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New Year's Resolution for 2018: Develop OFAC Compliance Strategy

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Two thousand seventeen may be remembered as the year that benefit plans became aware of the challenges they face in complying with sanction laws and regulations administered by the United States Department of Treasury's Office of Foreign Assets Control ("OFAC"). As a result of factors including North Korean nuclear tests, a worsening relationship with Iran, and Congressional fears about the Trump Administration's relationship with Russia, Congress strengthened sanction laws by passing the Countering America's Adversaries Through Sanctions Act (the "Sanctions Bill"). While Iran, the Russian Federation, North Korea, and Syria had all already been subject to trade sanctions, the Sanctions Bill codifies many of the sanctions programs that had previously been established through executive adds additional restrictions interactions with individuals who are subject to sanctions or reside in a sanctioned location, and restricts the ability of the President to modify sanctions or to grant licensing exceptions. Benefit plans, including non-US benefit plans, should be aware of the current and developing state of US sanction policy.

Historically, both US and non-US benefit plans have tended to view trade sanctions as something that applies to banks but that doesn't impact our retirement system. This view is wrong. While benefit plan compliance has not historically been a focus for many pension plans, in 2017 OFAC began to pay increased attention to pension plans and investigated an increased number for possible violations. Given this recent increase in investigations, as well as the Sanctions Bill's enactment, a good resolution for retirement plan administrators and fiduciaries to make for 2018 would be to take steps to avoid violations of US trade sanctions. Below we provide an overview of the US trade sanctions generally, steps plans can take to comply, and a more detailed look at the recent Russian sanctions in particular. Of particular importance to non-US benefit plans are US "secondary sanctions."

We note that this is an area of law that is rapidly evolving and one where OFAC appears to have intentionally created a wide grey area to encourage anyone who may be concerned that a possible action could violate US sanctions to seek specific permission from OFAC. Additionally, we note that the European Union and the United Kingdom each have their own set of sanction programs which are outside the scope of this article.

Background

OFAC currently oversees 26 different sanction programs. These include sanctions programs that apply to Belarus, Burundi, Central African Republic, Cuba, Iran, Libya, North Korea, Syria, Sudan, and North Zimbabwe, as well as sanctions focused on specific industries, such as organizations and individuals identified with trans-national criminal organizations, spread of weapons of mass destruction, and that are engaged in terrorism or drug trafficking or focused on deterring certain actors in various regions such as Iraq or Ukraine. OFAC maintains a list of individuals and entities that are sanctioned on three lists, the Specially Designated Nationals List ("SDN List"), the Foreign Sanctions Evaders List ("FSE List"), and the Sectoral Sanctions List ("SS List"). (To assist with compliance, OFAC offers an online search tool that allows users to compare names against the SDN and FSE Lists. The official tool can be found at: https://sdnsearch.ofac.treas.gov/. Other websites and software providers offer tools that search all three lists and allow batch searching.)

There are three primary types of sanctions.

Country Sanctions

When sanctions are discussed, the primary form of sanctions that people think about is country-level sanctions. Examples include Iran and North Korea. These types of sanctions make it unlawful to engage in transactions with anyone resident in a country or with that country's financial system. This would not only include pension fund investment, directly or indirectly, with residents of those countries, but also include payments of benefits to retirees or beneficiaries resident in those countries

Traditional Individual Sanctions

The SDN List and the FSE List are made up of individuals and entities that the US has deemed to be bad actors. Examples include

certain individuals associated with the Russian government who have been accused of fomenting unrest in Ukraine. Traditional sanctions make it unlawful to engage in transactions with or contract with individuals. The prohibitions also apply to any company 50% owned by a sanctioned individual. Although it is unlikely one of these individuals will be a participant or beneficiary, investment with such individuals or entities is a concern, particularly under the Ukraine-related sanctions.

Sectoral Sanctions

Sectoral sanctions are the last primary type of sanctions, and perhaps the most complex to deal with. Rather than targeting specific bad actors or all actors from a country generally, instead, the sanctions target specific industries and generally do not contain a blanket prohibition against all transactions. Examples include Directives 1 and 2 Pursuant to Executive Order 13662. Directives 1 and 2 restrict the ability of US persons to purchase debt or equity of certain Russian companies. Again, this is a concern with pension investment, particularly in the energy sector.

Application to Non-US Benefit Plans

While for the most part these sanctions only apply to US persons, non-US benefit plans are subject to sanctions classified as "secondary sanctions". These are generally imposed against foreign persons who are owned or controlled by, or who "knowingly" work for or on behalf of, or provide material support to, sanctioned individuals, entities, or provide assistance to sanctioned sectors. While the legality of secondary sanctions has been questioned, OFAC currently operates a number of secondary sanctions programs: North Korea, Russia and Iran are examples of countries currently subject to secondary sanctions.

A second way that non-US benefit plans typically find themselves in need of US sanctions assistance is when a benefit plan seeks to make a payment using the US financial system. When a plan seeks to make a payment that it may be permitted to make but that the US financial system cannot process, transactions can be delayed and funds can be frozen while the US financial institution seeks guidance from OFAC on how to process the request.

While OFAC has generally not targeted non-US benefit plans, it is possible that they could become a target of enforcement action should it be determined that one was providing substantial benefits or making investments that contravene US foreign policy. As a result, non-US benefit plans should evaluate their risks, including reputational risk.

Compliance Program Overview

Under OFAC guidance, US benefit plans are required to comply with OFAC programs and non-US benefit plans are required to comply with secondary sanctions. Failure to comply can lead to civil and criminal penalties. Through July 27, 2017, OFAC has imposed nine civil penalties totalling almost \$117 million. However, OFAC has not provided specific guidance on what the components should be for a compliance program. Rather, it has indicated that OFAC compliance is not "one size fits all" and that entities should apply a "risk-based approach when considering the likelihood that they may encounter OFAC issues."

Traditionally, OFAC compliance could be broken into four steps:

First, plans develop a compliance program and enter into contracts with service providers to assist with compliance. This involves:

- Drafting a compliance policy.
- Including language in service provider contracts that service providers and asset

managers will comply with OFAC sanction rules.

 Acquiring tools to permit the plan to comply with OFAC's sanction rules. Depending on a plan's risk factors, this could mean selecting an online SDN, FSE, and SS List search tool to use or it could mean contracting with a search tool provider or outsourced OFAC compliance provider.

Second, plans examine (and continue to monitor) existing contracts and participant and beneficiary lists to ensure that the payments the plan is making (and investments and transactions the plan is making) are permitted. This involves:

- Checking if plan assets and investments are connected with entities on the SDN, FSE, or SS lists (and for non-US benefit plans, evaluating whether secondary sanctions apply). The Russian sanctions may result in more investments that need to be reviewed than other sanctions in the past.
- Checking if participant or beneficiary payments are going to individuals on the SDN, FSE, or SS lists (for non-US benefit plans, additional evaluation of whether those individuals are subject to secondary sanctions).
- Identifying payments to sanctioned countries such as Cuba, Iran, Sudan, and North Korea (here there is a heightened risk of secondary sanctions applying).

Third, if this monitoring reveals that the plan is or would be engaged in a transaction with an OFAC sanctioned entity, the plan determines if OFAC has granted a license to permit the transaction. Or, primarily for non-US benefit plans, if a transaction is rejected or funds are frozen, determine whether a licensing request or a voluntary disclosure is required.

Fourth, if OFAC has not granted a license, plans take corrective action. This includes:

- Notifying OFAC.
- · Blocking the transaction.
- Continuing to hold the blocked assets.

• Potentially applying for an OFAC license.

Conclusions

Sanction laws and regulations continue to change and it is difficult for plans to know their risks of non-compliance. However, pension funds are large pools of money and OFAC may begin to take a closer look at plan compliance. Where plans have many individuals living outside the US, risk may be greater. Additionally, where plans are aggressively investing in funds managed by non-US managers, non-compliance risks may also be heightened. For non-US plans, the risk of violating sanctions law can even be heightened due to a lack of awareness over the US's claim that it can regulate the behaviour of third-country residents engaging in activities that take place entirely outside the US. Based on 2017, we anticipate that OFAC

will continue to devote resources to encouraging plans to comply with existing laws and regulations.

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