Sanctions and beneficial ownership—From arithmetic to calculus

Sanctions compliance is about to get a lot harder, and for once, the Office of Foreign Assets Control (OFAC) had nothing to do with it. The impending beneficial ownership rules, outlined in the August 4, 2014 Notice of Proposed Rulemaking, are going to create new compliance challenges that will have to be addressed from both a policy and a screening operations perspective. However, addressing those challenges will lead inevitably to a more robust, strategically sound and ultimately more effective sanctions compliance program.

It is no coincidence that the Notice of Proposed Rulemaking repeatedly cites improving the effectiveness of sanctions compliance as a justification for the impending rules.¹ Adding a new population of beneficial owners to a financial institution’s periodic customer OFAC scan will certainly lead to improved identification of sanctioned persons. However, there are two crucial questions that sanctions compliance professionals are going to have to answer with regard to these new beneficial owner populations. First, how does a compliance team incorporate beneficial ownership screening into the customer batch screening process, and second, what is the institutional risk tolerance for true matches?

This article sets out to answer both questions. Without giving too much away, the answer to the first question is more-or-less straightforward while the second question presents the greater challenge. Recent developments, including the introduction of the Sectoral Sanctions Identification (SSI) list, means that this “gray area” approach to evaluating sanctions matches is not completely new territory, but overall beneficial ownership represents another step in the evolution of sanctions from a black-and-white regime to a more subtle deployment of U.S. foreign economic policy.
Beneficial owners: To screen or not to screen?

Here is a dirty little secret: Sanctions compliance professionals regularly lie to their noncompliance colleagues. This is especially true when they are asked which customer populations OFAC requires U.S. companies to screen. It is not that sanctions compliance professionals have ill intent, or that they do not know the answers (usually). The issue is more that with OFAC, as with any strict liability regime, the emphasis is more on not breaking the law, rather than on how to avoid breaking it.

OFAC offers extensive guidance on what type of transactions are prohibited, but less guidance on customer screening.\(^2\) OFAC has set out clear rules on whether certain transactions should be blocked, rejected or allowed, depending on a multitude of factors, and the agency expects banks to follow these rules at the threat of severe monetary and other penalties.\(^3\) However as discussed herein, the regulations regarding customer screening are evolving in such a way that a “match” to a customer under today’s rules might require a very different type of response than a “match” prior to sectoral sanctions and the impending beneficial ownership rules. This ambiguity can put compliance folks in a sticky situation when pressed for an answer on the “requirements.” On one hand, when an institution is fretting over whether to include a particular client population in the overnight OFAC screen, advising that all customer information maintained electronically should be included in the batch screen is an easy answer. On the other hand, when considering a novel client population (think contingent beneficiaries), there might not be sufficient information available to clear a potential match, and it is unlikely that you will find specific guidance from OFAC on how to treat a unique customer type.\(^4\)

Unfortunately, more often than not, our business partners expect sanctions compliance professionals to be able to speak specifically to what the regulations require, even in situations when the regulations are mute. Of course, honesty is always an option: “Well, OFAC does not exactly require us to screen anyone, but we should anyway.” The problem with this approach is that when a noncompliance person hears that the government “does not require” them to do something, those words will translate into, “We do not have to do it.” Stating that “best practices are so-and-so,” is another option, but a canny corporate executive might pick up on the dodge, especially when the fact pattern is a case of first impression. Because of this, when confronted with a new customer type not previously included in the periodic OFAC screen (perhaps because it is a new type to your institution), it can be in everyone’s best interest to sometimes extend the truth and simply state, “OFAC requires us to include them in the batch screen.” Really, what can go wrong?

So we have a hit: Now what?

Under “Sanctions 1.0” (pre-sectoral and beneficial ownership), “We have to screen them” was indeed the best answer—even if not the most honest—for several reasons. First, adding a customer population to the overnight batch is conservative, and thus loved by regulators, and also easy to explain, which is loved by those who talk to regulators. What’s more, assuming that interdiction software is decently tuned and human resources are adequate, screening an additional population already stored in a company system should not result in significant operational pain when searching for Specially Designated Nationals (SDNs), at least after the initial flood of potential matches. Finally, and perhaps most importantly, if there is a match to a listed party, the next step—close and/or block the account—is a straightforward no-brainer.

With “Sanctions 2.0” the math has changed, and the first part of the equation is how to handle a potential hit on a beneficial owner from an operational perspective.

The advent of two recent developments has transformed to what used to be simple arithmetic (SDN= freeze and/or boot) into something resembling calculus. These developments are the SSI list, and the upcoming beneficial ownership requirements. Fortunately, some of the operational lessons learned from SSI screening may be able to assist with the mechanics of screening beneficial owners.

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2. See, e.g., U.S. Department of the Treasury, “OFAC Regulations for the Financial Community,” pp 4-30, January 24, 2012. This document gives a detailed overview of the “Prohibited Transactions” under each sanctions regime, but only implicitly discusses the requirement to monitor customer accounts against the OFAC lists (see pg. 4).
The question of screening will come up—rather inevitably—in a meeting about the upcoming changes to beneficial ownership. Some institutions may have made an effort to get out ahead of the anticipated rules and begin collecting beneficial ownership details in advance. In this case, a new customer bucket of legal entity owners may already be accumulating in the company’s database. The next decision is whether to include this new population of “flesh and blood” corporate owners in our daily OFAC screen, and more importantly, what to do with potential matches.

The first part should be easy: “Does OFAC require us to screen beneficial owners?” “Yes, of course it’s required [Emphasis added].”

Now for the challenging part: Under the proposed beneficial ownership rules, a member of a “beneficial ownership” basket can own as little as 25 percent of the company, or may own none yet exercise effective control. In other words, even after identifying the matching party as a beneficial owner, compliance still has to determine how and to what extent the match owns or controls the company’s client.

This may require several operational enhancements to the screening processes. Foremost, a flag enabling a screener to identify a potential match as an owner, and not just a customer, is important. This is where an institution may be able to leverage its existing process for identifying SSIs. Sanctions screeners are most likely familiar with SSI matches that require additional analysis, as opposed to a hard stop. In this case the system should flag to the customer file, rather than the OFAC list, but the concept of applying a different logic to the match should be similar.

Assuming one’s institution is comfortable subjecting beneficial ownership matches to additional analysis before deciding whether to exit (see measuring tolerance section), the next step would be determining the institution’s level of risk exposure with that particular owner. At this point, the somewhat awkward yet straightforward OFAC rule on ownership applies: If an SDN or combination of SDNs do not own at least 50 percent of an entity, for all effective purposes OFAC does not care whether you bank that entity or not. Compliance will still need to be mindful of effective control (some programs call this out, while others do not), but operationally the first question upon identifying a match might very well be: “How much of the company do they own?” Whether to exit, or maintain and monitor, depends on an institution’s OFAC policy and associated risk tolerance.

### Measuring tolerance: Defining a framework

The fact that a company is owned in part by an SDN does not in and of itself make that company an SDN. This creates an element of choice for an institution, which means a clearly defined—and board-approved—policy on accounts linked with listed beneficial owners will become a critical part of a robust sanctions policy. While the risk of potentially servicing an SDN through a 50 percent or more owned company should not be understated, there is significant space between 25 percent and 50 percent, in which it is permissible to bank a legal entity linked to a listed individual.

The question of risk tolerance becomes even murkier with regard to SSI owners. Financial institutions are restricted from providing a defined band of services to SSIs and 50 percent or more SSI-controlled entities. Understanding a client’s business is crucial when deciding whether to continue banking a company owned in part by an SSI. An Internet start-up owned in part by a listed SSI bank is going to be much lower risk than a venture capital firm partially owned by the same parent, since the types of activities each client typically engage in are far apart, or very close to the transactions prohibited by the sectoral sanctions. The corresponding risk should, therefore, influence the policy decision on how to treat SSI matches among the beneficial ownership pool.

For a financial institution with a robust program—and a sturdy backbone—continuing to bank clients partially owned by a listed entity, either SSI or SDN, may fit within a defendable risk tolerance, but only if supported by an effective monitoring program. The challenge with accepting risk on beneficial owners is that ownership percentages can shift with time, and from an OFAC compliance perspective, a few percentage points can mean the difference between a permissible relationship and one that may cause some very difficult questions from the U.S. Treasury.

In conclusion, a paradigm shift is already underway in sanctions compliance. As targeted sanctions continue to be utilized against government and individuals in relatively interconnected economies, the chance of a listed person having an ownership stake in a client is going to continue to increase. This compels a risk-based analysis, rather than the traditional blanket strategy of alerting and exiting. The result may not be a completely tailored approach that treats each potential match differently, but at the very least the operational process and policy should be pre-sized to address different buckets of risk.

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1. Customer Due Diligence Requirements, supra.
3. Id.