

FINANCIAL FRAUD LAW REPORT

VOLUME 4

NUMBER 8

SEPTEMBER 2012

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POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. ISSN 1936-5586

Recent Settlement Highlights Need for OFAC Diligence

THOMAS C. BOGLE AND MIRIAM GONZALEZ

A recent OFAC settlement should cause all asset managers, wherever they are located, to reassess their OFAC compliance policies and procedures, particularly as they relate to investment activities and services performed by third-party agents.

The Office of Foreign Assets Control (“OFAC”)¹ recently entered into a settlement agreement with a European-based asset manager for an alleged violation of United States sanctions against Iran.² The settlement agreement follows the announcement of a number of new measures that significantly expand U.S. sanctions against Iran. What is significant about the new measures is that they explicitly target certain activities of non-U.S. companies as well as U.S. companies.

The recently announced settlement highlights the need for all asset management firms, wherever they may be located, to understand their obligations under U.S., EU and wider United Nations sanctions programs, and to develop policies and procedures designed to prevent sanctions violations.

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BACKGROUND

The party entering into the settlement with OFAC is an investment management firm headquartered in the United Kingdom, but organized as a Delaware limited liability partnership (the “U.S. Manager”). The U.S. Manager serves as investment manager of a Guernsey-organized investment fund (“Guernsey Fund”) and, in that capacity, has the power and authority to select portfolio holdings and otherwise manage the assets of the Guernsey Fund. However, the U.S. Manager delegated responsibility for selecting the Guernsey Fund’s investments to its subsidiary, a limited liability partnership headquartered and organized under the laws of the United Kingdom (“U.K. Delegate”).

According to OFAC’s settlement release, in 2007 the U.K. Delegate caused the Guernsey Fund to purchase approximately \$3 million in shares of First Persian Equity Fund (“Persian Fund”), a Cayman Islands fund that invests exclusively in Iranian securities. OFAC apparently determined that this action caused the U.S. Manager to violate its obligation to comply with U.S. sanctions against Iran.

LEGAL BACKGROUND AND DISCUSSION

Characteristically, OFAC released only limited information about the alleged sanctions violation that occurred in this case. OFAC’s release states only that the U.S. Manager had allegedly violated the Iranian Transactions Regulations (“ITR”), without citing to any specific rule under the ITR. For this reason, one can only speculate about the actual sanctions violation that allegedly occurred.

Based on the facts released by OFAC, it appears that the transaction at issue occurred entirely outside of the United States. Nevertheless, all “United States persons” are required to comply with the ITR. Under the ITR, the term “United States person” refers to, among other things, “any...entity organized under the laws of the United States (including foreign branches).”³ Accordingly, even though the transaction at issue here appears to have occurred outside of the United States, the U.S. Manager was required to comply with the ITR because it is organized as a Delaware limited liability partnership.

Significantly, however, it appears that the U.S. Manager had no direct connection to the alleged sanctions violation in this case. The U.K. Delegate,

not the U.S. Manager, was the party that caused the Guernsey Fund to invest in the Persian Fund. OFAC apparently determined that the U.S. Manager was nonetheless responsible for the investment decision because the U.K. Delegate was acting as the U.S. Manager's agent.

In addition, there is some uncertainty about the precise reason why OFAC decided an investment in the Persian Fund implicated the ITR. OFAC added the Persian Fund to its list of Specially Designated Nationals ("SDN List") in 2009, effectively blocking the fund's property in the United States and prohibiting United States persons from dealing with the fund. However, the alleged sanctions violation in this case occurred in 2007, two years before the Persian Fund was added to the SDN List.

The ITR separately prohibits "any new investment by a United States person in Iran..."⁴ As noted above, however, the Persian Fund is organized under the laws of the Cayman Islands, and an investment in the fund arguably is not an investment "in Iran." It appears that OFAC concluded that an investment by the Guernsey Fund in the Persian Fund constituted prohibited new investment in Iran, either because: (i) the Persian Fund is managed by an affiliated entity of Bank Melli, an Iranian bank, so any investment in the Persian Fund effectively constitutes an investment in Iran; or (ii) the Persian Fund invests predominantly in the Iranian market, such that OFAC considers an investment in the fund to constitute prohibited new investment in Iran.⁵ Alternatively, OFAC may have concluded that an investment in the Persian Fund constituted a violation of section 208 of the ITR, which makes it unlawful for a United States person to "finance" or "facilitate" a transaction by a foreign person where the transaction "would be prohibited by [the ITR] if performed by a United States person or within the United States."⁶

IMPLICATIONS AND GUIDANCE FOR U.S. AND NON-U.S. ASSET MANAGERS

Because OFAC releases only limited information about its settlements, there remains substantial uncertainty about the specific violation alleged to have occurred in this case. Nevertheless, the settlement should cause all asset managers, wherever they are located, to reassess their OFAC compliance

policies and procedures, particularly as they relate to investment activities and services performed by third-party agents

- *Assessing Portfolio Holdings for OFAC Compliance.* Asset managers should implement risk-based procedures for assessing whether portfolio holdings implicate OFAC sanctions. As a general rule, U.S. funds and accounts may not invest in any company listed on the SDN List or any company that is owned 50% or more by a person on the SDN List. Moreover, U.S. funds and accounts may not invest in sovereign debt issued by sanctioned governments (*e.g.*, Iran) and may not invest in companies located in sanctioned jurisdictions. Finally, as the case above highlights, U.S. funds and accounts should carefully scrutinize investments in third-party funds or companies whose investments and/or profits are predominately derived from sanctioned jurisdictions. While these restrictions broadly apply to United States persons, a non-U.S. asset manager should take steps to comply with these restrictions when it manages accounts for U.S. clients (including, without limitation, funds organized under United States law).
- *Performing Due Diligence on Delegates.* The settlement here underscores that United States persons may be liable for sanctions violations when they delegate responsibilities to service providers outside the United States. Accordingly, a U.S. asset manager that delegates investment advisory responsibilities to a non-U.S. manager should obtain reasonable assurance that the non-U.S. manager will comply with OFAC restrictions applicable to United States persons.⁷

NOTES

¹ OFAC is the bureau of the United States Department of the Treasury that is charged with administering and enforcing U.S. economic sanctions programs.

² Office of Foreign Assets Control, Genesis Asset Managers, LLP Settles Apparent Violation of the Iranian Transactions Regulations (May 21, 2012), available at http://www.treasury.gov/resource-center/sanctions/CivPen/Documents/05212012_genesis_notice.pdf.

³ 31 C.F.R. § 560.314.

⁴ *Id.* § 560.207.

⁵ *Cf. id.* § 538.412 (noting that, under the Burmese Sanctions Regulations, prohibited “new investment” in Burma occurs through the “purchase of shares in a third-country company...where the company’s profits are predominantly derived from the company’s economic development of resources located in Burma”).

⁶ *Id.* § 560.208.

⁷ One must consider, however, that non-U.S. asset managers may not be legally permitted to comply with certain U.S. sanctions that have an extraterritorial impact (*e.g.*, U.S. sanctions against Cuba). *See, e.g.*, Council Regulation No. 2271/96, OJ. L 309/1 (1996) (blocking extraterritorial application of certain sanctions measures in the European Union).