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EDITOR'S NOTE: CORRUPTION COMPLIANCE

Steven A. Meyerowitz

ANTI-CORRUPTION COMPLIANCE IN 2013: POST-GUIDANCE TRENDS AND SIGNALS FOR THE FUTURE

Paul R. Berger, Sean Hecker, Andrew M. Levine, Bruce E. Yannett, Steven S. Michaels, Philip Rohlik, Noelle Duarte Grohmann, and Jane Shvets

COMPLIANCE ISSUES ARISING OUT OF THE TARGET DATA BREACH

H. David Kotz

CYBERSECURITY: AMID INCREASING ATTACKS AND GOVERNMENT CONTROVERSY, A FRAMEWORK TO REDUCE RISK EMERGES

Stuart D. Levi

"KNOW YOUR CUSTOMER": OFAC RAISES DUE DILIGENCE EXPECTATIONS OF NON-US BANKS

Sean M. Thornton

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT UPDATE

David A. Elliott, Rachel Blackmon Cash, Kristen Peters Watson, and E. Jordan Teague

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“Know Your Customer”: OFAC Raises Due Diligence Expectations of Non-US Banks

SEAN M. THORNTON

While penalizing customers is a notable departure from the U.S. government's established model, the author of this article cautions that the practice likely serves as a new warning to non-U.S. banks that they will be required to improve due diligence programs significantly to avoid harsher penalties in 2014 and beyond.

Since 2005, a series of very large non-U.S. banks — including ABN AMRO, Credit Suisse, and ING — have paid significant penalties to U.S. authorities for processing funds transfers through the United States related to business with Iranian, Cuban and other clients that are subject to U.S. economic sanctions. Some of these payments were directly on behalf of sanctioned entities (such as an Iranian or Cuban bank), while others were more generally related to business with sanctioned countries (such as trade finance transactions involving European exports to Burma). All of these funds transfers violated regulations of the Office of Foreign Assets Control (“OFAC”).

In September and October 2013, OFAC tried something new: It announced the imposition of civil penalties not against non-U.S. banks, but rather directly against their non-U.S. customers for originating payments related

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to business with Iran. While penalizing customers is a notable departure from the U.S. government's established model, the practice likely serves as a new warning to non-U.S. banks that they will be required to improve due diligence programs significantly to avoid harsher penalties in 2014 and beyond.

THE CUSTOMER PENALTIES

OFAC first penalized an obscure Turkish trading company \$750,000 for making payments through the United States for the benefit of persons in Iran, and then it penalized a company in the United Arab Emirates \$1.5 million for doing substantially the same. The Emirati company, Alma Investments LLC, appears to have been the subject of a previous "scam alert" by the Dubai Financial Services Authority. Neither the Turkish nor the Emirati company appears to have participated in OFAC's enforcement proceedings, and OFAC seems unlikely to collect the money penalties. It is possible that the banks were penalized separately; OFAC did not name the financial institutions involved.

These penalties are consistent with OFAC's recent focus on third parties that transact on behalf of Iranian companies, which apparently have turned to trading companies and exchange houses because the recent escalation of U.S. sanctions effectively has shut them out of the international financial system. In January 2013, OFAC issued a rare advisory to U.S. financial institutions to be on the lookout for third-country (*i.e.*, non-U.S., non-Iranian) exchange houses and trading companies that act as money transmitters for Iranian businesses. OFAC also is responsible for implementing Executive Order 13608, which, since 2012, has authorized economic sanctions against "foreign sanctions evaders." OFAC has explained that it may use the order to sanction third-country entities that conduct deceptive financial transactions on behalf of Iranian companies, "where the foreign person had no physical, financial, or other presence in the United States and did not submit to U.S. administrative proceedings.... Such a listing under Executive Order 13608 also provides Treasury with the capability to put the world on notice as to such foreign persons' activity and the risk of similar future activity." The Turkish and Emirati trading companies would appear to have met the criteria for sanctions under Executive Order 13608, but OFAC instead elected to

penalize them under its traditional administrative proceedings, even though they did not appear to submit to those proceedings. This illustrates how the same transaction involving Iran now can trigger multiple, overlapping laws from which OFAC or other U.S. authorities may choose.

OFAC'S REAL AUDIENCE

Superficially, this new approach seems fairer than penalizing the banks, which despite robust know-your-customer programs cannot reasonably be expected always to know their customers' reasons for making particular payments. It is unlikely that fake, disposable front companies for Iranians would be undeterred by these types of penalties, which they may never have to pay.

However, the real audience for these trading-company penalties seems once again to be non-U.S. banks, which OFAC explicitly encouraged to exercise greater due diligence for these types of customers. In this sense, the purpose of these newer penalties against trading companies seems to reinforce OFAC's prior warnings to non-U.S. banks and possibly to lay a foundation for future penalties against such banks that, in the eyes of U.S. authorities, should have done a better job ferreting out these types of customers.

It is not clear how exactly OFAC or other U.S. authorities expect a bank to detect sanctions evasion by trading companies or exchange houses, but two developments earlier last year indicate that resubmitted payments may be the clearest sign of a problem:

In its January 2013 advisory, OFAC explained that the third-country exchange houses and trading companies commonly omitted references to Iranian names or addresses. So what is a bank to look for, if the Iranian funds transfers purposely do not mention Iran? OFAC identified three red flags, of which two were essentially resubmitted payments, i.e., payments initiated by a customer that the bank rejects for compliance reasons, and which the customer then alters and resubmits in an effort to avoid detection. (The third red flag was unusual patterns in the volume or frequency of payments.)

In February 2013, OFAC concluded a civil penalty settlement with the Bank of Guam because a bank employee resubmitted a single payment that another bank rejected due to a reference to Iran. The Bank of Guam settlement likely reflects a regulatory expectation that once a payment is rejected

for OFAC-related reasons by one bank, any bank that processes it is on notice of a serious problem that requires attention. A trading company or exchange house that attempts to send a funds transfer referencing Iran through the United States probably should not be given a second chance.

LOOKING AHEAD

Despite the November 2013 nuclear deal between Iran and six other nations that calls for temporary relief from economic sanctions, OFAC is unlikely to ease its scrutiny and will continue to levy civil penalties aggressively when it identifies transactions in violation of U.S. law. Even though OFAC has begun a practice of penalizing non-U.S. companies for their banking transactions, that does not reduce the exposure of the banks themselves. Risk-averse non-U.S. financial institutions will need to consider re-evaluating and, where possible, strengthening their due diligence programs or potentially face negative publicity, significant fines or both.