OFAC or exempt) constitute a violation of OFAC sanctions. Protecting a firm from doing business directly with an individual or entity that appears on OFAC's SDN List is relatively straightforward. One of the most effective and common methods employed to mitigate the risk of such a violation is to screen customers' names and other keywords in transactions against the SDN List in order to identify and investigate possible OFAC issues. Most large securities firms use automated interdiction software to perform this type of screening. However, screening names and keywords alone does not completely eliminate a firm's exposure to OFAC risk. The name or location of a sanctions target may not be clearly evident on the face of a transaction, account, or activity, which could result in a firm unwittingly engaging in unlawful activity.

Doing business with a sanctions target indirectly, or where the involvement of the sanctioned party is not readily apparent, is a far more insidious type of OFAC-related risk, as it is harder to identify and more difficult to protect against. While screening individual, entity, or country names and other identifying information can help alert firms to possible red flags in transactions, identifying the indirect involvement of a sanctioned party requires extra scrutiny and due diligence. For instance, the fact that an entity is 50 percent or more owned by a blocked person may not be obvious and may require research into the parties involved. This type of risk is particularly relevant to the securities and investment sector, which historically has placed a premium on customer privacy and confidentiality. The industry

employs as its standard business model practices and procedures that can make it more difficult for firms to discern the potential interest or involvement of sanctioned persons or countries. This difficulty was encountered by the securities community during the implementation of recent sanctions involving Libya. One example was the layering involved in securities custody arrangements where multiple institutions – including custodian banks and central securities depositories – are often involved in the safekeeping of assets[8]. Because the true beneficial owners of the securities may not be known across the tiers of custody and may change over time, this arrangement may mask the interest of a blocked person or a sanctioned country, causing US firms to find themselves in unexpected troubles. Similarly, the use of intermediary institutions, such as wealth management companies, to make investments on behalf of customers can also pose an OFAC risk as the true customers' names may not be disclosed to the US parties involved.

The hypothetical examples that follow highlight several scenarios that may result in violations of OFAC sanctions. Although the examples are not comprehensive, they are intended to be helpful in assisting firms to better understand indirect OFAC risk and to provide insight into how to mitigate such risk effectively. The examples are divided into two categories: the first encompasses cases where a US person provides investment-related services to or for a blocked person or a person in a sanctioned jurisdiction, and the second involves a US person investing in a sanctioned jurisdiction or entity.

Category I – providing services to or for a sanctioned party

1. A US custodian bank holds shares on behalf of its European customer of a Cayman Islands-based company that is 50 percent owned by an entity designated by OFAC as a Weapons of Mass Destruction Proliferator. Such activity would likely violate §544.201 of the Weapons of Mass Destruction Proliferators Sanctions Regulations, 31 C.F.R. part 544, which prohibits US persons from dealing in property or interests in property, directly or indirectly, of any individual or entity designated pursuant to this sanctions program.
   - Comment: Firms that provide custody services – i.e. holding securities such as stocks and bonds on behalf of their customers – could find themselves running afoul of OFAC sanctions if the issuer of the securities is owned 50 percent or more by a blocked person. Firms should use a risk-based approach to determine when additional due diligence is warranted to identify the potential sanctions implications of holding certain securities.
2. A US custodian bank's overseas customer uses its omnibus account at the US custodian bank to hold interests in securities that are beneficially owned by an entity located in Iran. This conduct would likely violate §560.204 of the Iranian Transactions Regulations, 31 C.F.R. part 560, prohibiting the exportation of services, directly or indirectly, from the United States or by a US person to Iran.
   - Comment: Firms that hold a securities or investment account for another financial institution that is maintaining the account for its own customers – referred to as an omnibus account – can face higher OFAC risk in certain circumstances. For instance, if the US institution's direct customer is a foreign financial institution located in a high-risk location that uses its omnibus account to trade or hold securities on behalf of a multitude of undisclosed third parties, then enhanced due diligence may be needed to mitigate the risk of an OFAC violation.
3. In the recent Libyan sanctions, the Government of Libya (''GOL'') had invested in a number of US-based investment vehicles through its third-country institutional wealth manager. The investments were made legitimately prior to the imposition of sanctions on the GOL, but when the GOL was blocked in February 2011, the interest of the GOL in the US investment vehicles was not immediately evident because of the intermediation of the third-country wealth manager. Had the US investment vehicles not blocked and reported the investments, they would likely have violated §570.201 of the Libyan Sanctions Regulations, 31 C.F.R. part 570.

- Comment: A US hedge fund or other investment vehicle with overseas institutional investors might unknowingly provide investment management services to a blocked person or a person located in a sanctioned jurisdiction in cases where the US fund's direct investor is investing on behalf of its own clients, whose identities are not disclosed to the US fund. US investment vehicles should use a risk-based approach to determine when additional due diligence is warranted to identify the potential sanctions implications of their investment activities.

Category II – investing in a sanctioned jurisdiction or entity

1. US persons that invest in foreign securities might run afoul of US economic sanctions if the foreign issuer of the security is located in a sanctioned country or 50 percent or more owned by a blocked person. US persons may also encounter greater exposure to OFAC sanctions issues when investing in foreign investment funds or exchanges that are not subject to US jurisdiction. This type of OFAC risk is generally elevated when investing in high-risk geographic areas.
2. A number of the sanctions programs administered by OFAC prohibit US persons from facilitating any transaction by a foreign person where the transaction would be prohibited if performed by a US person or within the US[9]. For example, US investment advisors or managers responsible for making investment decisions for an offshore fund could find themselves in violation of OFAC sanctions regulations if they direct, authorize, or otherwise facilitate an investment in Iran by the offshore fund.

OFAC compliance in the securities and investment sector

The above examples are intended to raise awareness about the more challenging types of OFAC risk in the securities and investment sector and encourage firms to establish and maintain OFAC compliance programs designed to detect, monitor, and address potential violations in a systematic and thorough manner. Developing a robust OFAC compliance program in the securities and investment sector begins with conducting a risk assessment of a firm's business to identify those areas that may pose greater risk of violating OFAC sanctions. Identifying such vulnerabilities provides a firm with a basis for developing comprehensive policies and procedures for mitigating the risks and preventing violations from occurring. A risk-based approach should take into account factors such as: the type of products and services offered by a firm; the nature of its customer base, including geographic location and (for institutional customers) market, products, and downstream customers; and the jurisdictions in which a firm deploys its capital[10].

Since no two firms are exactly alike, every firm will exhibit a different OFAC risk profile that calls for its own compliance program – there is no ''one size fits all'' solution appropriate for every person operating in the securities and investment sector. Some measures that are appropriate for large, multinational investment firms may be unnecessary or impractical for a small, regional broker-dealer with a different business model. A large international firm involved in the securities custody industry may find it prudent, given its particular risk profile, to employ software designed to alert the firm to securities transactions that may implicate US sanctions, including by identifying questionable or unusual activity, relationships across multiple data sources, and evasion attempts. However, such sophisticated software might not be necessary for a smaller firm that principally holds securities issued by US companies on behalf of US customers.

Although mitigating OFAC risks may be complicated by a lack of information regarding the beneficial ownership of securities or other investments, there are steps that US firms can take to identify beneficial ownership. While compliance with sanctions regulations and with anti-money laundering rules are distinct matters, there may be overlapping best practices when it comes to the operational processes and procedures used to implement requirements under US law. Guidance issued by the Financial Crimes Enforcement Network (''FinCEN'') in March 2010, for instance, states that financial institutions should use customer due diligence (''CDD'') procedures ''that are reasonably designed to identify and

verify the identity of beneficial owners of an account [. . .]''[11]. The information gleaned from such due diligence can often be used to identify potential sanctions concerns as well.

Even when obtaining specific information about beneficial ownership of an account or a transaction is difficult or impossible, robust communication of a firm's OFAC obligations to its clients, affiliates, or counterparties to a transaction can mitigate OFAC risk and help protect the firm from exploitation by sanctions targets. US companies may wish to consider including appropriate disclaimers in communications between, and requiring agreements from, direct customers or affiliates, to protect the US company from becoming entangled in prohibited transactions. In transactions or relationships involving heightened risk, such measures may include obtaining agreements at the time a customer relationship is established, seeking affidavits or warranties prior to execution of significant transactions, or including a clause in relevant or vulnerable contractual agreements, in which the customer pledges not to engage in transactions involving the US firm that violate OFAC sanctions regulations. While these measures are no guarantee that an OFAC violation will not occur or that OFAC will not pursue an enforcement action, including such measures as part of a firm's OFAC compliance program demonstrate that the firm is aware of and actively trying to prevent OFAC sanctions violations.

Finally, given the dynamic nature of US sanctions programs and the speed with which some programs are announced and evolve, the key to effective OFAC compliance is now more than ever regular employee training, including developing the ability to identify potential sanctions issues and to resolve them appropriately. Automated screening can go only so far in helping to detect sanctions violations. In the end, identifying your institution's frontline employees and making sure they are aware of and understand the sanctions vulnerabilities you may face is the ultimate weapon in any effective OFAC compliance program.

Conclusion

Today's securities and investment sector is increasingly interlinked and access to global markets has never been more efficient, creating opportunities for substantial economic growth and gain. A well thought out, responsibly implemented OFAC compliance program that takes into account the sanctions risks that go hand in hand with such an interconnected financial system will allow US persons to reap the benefits of the system while simultaneously strengthening their ability to comply with US sanctions regulations.

Notes

1. See 50 U.S.C. §§1701-06.
2. See 50 U.S.C. App. §§1-44.
3. For the purposes of this article, ''US person'' means any US citizen, permanent resident alien, entity organized under the laws of the US or any jurisdiction within the US (including foreign branches), or any person in the US. The Cuban Assets Control Regulations, 31 C.F.R. part 515, use a more broadly defined term, ''Persons subject to the jurisdiction of the US,'' that includes foreign subsidiaries of US companies. See 31 C.F.R §§515.329, 515.330.
4. Specific information on each of OFAC's sanctions programs is publicly available on the OFAC website. See www.treasury.gov/ofac. The SDN List is also publicly available via OFAC's website. See www.treasury.gov/sdn. See also OFAC's ''Guidance on Entities Owned by Persons Whose Property and Interests in Property Are Blocked,'' February 14, 2008, available at: www.treasury.gov/resource-center/sanctions/Documents/licensing_guidance.pdf
5. Persons may face criminal liability for willful violations of OFAC sanctions.
6. See 31 C.F.R. part 501, App. A, available at: www.treasury.gov/resource-center/sanctions/Documents/fr74_57593.pdf
7. Ibid.
8. See, for instance, Chan et al., ''The Securities Custody Industry,'' European Central Bank, Occasional Paper Series No. 68 (2007).

9. See, for example, the Burmese Sanctions Regulations, 31 C.F.R. 537.205, the Iranian Transactions Regulations, 31 C.F.R. 560.208, and the Sudanese Sanctions Regulations, 31 C.F.R. 538.206.

10. For more information regarding the assessment of risk factors, see ''Risk Factors for OFAC Compliance in the Securities Industry,'' Office of Foreign Assets Control, November 5, 2008. Available at: www.treasury.gov/resource-center/sanctions/Documents/securities_risk_11052008.pdf

11. See ''Guidance on Obtaining and Retaining Beneficial Ownership Information,'' FinCEN, March 5, 2010, available at: www.fincen.gov/statutes_regs/guidance/html/fin-2010-g001.html. On March 5, 2012, FinCEN issued a proposed rule regarding CDD and beneficial ownership that contemplates a categorical requirement for financial institutions to obtain information about the beneficial owners of accounts as well as of the assets within accounts. See ''Advance Notice of Proposed Rulemaking: Customer Due Diligence Requirements for Financial Institutions,'' FinCEN, Federal Register, Vol. 77 No. 43, March 5, 2012.

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