

OFAC Issues New Compliance and Enforcement Guidance for Securities Industry

On November 5, 2008, the Department of Treasury's Office of Foreign Assets Control ("OFAC"), which administers and enforces U.S. economic and trade sanctions, issued new guidance for securities and futures firms regarding measures these firms are expected to take when accepting new clients. The new guidance builds upon an interim final rule that OFAC issued on September 8, 2008, regarding new enforcement procedures.

A NEW RISK-BASED COMPLIANCE REGIME

The November 5 guidance underscores the increased priority that OFAC is giving to sanctions compliance by securities and futures firms ("firms"). To maximize compliance, OFAC now recommends that firms employ risk-based measures to verify the identity of each new customer that opens an account, and that they establish a suggested screening process for new clients and old clients who engage in new transactions.

In a matrix also published on November 5, OFAC identifies specific risk factors for several types of transactions relevant to the securities industry, such as a "high number of international transactions, cross-border transactions, or investments in a foreign investment fund or a foreign exchange" or "a large, fluctuating client base across a number of foreign jurisdictions involving a large number of security transactions." While firms are encouraged to consider their own specific characteristics, as well as the specific risks posed by each customer and each transaction, the presence of any of these factors is intended to prompt a heightened level of scrutiny.

OFAC likens an effective risk-based compliance program to the Customer Identification Program ("CIP") required

by the Bank Secrecy Act. Many firms already have a CIP in effect, but others (investment advisers, commodity pool operators and commodity trading advisers) have not yet been required to implement one. Those that have implemented a CIP should note two important differences between the expectations for CIP programs and the risk-based compliance programs that OFAC recommends.

First, OFAC sanctions apply to all property and interests in property within the possession or control of a sanctioned U.S. person. Consequently, unlike CIPs, OFAC regulations apply to the underlying beneficial owners as well as to accountholders. This distinction is important in certain accounts, such as trusts and omnibus accounts. Thus, OFAC suggests verifying information for at least some beneficial owners, guarantors and principals.

Second, whereas the required CIP allows a financial institution to rely on another financial institution to identify and verify customers and clients that the institutions have in common, OFAC does not permit shifting compliance liability to a third party. If a firm delegates its OFAC compliance responsibilities to a third party, and a violation ensues, OFAC will hold both the firm and the third party liable.

In addition to the risk-based measures, the November 5 guidance emphasizes that OFAC expects firms to screen potential new clients and their transactions and investments against both the OFAC Specially Designated Nationals and Blocked Persons list and other applicable OFAC sanctions programs. This screening should occur both when new clients are accepted and when any client selects new investments or engages in new transactions. OFAC advises firms to screen counterparties and vendors, as well as periodically screening especially risky non-acountholders, like guarantors, beneficial owners and principals. OFAC also advises firms to document any

screening that occurs to prove their compliance efforts in any subsequent potential enforcement action.

The guidance indicates that this screening should occur before a new account is opened or within a reasonable time thereafter, and that firms should restrict transactions until they have completed the identity verification and screening process. The guidance does not define what constitutes a “reasonable” time. Given the fast pace with which transactions may occur and the harm that can result from restricting transactions, the ambiguity regarding what is “reasonable” may necessitate further clarification.

THE REVISED ENFORCEMENT PROCESS

The November 5 guidance builds upon the September 8 interim final rule, which focused on creating a uniform and transparent standard for OFAC’s enforcement actions. The September 8 rule highlights four significant changes from previous enforcement regimes.

First, the rule emphasizes that OFAC will no longer assess penalties by examining “aggravating” and “mitigating” factors. Among the eleven general factors OFAC will now use to determine an appropriate enforcement response to an apparent violation is the compliance program employed by the subject.

Second, the rule now allows OFAC to issue either “cautionary letters” or “findings of violation” under certain circumstances, as well as the customary penalties. “Cautionary letters” put subjects on notice that similar conduct in the future may result in a penalty. “Findings of violation” document violations without actually imposing a civil monetary penalty on the firm.

Third, the September 8 rule distinguishes between “egregious” and “non-egregious” violations. OFAC makes this distinction in light of the enhanced maximum civil penalties now available to it and its desire to reserve those enhanced penalties for only serious cases. The rule defines “egregious” as those cases that involve serious sanctions violations, focusing particularly on a subject’s willfulness and recklessness, awareness of the

actions, and individual sanction history, as well as the harm caused by the subject’s actions.

Finally, the rule outlines the new process OFAC will use to determine the amount of a civil monetary penalty. Henceforth, OFAC will now determine “a base penalty” by determining the egregiousness of the violation and the presence or lack of a voluntary self-disclosure, and then adjust the penalty upward or downward based on other relevant factors.

WHAT FIRMS SHOULD DO

At a minimum, securities firms should take the following actions in response to the new compliance and enforcement guidance:

- Update the firm’s existing compliance program, including existing screening processes for new clients and new transactions, to effect application of the new risk-based factors.
- Ensure that actions to implement compliance with OFAC’s sanctions regulations are accurately and contemporaneously documented.
- Review the eleven factors that OFAC is now using to determine penalties and make any modifications necessary to existing compliance procedures to minimize penalties if a violation occurs.

We will monitor OFAC’s website and the Federal Register for publication of the final rule. In the meantime, if you have any additional questions regarding these developments, or any other matters regarding compliance with sanctions laws and OFAC enforcement policies, please contact:

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