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Sanctions 2020

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First Edition

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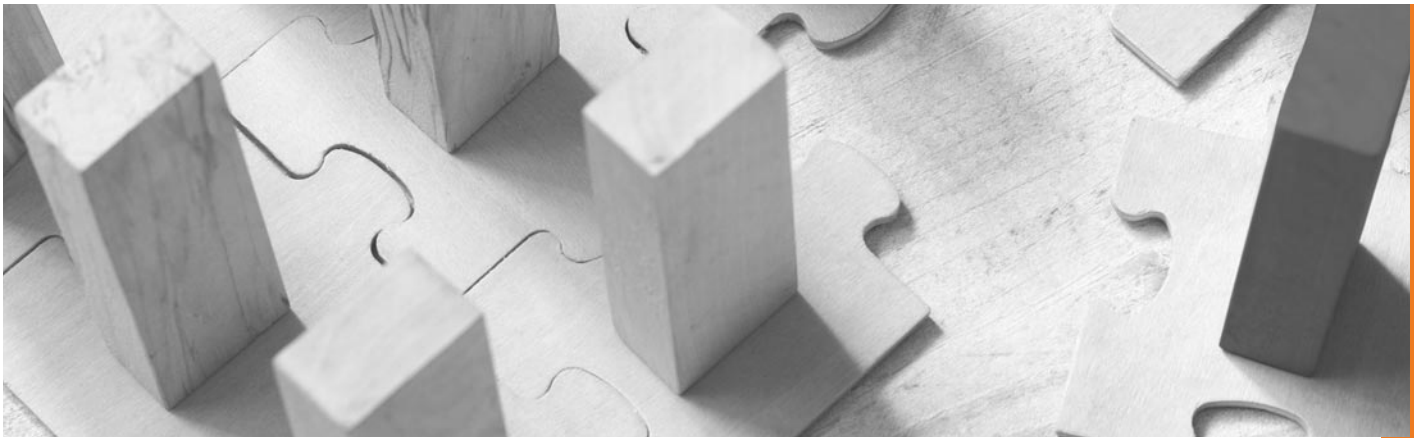

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Recent Developments in U.S. Sanctions: OFAC Compliance Guidance and Enforcement Trends

Paul, Weiss, Rifkind, Wharton & Garrison LLP

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Introduction

The U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") is in the midst of a record-setting year for enforcement. In the first seven months of 2019, OFAC has taken 19 public enforcement actions and assessed nearly $1.3 billion in civil monetary penalties, representing the highest level of penalties assessed by OFAC in any calendar year. (Along with sanctions-related resolutions by the U.S. Department of Justice and federal and state banking agencies, the total comes to over $2.5 billion so far in 2019.) Additionally, under the leadership of Treasury Under Secretary for Terrorism and Financial Intelligence Sigal Mandelker, OFAC has launched a new initiative to focus on compliance expectations. OFAC has made a set of 23 compliance commitments a standard part of its settlement agreements, and in May 2019 it published "A Framework for OFAC Compliance Commitments" (the "Framework"), which for the first time comprehensively explains the agency's expectations for sanctions compliance programmes for U.S. and non-U.S. companies.

This chapter discusses OFAC's compliance programme expectations and lessons learned from OFAC's recent enforcement actions.

OFAC's New Compliance Framework

The Framework, and the related "compliance commitments" that are now a standard part of OFAC settlements, represent a new effort by OFAC to more clearly and comprehensively communicate its expectations about appropriate sanctions compliance practices. OFAC made clear that the guidance is intended not only for U.S. companies, but also for non-U.S. companies that conduct business in or with the United States, with U.S. persons, or using U.S.-origin goods or services. U.S. and non-U.S. companies would be well-advised to study the Framework carefully because, among other things, OFAC will consider satisfaction of the Framework a mitigating factor in the event of an enforcement action.[1]

The Framework describes five "essential components" of an effective sanctions compliance programme:[2]

- Management Commitment. The Framework notes that Senior Management's[3] commitment to, and support of, a company's risk-based sanctions compliance programme ("SCP") is "one of the most important factors in determining its success". This commitment can be evidenced by management's: (1) review and approval of the SCP; (2) ensuring that the compliance function has sufficient authority and autonomy to deploy policies and procedures to effectively control OFAC risk (this includes the designation of a sanctions compliance officer); (3) ensuring the compliance function receives adequate resources; (4) promoting a "culture of compliance"; and (5) recognition of the seriousness of, and the implementation of necessary measures to reduce the occurrence of, sanctions violations.[4]
- Risk Assessment. As is consistent with OFAC's past practice, the Framework recommends that SCPs be designed and updated pursuant to a "risk-based approach". OFAC officials have emphasised that not every company is expected to satisfy every element of the Framework, but rather companies should tailor their programmes to their unique risk profiles. One of the "central tenets" of a risk-based approach is for companies to "conduct a routine, and if appropriate, ongoing 'risk assessment' for the purposes of identifying potential OFAC issues they are likely to encounter".[5] OFAC identifies two core elements of a commitment to meet this compliance component: periodic risk assessments (including the conducting of due diligence during client and third-party onboarding and merger and acquisition activities); and development of a methodology to analyse and address the particular risks identified by these risk assessments (which could include the root causes of any apparent violations or systemic deficiencies identified by the organisation during the routine course of business as well as through its testing and audit function).[6]
- Internal Controls. Effective OFAC compliance programmes generally include internal controls to identify, interdict, escalate, report, and keep records pertaining to prohibited activity. Key elements include: (1) written policies and procedures tailored to the organisation's operations and risk profile and enforced through internal and/or external audits; (2) adequately addressing the results of a company's OFAC risk assessment; (3) implementation of immediate and effective remedial actions; (4) clear communication of policies and procedures to all relevant staff; and (5) identification of designated personnel responsible for integrating policies and procedures into daily operations.[7]
- Testing and Auditing. A comprehensive and objective SCP audit function ensures the identification of programme weaknesses and deficiencies. OFAC notes that it is the company's responsibility to enhance its programme, including all programme-related software, systems and other technology, to remediate any identified compliance gaps.
- Training. The Framework describes training as "integral" and outlines OFAC's expectation that training programmes be: "provided to all appropriate employees and personnel on a periodic basis (and at a minimum, annually) and generally should accomplish the following: (i) provide job-specific knowledge based on need; (ii) communicate the sanctions compliance responsibilities for each employee; and (iii) hold employees accountable for sanctions compliance training through assessments."[8]

OFAC Director Andrea Gacki explained that the Framework was developed as part of OFAC's continuing effort to strengthen sanctions compliance practices "across the board", and underlines OFAC's "commitment to engage with the private sector to further promote understanding of, and compliance with, sanctions requirements".[9] Consistent with OFAC's Economic Sanctions

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Enforcement Guidelines (the "Guidelines"), the Framework emphasises that, in the event of an OFAC enforcement action, the agency will consider favourably that a company had an effective SCP at the time of the apparent violations; it will also consider the Framework in evaluating a company's remedial actions.[10] The Framework also states that, in appropriate cases, OFAC will consider the effectiveness of a company's SCP at the time of the apparent violations in determining whether they are "egregious" under the Guidelines.[11] While OFAC's Enforcement Guidelines have always stated that the agency's egregiousness determination will be based on an analysis of the General Factors (which include reference to consideration of a company's risk-based compliance programme), OFAC has historically not given the compliance programme factor much weight in these determinations.[12] The Framework's explicit recognition of compliance as a factor for consideration in OFAC's egregiousness determination is reflective of OFAC's increased focus on compliance.

As an appendix to the Framework, OFAC also describes some of the common "root causes" of the violations that were the subject of its prior enforcement actions. These themes and others are addressed in the enforcement trends section below.

The practices described by the Framework largely align with the compliance expectations of the U.S. federal banking regulators as described in the Federal Financial Institutions Examination Council ("FFIEC") Bank Secrecy Act/Anti-Money Laundering Examination Manual.[13] Accordingly, many banks operating in the United States likely already incorporate the elements described in the Framework (at least in their U.S. operations), and many large, sophisticated companies outside the financial sector probably do as well. For many U.S. and non-U.S. companies that engage in international trade, however, there may be gaps between their current practices and the elements described in the Framework. It is important for such companies to study the Framework in light of their own sanctions risk profiles (including factors such as the company's size and sophistication, products and services offered, customers and counterparties, and geographic locations) to determine whether updating or enhancing their programmes would be advisable. In many ways, the Framework can be viewed as the "gold standard" for compliance, and companies with lower risk profiles may be able to implement lesser measures.

Enforcement Trends

Consistent with its new focus on compliance, OFAC has incorporated 23 compliance commitments into over half a dozen of its public settlement agreements since December 2018; these settlements have involved both financial institutions and non-financial institutions.[14] In these settlements, OFAC has also imposed a requirement that the settling party annually certify its compliance with the commitments over a five-year period. Complying with the commitments and the annual certification obligation will likely require settling parties to invest additional resources in their SCPs and therefore increases the costs associated with OFAC settlements.

OFAC's enforcement actions in 2018 and 2019, together with the Framework's discussion of "root causes", highlight compliance deficiencies or breakdowns that are commonly responsible for sanctions violations. We describe the major areas of concern below.

Use of the U.S. financial system, including the use of U.S. dollar payments

OFAC views the use of the U.S. financial system for the benefit of sanctioned persons or jurisdictions as constituting a violation of U.S. sanctions.

The November 2018 Société Générale S.A. resolution ($1.3 billion) and the April 2019 UniCredit Group resolution ($1.3 billion) show that the march of large, multi-agency enforcement actions against banks for "wire stripping" or other non-transparent payment methods – involving conduct largely from a decade ago – continues to the present day.[15] Further, the April 2019 multi-agency settlement with Standard Chartered Bank ($1.1 billion), which concerns largely pre-2012 conduct, demonstrates that U.S. regulators have also taken enforcement action against financial institutions outside the context of "wire stripping" or other non-transparent payment methods. For example, OFAC cited the bank's alleged delays in restricting sanctioned country access to its online banking platform and fax transmissions as a compliance failure that led to apparent sanctions violations.

Additionally, in 2017, OFAC made clear through its enforcement action against Singaporean entity CSE Global Limited and its subsidiary CSE TransTel Pte. Ltd. that non-U.S. companies can violate U.S. sanctions by *causing* – through initiating U.S. dollar payments – U.S.-based banks or branches to violate sanctions by engaging in the prohibited exportation of financial services from the United States for the benefit of sanctioned parties or jurisdictions. In announcing this enforcement action, OFAC stated that the action "highlights the sanctions compliance obligations of all individuals and entities that conduct business in OFAC-sanctioned jurisdictions or with OFAC-sanctioned parties and that also process transactions directly or indirectly through the United States, or involving U.S. companies, or U.S.-origin goods, services, and technology".[16] In certain circumstances, we believe OFAC would also likely view a non-U.S. company's *receipt* of U.S. dollar payments involving sanctioned persons or jurisdictions to constitute a violation (for example, where a non-U.S. seller advised a non-U.S. buyer how to accomplish a wire transfer in U.S. dollars without alerting U.S. banks to the involvement of an OFAC-sanctioned person or jurisdiction).

Utilising non-standard payment or commercial practices

The Framework notes that companies are best positioned to determine whether a particular dealing, transaction, or activity is performed in a manner consistent with industry practice. Sometimes deviations from standard practice are driven by an effort to evade or circumvent sanctions. For example, in both the Société Générale and UniCredit matters discussed above, the financial institutions allegedly adopted non-standard, non-transparent practices designed to avoid detection by U.S. financial institutions (*e.g.*, removing, omitting, or obscuring references to sanctioned parties or sanctioned jurisdictions from the wire payment instructions). In other instances, a customer may ask for an accommodation that results in a sanctions violation (*e.g.*, in the Haverly Systems case, discussed below, a Russian customer requested that an invoice be reissued with a different date, resulting in the processing of a payment that otherwise may have been rejected pursuant to OFAC requirements).

Export or reexport of U.S.-origin goods

OFAC has regularly pursued enforcement actions against non-U.S. companies that purchased U.S.-origin goods with the intent of reexporting, transferring, or selling the items to a sanctioned person or jurisdiction. As noted in the Framework, OFAC's public enforcement actions in this area have generally been focused on large or sophisticated entities that "engaged in a pattern or practice that lasted multiple years, ignored or failed to respond to numerous warning signs, utilized non-routine business practices, and – in several instances – concealed their activity in a willful or reckless manner".[17]

For example, in December 2018, Chinese entity Yantai Jereh Oilfield Services Group Co. and its worldwide affiliates ("Jereh") reached a $2,774,972 settlement with OFAC relating to the export or reexport of U.S.-origin goods, including oilfield equipment, through China to Iran. Jereh concurrently settled related U.S. export

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control violations with the Department of Commerce's Bureau of Industry and Security ("BIS") for $600,000. OFAC noted that Jereh did not cease its violative behavior until BIS added several Jereh companies and related individuals to its Entity List in March 2016, which resulted in a prohibition on the receipt of U.S. exports without a licence.

Facilitating activities of non-U.S. affiliates

Multiple OFAC enforcement actions have involved U.S. firms referring business to, approving or otherwise facilitating dealings with sanctioned persons or jurisdictions by their non-U.S. affiliates. For example, Zoltek Companies, Inc. ("Zoltek"), a U.S. industrial equipment and services company, approved 26 purchases between a Hungarian Zoltek subsidiary and a Belarusian SDN. OFAC determined that, although multiple U.S. management personnel engaged in discussions regarding the sanctioned status of the Belarusian company, the U.S. parent continued to review and approve the Hungarian subsidiary's transactions with the sanctioned entity.[18] Non-U.S. companies with U.S. operations should take steps to ensure that U.S. offices and employees are walled off or recused from any sanctioned business engaged in by non-U.S. parts of the company.

Improper due diligence on customers/supply chain/other third parties

A fundamental element of sanctions compliance is conducting appropriate due diligence on customers, supply chains, intermediaries, and counterparties. OFAC has recently brought several enforcement actions resulting from deficient due diligence.

As demonstrated by the UniCredit settlement, financial institutions are expected to review the ownership structure of entities and to not permit entities affiliated with sanctioned persons or entities access to U.S. dollar accounts without additional diligence. In addition, OFAC and other regulators expect companies to fully review all the documentation they receive for potential indicia of a nexus to a sanctioned jurisdiction or person prior to sending, approving, or facilitating a payment. The issue of a sanctioned entity's use of affiliates and third parties as proxies continues to be a difficult compliance challenge for companies across sectors.

As OFAC demonstrated in its January 2019 settlement with California-based e.l.f. Cosmetics, Inc. ("ELF"), and consistent with its 2018 advisory regarding North Korea supply chain links,[19] OFAC expects companies to conduct "full-spectrum supply chain due diligence" to identify goods, services, technology and labour from sanctioned jurisdictions when sourcing products from overseas, "particularly in a region in which [North Korea] as well as other comprehensively sanctioned countries or regions, is known to export goods".[20] Although OFAC noted that ELF's compliance programme was either non-existent or inadequate during the relevant period, OFAC did not note any specific red flags or other information that suggested that ELF's Chinese suppliers were incorporating North Korean materials. As a result, this action is a reminder of OFAC's willingness to apply a strict liability standard in certain circumstances. Non-U.S. companies could also face OFAC liability if they export products to the United States that were sourced in sanctioned jurisdictions or incorporate sanctioned country materials or components.

Misinterpreting, or failing to understand the applicability of, OFAC's regulations

Often companies will misunderstand the applicability or scope of OFAC's sanctions prohibitions either because they are not aware of sanctions regulations or because they are unaware that such regulations apply to them by virtue of their status as U.S. persons, U.S.-owned subsidiaries (with respect to Cuba and Iran sanctions), or non-U.S. persons engaged in activities with a U.S. nexus (involving U.S. persons, U.S.-origin goods, or U.S. territory, including payments transiting the U.S. financial system).

For example, in OFAC's May 2019 settlement with U.S.-based Haverly Systems, Inc., OFAC determined that the company collected a debt from an entity on the Sectoral Sanctions Identification ("SSI") List outside of the permitted maturity window.[21] Although the initial payment terms were between 30 and 70 days (which were under the 90-day maximum), Haverly encountered certain delays in providing tax documentation required by the SSI entity to make payment. This resulted in a delay of nearly nine months from the time the invoice was issued until the SSI was prepared to make payment. OFAC treats delayed payments as debt subject to the limits of relevant sectoral sanctions Directives and noted that, although Haverly "did not recognize that the delayed collection of payment was prohibited", the company, upon encountering processing issues related to the payment, "did not approach OFAC for guidance or authorization. . . and instead explored various options to collect the payment" and, at the suggestion of the SSI, "reissued and re-dated" the invoice in apparent violation of OFAC sanctions.

Lack of a sanctions compliance programme; decentralised compliance function

As the OFAC Framework acknowledges, OFAC's regulations do not themselves require the implementation of an effective sanctions compliance programme. Not having one, however, may be viewed by the agency as an aggravating factor in the event of an enforcement action. For example, in its May 2019 settlement with U.S.-based MID-SHIP Group LLC, OFAC noted that the company appeared to have a "deficient culture of compliance".[22] Likewise, OFAC found Haverly's lack of an OFAC compliance programme to be an aggravating factor, and noted in the Jereh and ELF matters that the companies' compliance controls were non-existent or inadequate.

Compliance failures also arise when large companies adopt a decentralised compliance function, or lack a formal escalation process to review high-risk transactions. For example, in its finding of violation against State Street Bank and Trust Co., OFAC noted that compliance personnel aligned with the line of business who lacked sanctions expertise – rather than the bank's centralised sanctions compliance personnel – were responsible for manually reviewing sanctions hits related to Iran and approving the processing of the violative payments.[23] These personnel apparently did not identify the sanctions issues related to the company processing 45 pension payments to a U.S. citizen who was resident in Iran.

Screening software limitations

Many companies screen their customers and other third parties, but such screening may be deficient due to a failure to adequately calibrate, update, or audit their screening software and screening procedures.

OFAC's November 2018 settlement with Cobham Holdings, Inc. ("Cobham") makes clear that the utilisation of defective screening software will not provide a shield against regulatory enforcement.[24] According to OFAC, U.S.-based Cobham made three shipments of goods through distributors in Canada and Russia to an entity that did not appear on the SDN List, but which was blocked under OFAC's "50 per cent rule" because it was 51% owned by a Russian SDN. The apparent violations appear to have been caused by reliance on deficient third-party screening software. Although Cobham had selected "fuzzy" searching to detect partial matches, the software instead used the more permissive "all word" match criteria. The names of the blocked party and its subsidiary both contained several

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of the same uncommon words such that fuzzy searching apparently would have detected the match; however, under the "all word" criteria, the transactions were not flagged and were processed.

Likewise, OFAC issued a Finding of Violation to JPMorgan Chase & Co. ("JPMCC") in 2018 for sanctions violations involving the processing of transactions and maintenance of accounts on behalf of SDN customers. For six years, JPMCC employed a vendor screening system that failed to identify these individuals as SDNs despite strong similarities between the accountholder's names, addresses, and dates of birth in JPMCC account documentation and on the SDN list. This was because the system's screening logic capabilities failed to identify customer names with hyphens, initials, or additional middle or last names as potential matches to similar or identical names on the SDN List. OFAC found that although JPMCC identified weaknesses in the screening system as early as 2010 and implemented a series of improvements between 2010 and 2012, the apparent violations were not identified until 2013 when JPMCC transitioned to a new screening system that identified the apparent violations. OFAC stressed the "importance of financial institutions remediating known compliance program deficiencies in an expedient manner, and when that is not possible, the importance of implementing compensating controls to mitigate risk until a comprehensive solution can be deployed".[25]

OFAC also entered into a 2019 settlement with Western Union related to the company's alleged failure to screen sub-agent data for sanctions-related issues as part of its review process. Western Union's agent, a Gambian bank, established a sub-agent relationship with an SDN entity, which Western Union entered into its system as an agent location (*i.e.*, a different branch) of the bank, and not as a discrete legal entity acting as a sub-agent. During the period at issue, Western Union did not screen agent location data for sanctions-related issues and, as a consequence, Western Union's screening process and software apparently failed to identify its transactions with the SDN that were routed through its agent for a period of five years.[26]

OFAC has stated that companies should carefully review and understand the functionality and limitations of their sanctions screening software, ensure sufficient staff training regarding the software, update the software accordingly, and periodically evaluate the software with test data to ensure that it sufficiently flags transactions even absent an exact match. The Cobham settlement also suggests that, depending on their risk profile, companies should consider investing in systems for identifying entities that are treated as SDNs under OFAC's 50 per cent rule. In that settlement, OFAC recognised Cobham's adoption of such a system as a risk-reducing measure.

Mergers and acquisitions

Multiple recent OFAC enforcement actions highlight the importance of performing adequate sanctions due diligence with regard to potential acquisition targets and to implementing strong sanctions compliance procedures following acquisition. OFAC's 2019 settlements with Kollmorgen Corporation, Stanley Black and Decker, and AppliChem GmbH all involved conduct by recently acquired non-U.S. subsidiaries subject to U.S. sanctions under the Iran and Cuba sanctions programmes.[27] In all three instances, these non-U.S. subsidiaries were required by their U.S. parents to cease their transactions with sanctioned jurisdictions, but the non-U.S. subsidiaries failed to do so.

The Kollmorgen settlement demonstrates that robust pre-acquisition sanctions due diligence and post-acquisition sanctions compliance enhancements (including the availability of an ethics hotline for the reporting of potential misconduct to U.S. headquarters) can serve as important mitigating factors in the OFAC enforcement context. Despite the strong aggravating factors in that case, OFAC determined that the company's conduct was non-egregious, resulting in a significantly lower penalty amount.

Higher-risk jurisdictions

As evidenced by recent enforcement actions, OFAC continues to focus on transactions involving jurisdictions that are perceived as carrying a higher risk of sanctions violations. For example, the pre-2012 conduct at issue in the Standard Chartered settlement demonstrates that the UAE has been a higher-risk jurisdiction for Iran-related transactions, and the resolutions with Jereh, Stanley Black and Decker, and ELF involved transactions with China. These enforcement actions underscore the need to implement and maintain sanctions controls commensurate with the risks posed by transactions involving higher-risk geographies.

Individual liability

Historically, OFAC has generally not pursued enforcement actions against individuals outside of the Cuba-travel context. However, the Framework notes that "individual employees – particularly in supervisory, managerial, or executive-level positions – have played integral roles in causing or facilitating" sanctions violations, even in instances where "the U.S. entity had a fulsome sanctions compliance program in place", and in some cases these employees "made efforts to obfuscate and conceal their activities from others within the corporate organization, including compliance personnel, as well as from regulators or law enforcement".[28] The Framework states that, in such instances, OFAC will consider enforcement actions not only against the entities, but against the individuals as well.[29]

In the Kollmorgen matter, OFAC took the unprecedented step of designating a former company manager as a foreign sanctions evader while concurrently announcing a settlement with the company's U.S. parent.[30] Specifically, OFAC designated the former managing director of the U.S. company's Turkish subsidiary whom OFAC determined to be primarily responsible for directing the apparent violations at issue and seeking to conceal them. This designation highlights increased personal risk for personnel (including personnel outside the United States) who play a central role in causing violations of U.S. sanctions law.

Conclusion

With OFAC's heightened focus on the adequacy of sanctions compliance programmes and its record-breaking year for enforcement penalties, U.S. and non-U.S. companies alike would be well-advised to study the Framework guidance and OFAC's recent enforcement actions and consider making appropriate enhancements to their compliance practices.

Endnotes

1. Paul, Weiss, *OFAC Issues Guidance on Sanctions Compliance Programs and Flags "Root Causes" Underlying Prior Enforcement Actions* (May 14, 2019), available at https://www.paulweiss.com/practices/litigation/economic-sanctions-aml/publications/ofac-issues-guidance-on-sanctions-compliance-programs-and-flags-root-causes-underlying-prior-enforcement-actions?id=28725.
2. U.S. Dep't of the Treasury, Office of Foreign Assets Control, *A Framework for OFAC Compliance Commitments* (May 2, 2019), available at https://www.treasury.gov/resource-center/sanctions/Documents/framework_ofac_cc.pdf.
3. OFAC considers "senior management" to "typically include senior leadership, executives, and/or the board of directors". *See* Framework at 2.
4. *Id.* at 2–3.
5. *Id.* at 3.
6. *Id.* at 3–5.

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7. *Id.* at 5–6.
8. *Id.* at 7.
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