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The Intersection of the Investment Advisers Act Rules and OFAC Guidance: A Practical Guide for Investment Advisers

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Over the past several years, the scope of the United States' economic sanctions programs has expanded dramatically in response to foreign policy, national security, and economic goals, as have the number of enforcement actions brought against companies and individuals for US sanctions violations. Registered investment advisers conducting cross-border business, which already are subject to regulation under the Investment Advisers Act of 1940 (Investment Advisers Act) and other securities laws, are particularly susceptible to evolving sanctions risks by virtue of their business model. Noting the sanctions risks unique to securities firms, the US Department of the Treasury, Office of Foreign Assets Control (OFAC) has made clear that it is focused on the securities industry with respect to sanctions compliance and enforcement. OFAC asserted that securities firms particularly are susceptible to being "approached by terrorist organizations or other illicit actors desiring to exploit the relative lack of transparency that accompanies many securities transactions and investment vehicles . . . ."[1]

Consequently, registered investment advisers are on notice that their compliance programs will be subject to scrutiny by US regulators. Under the Investment Advisers Act, registered investment advisers are required to implement effective securities compliance programs, as well as comply with the Act's books-and-records, anti-fraud, and reporting requirements. Although OFAC does not mandate formal sanctions compliance programs, it has clearly stated its expectation that investment advisers implement risk-based sanctions compliance programs and has issued guidance concerning the components of an effective program.

Registered investment advisers, therefore, should heed OFAC's guidance by incorporating risk-based sanctions compliance measures into their compliance programs as mandated by the Investment Advisers Act. Failure to do so may result in a registered investment adviser's failure to meet its compliance, books-and-records, and reporting requirements under the Act, as well as increased penalties in the event of an OFAC enforcement action. Moreover, the fluid nature of sanctions regulations can turn a well-researched, profitable investment into a compliance risk in need of an exit. A nuanced and technical understanding of an adviser's sanctions risks and the relevant sanctions programs thus will help advisers to effectively assess sanctions risk and maximize investor returns.

Registered Investment Advisers' Obligations Under the Investment Advisers Act and OFAC Sanctions

Investment Advisers Act of 1940

The Investment Advisers Act imposes compliance, books-and-records, anti-fraud, and reporting obligations on investment advisers registered with

the US Securities and Exchange Commission (SEC). Every registered investment adviser must adopt and implement written policies and procedures reasonably designed to prevent violations of the Act and the SEC rules promulgated thereunder, and must designate a chief compliance officer to administer the policies and procedures.[2] Registered investment advisers also must make and keep true and accurate books and records.[3] Moreover, registered investment advisers are prohibited from defrauding any client or prospective client, and from engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.[4] Advisers are further prohibited from willfully making material misstatements or omissions in filings with the SEC.[5]

OFAC Sanctions and Relevant Guidance

OFAC administers and enforces list-based and country-based economic sanctions against targeted foreign countries, terrorists and terrorist organizations, and others in furtherance of US foreign policy, national security, and economic goals. All US persons, including registered investment advisers and other securities firms, are subject to OFAC's requirements.[6] Additionally, non-US persons may be subject to OFAC's requirements under certain circumstances, including US subsidiaries of foreign entities, foreign subsidiaries of US entities under certain sanctions programs, and those involved in transactions with a US nexus.

The United States maintains a comprehensive trade embargo against Cuba, Iran, North Korea, Syria, and the Crimea region of Ukraine. Additionally, US persons generally are prohibited from dealing directly or indirectly in the property[7] of individuals and entities included on OFAC's List of Specially Designated Nationals and Blocked Persons (SDN List), which includes individuals and entities that are owned or controlled by, or acting for or on behalf of, targeted countries, as well as individuals such as terrorists and narcotics traffickers designated under programs that are not country-specific. US persons also are prohibited from dealing with any entity that is directly or indirectly owned 50 percent or more by an SDN, or 50 percent or more in the aggregate by multiple SDNs (50 percent rule).[8]

While each sanctions program differs, the general purpose of the programs is to restrict sanctions targets' access to the US financial system by prohibiting transactions in certain property in the United States or involving US persons, and by requiring US persons to freeze the property of SDNs and entities that are owned 50 percent or more by such persons. Therefore, for instance, a registered investment adviser is prohibited from dealing in the property of an SDN or providing services to an SDN, even if the SDN invests solely in non-US funds. Civil penalties for sanctions violations are assessed on a strict liability basis. Thus, even inadvertent sanctions violations may result in significant civil penalties, depending on the circumstances. However, OFAC may issue general or specific licenses authorizing transactions that would otherwise be prohibited by a sanctions program.

OFAC exerts extraterritorial jurisdiction over cross-border business and transactions using two primary tools: (1) "facilitation" prohibitions and (2) "secondary" sanctions. First, impermissible facilitation may occur when a US person, wherever located, directs or approves a transaction involving sanctioned persons that the US person could not undertake directly. The particular prohibitions on facilitation vary by sanctions program. For example, a US investment adviser may not approve, finance, facilitate, or guarantee any transaction by a foreign person in which the adviser itself would be prohibited from engaging under the Iran sanctions program.[9] Nor may a US investment adviser transact in the securities of an issuer that provides financing for a sanctions target. Second, under so-called secondary sanctions, OFAC has the power to designate as SDNs non-US companies that conduct business with SDNs, under certain circumstances, even in the absence of a direct US nexus. Secondary sanctions are a powerful tool that the US government uses to

deter dealings by non-US parties with disfavored entities around the world.

OFAC Guidance Regarding Risk Factors for the Securities Industry (2008)

While OFAC does not mandate a formal compliance program, OFAC has confirmed that it expects investment advisers, both registered and unregistered, and other securities firms to develop risk-based compliance programs to detect, monitor, and address potential OFAC violations that may arise before they conduct business on behalf of a customer, or prior to the execution of a transaction.[10]

In 2008, OFAC issued guidance concerning "Risk Factors for OFAC Compliance in the Securities Industry" (OFAC Securities Guidance).[11] The OFAC Securities Guidance made clear that OFAC is focused and "actively engaged" with the securities industry, including investment advisers. The Guidance highlighted, in particular, risks posed by cross-border relationships, in which investment advisers and other securities firms may handle funds from foreign financial institutions whose customers are not transparent.

The OFAC Securities Guidance outlined the nature and scope of due diligence that OFAC expects securities firms to perform on each client and intermediary as part of a risk-based sanctions compliance program. The Guidance specified that firms' diligence should encompass all of their affiliates, including banks and broker-dealers.

The Guidance also set forth certain risk factors in potential client relationships or transactions that investment advisers should be aware may warrant heightened scrutiny. These risk factors include: (1) a large number of international transactions; (2) a large number of foreign customers and accounts, particularly in high-risk jurisdictions; (3) the involvement of foreign broker-dealers, including introducing brokers, which are not subject to OFAC regulations, and which may lead to a lack of information regarding beneficial owners of securities; (4) investments in foreign securities, including the risk that the securities may be issued by a sanctioned country or party or otherwise in violation of OFAC sanctions; (5) third-party introduced business, including business introduced by an overseas bank, affiliate, or other investor based in high-risk or inadequately regulated jurisdictions; and (6) very high net worth institutional accounts, hedge funds, funds of hedge funds, and other alternative investment funds, such as private equity and venture capital funds, and intermediary relationships that lack transparency regarding securities/investments and beneficial owners.

The Guidance provided several examples of high-risk transactions or clients that would call for investment advisers to exercise heightened diligence. For example, an investment adviser that manages a private equity fund that has a number of US and non-US investors, including an offshore trust that lacks transparency, should exercise greater scrutiny. Similarly, an investment adviser that manages a US hedge fund with an offshore related fund where the beneficial owners are offshore investors should remain attuned to heightened sanctions risks. The Guidance also highlighted sanctions risks associated with subscription funds that originate from or are routed through an account maintained at an offshore bank, a bank organized or chartered in an inadequately supervised or poorly regulated jurisdiction, or a foreign shell bank.

Framework for OFAC Compliance Commitments (2019)

In 2019, OFAC issued its most comprehensive compliance guidance to date, entitled, "A Framework for OFAC Compliance Commitments" (Framework).[12] The Framework offers clear insight into OFAC's expectations with respect to sanctions compliance programs. Significantly, OFAC also clarified that it would "consider favorably" companies that had effective sanctions compliance programs at the time of an apparent violation, and that it may, in certain cases, consider the existence of a sanctions compliance program at the time of

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an apparent violation as a factor in its analysis as to whether a case is deemed to be "egregious" under the Enforcement Guidelines.

In particular, the Framework detailed five components that OFAC considers to be indispensable for an effective risk-based sanctions compliance program. OFAC specified that, while sanctions compliance programs will vary depending upon the particular characteristics and risks of the company, every compliance program should incorporate the following components: (1) management commitment and support; (2) risk assessment; (3) internal controls; (4) testing and auditing; and (5) training.

In addition to providing insight into sanctions compliance program priorities, OFAC also outlined several root causes that have led to sanctions compliance deficiencies. These included: (1) lack of a formal OFAC sanctions compliance program; (2) misinterpreting or failing to understand the applicability of OFAC regulations; (3) facilitating transactions by non-US persons, including through or by overseas subsidiaries or affiliates; (4) utilizing the US financial system, or processing payment to or through US financial institutions, for commercial transactions involving sanctioned persons or countries; (5) sanctions screening software or filter faults; (6) improper or incomplete due diligence on clients and intermediaries, among others; (7) decentralized compliance functions and inconsistent application of a sanctions compliance program; (8) utilizing non-standard payment or commercial practices; and (9) individual liability, meaning that OFAC can take enforcement action against individuals that play integral roles in causing or facilitating violations.

The Intersection of the Investment Advisers Act and OFAC Sanctions

Registered investment advisers operate in a highly regulated environment. While OFAC does not mandate formal sanctions programs, given the scrutiny to which registered investment advisers are subject by both securities and sanctions regulators, they should view risk-based sanctions compliance as a key component of their compliance programs mandated under the Investment Advisers Act. Moreover, investment advisers may be required to make representations concerning their sanctions compliance programs to give comfort to their financial institutions that they are not exposing the institutions to material sanctions risks.

Failure to implement an effective sanctions compliance program may result in a registered investment adviser's failure to meet its compliance, books-and-records, and reporting requirements under the Investment Advisers Act. Significantly, in 2018, the SEC sent comment letters to at least 42 companies regarding their activities in areas subject to OFAC sanctions.[13] The SEC's comment letters suggest that it may scrutinize whether any deficiencies in a registered investment adviser's sanctions controls and compliance program lead to improperly recorded transactions in its books and records, fraudulent public disclosures, and/or material misstatements or omissions in the adviser's filings with the SEC regarding the sufficiency of its internal controls, the accuracy of its financial statements, and the nature of its business risks.

Accordingly, a registered investment adviser's failure to adopt and implement a sanctions compliance program consistent with the priorities set forth in the Framework could lead not only to serious OFAC enforcement risk, but also draw scrutiny from securities regulators with respect to the adviser's compliance with its Investment Advisers Act obligations.

Current and Emerging Areas of Sanctions Risk for Investment Advisers

It is critical that investment advisers understand the scope and nature of their particular sanctions risks in order to implement tailored, risk-based sanctions programs. Developing a nuanced and technically sound view of OFAC's sanctions programs and an adviser's sanctions risks not only will mitigate the adviser's OFAC and SEC enforcement risks, as

discussed above, but also can form part of a strategy for maximizing returns for investors. An adviser, for instance, may be required to terminate a profitable investment or client relationship that directly or indirectly involves an SDN, even if the SDN was designated post-investment. Conversely, a lack of understanding of an adviser's risks and OFAC's programs could result in an adviser avoiding certain potentially profitable clients and transactions because of perceived sanctions risks.

Given investment advisers' business model and the evolving and technical nature of OFAC's sanctions programs, advisers generally should be prepared to address heighted sanctions risks in two areas highlighted in OFAC's Framework: (1) facilitating transactions by non-US persons and (2) misinterpreting or failing to understand the applicability of OFAC regulations. First, investment advisers are at particular risk for indirectly facilitating prohibited transactions by non-US persons or providing prohibited services to or on behalf of blocked persons. Investment advisers, for instance, often source investments globally in their quest for returns for investors, including through introducing brokers in emerging markets or other high-risk jurisdictions. However, the true beneficial owners of clients, securities, and other investments may not be known or may change over time. Thus, a US hedge fund with an overseas institutional investor that invests on behalf of its own clients, whose identities are not disclosed to the fund, may unknowingly provide investment advisory services to a blocked person or a person located in an embargoed jurisdiction, such as Crimea or Iran. Moreover, investment advisers face complicated sanctions risk analyses as a result of the structure of their investments, including, for instance, where a US person represents a hedge fund on a company's board of directors, or where a US hedge fund has a substantial investment but no control in a company with overseas operations.

OFAC's 50 percent rule also poses challenges. It may be difficult for investment advisers to determine beneficial ownership information, particularly given that investment advisers must understand the aggregation of multiple ownership interests in a company.[14] In addition, investment advisers should exercise caution prior to dealing with entities in which an SDN has less than 50 percent ownership, but which are controlled by the SDN, as such entities may be subject to future sanctions designation risk, pursuant to secondary sanctions, or an enforcement action by OFAC.

Additionally, investment advisers' general practice of relying upon sanctions screening conducted by third parties, such as introducing firms or intermediary banks, also could subject them to sanctions risks. OFAC has specified that it generally does not permit securities firms to rely on the representations of third parties with respect to OFAC compliance,[15] and that a firm could be held liable for any OFAC violations that occur as a result of a third party's negligence.[16] OFAC's Framework may be difficult for investment advisers to implement in full, given that many are leanly staffed and reliant on third-party relationships and information. However, OFAC has made clear that it expects investment advisers to conduct their own sanctions due diligence on potential clients and investments, rather than delegating sanctions compliance to third parties. Even when investment advisors utilize sanctions screening software, for example, such tools are no panacea, as screening tools are only as good as the data they rely upon. In the current era of aggressive sanctions expansion, it is difficult to keep up with the pace at which the SDN and Sectoral Sanctions Identifications (SSI) Lists are growing and screening failures are not uncommon. While robust sanctions screening is an appropriate part of nearly all risk-based sanctions compliance, investment advisors cannot rely upon it exclusively; it should be considered to be one part of an integrated sanctions compliance program.

Second, the technical and evolving nature of OFAC's sanctions programs poses challenges for investment advisers that have, or that seek to, invest

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in implicated debt or equity. For example, as part of both the Russia and Venezuela sanctions programs, OFAC prohibits US persons from dealing in the "new debt" or "new equity" of certain sanctioned entities. With respect to Russia, OFAC has imposed sanctions that prohibit US persons from dealing in new debt over a certain maturity and new equity of certain major Russian financial institutions,[17] energy companies,[18] and companies in the defense sector[19] that have been designated as SSIs. With respect to Venezuela, OFAC previously has prohibited US persons from dealing in new debt over a certain maturity and new equity issued by the Venezuelan Government, as well as from purchasing equity securities issued by a non-sanctioned party from the Government of Venezuela.[20] Recently, a new Executive Order further restricted US person dealings with the Government of Venezuela by designating the entire Government as blocked.[21] Thus, any natural person or entity meeting the broad definition of the Government of Venezuela, or which is owned directly or indirectly 50 percent or more by the Government, are blocked regardless of whether they appear on the SDN List.

These broad new restrictions on the Government of Venezuela demand that investment advisors reassess previously acquired or traded Venezuelan debt and equity to ensure that they remain compliant with the latest prohibitions from OFAC. Moving forward, investment advisers will need to undertake complicated analyses with respect to issues such as divestment, restructuring, and investment in instruments that involve these potentially problematic debt instruments and securities.[22]

Beyond the technical requirements of dealing in debt and equity in certain sanctioned countries, the sheer increase in the volume of sanctioned parties over the past several years has created significant risk for investment advisors. As described above, difficulties in determining beneficial ownership—whether of customers, financial institutions, or securities—presents a major risk, as OFAC has shown itself to be unyielding in its expectation that investment advisors and other financial sector entities conduct risk-based due diligence on such parties.

The challenges are compounded by the nature of the expansion of OFAC's SDN List. While there remain many individuals and entities targeted for sanctions for more traditional reasons (for example, support for terrorism, undermining of nuclear non-proliferation efforts) there are now a growing number of wealthy individuals targeted largely for their support for and involvement in political corruption or human rights abuses.[23] For the most part, this cohort of sanctioned individuals is highly sophisticated and often have a network of lawyers, financiers, and government officials at its disposal to help move, hide, and shelter their assets. Over time, these parties have gotten better at avoiding the impact of sanctions. As their tactics evolve, OFAC expects that investments advisors will likewise modify their sanctions compliance programs to better detect any connections to these sanctioned parties and take appropriate steps to avoid being complicit in their sanctions evasion efforts.

Nevertheless, although OFAC can pursue civil monetary penalties for sanctions violations under a strict liability standard, US firms are not necessarily prohibited from an investment simply because it involves a sanctioned jurisdiction, entity, or individual. Ultimately, the answer may differ from case-to-case based on the unique circumstances involved. Because of the nuance and complexity involved in this area, a straightforward all-or-nothing approach to compliance may be ill-fitting. And although an investment adviser may decide to forego certain transactions as part of its sanctions risk mitigation strategy, making an informed, risk-based decision requires a complete understanding of the relevant sanctions issues and the adviser's corresponding risks.

Compliance Strategies to Minimize Sanctions Risk

Some registered investment advisers will be able to leverage their existing compliance and internal control structures in order to assure compliance with

the OFAC Framework. Anti-money laundering and anti-corruption compliance and control processes often incorporate elements of what is expected under the OFAC Framework. That said, proactive advisers should evaluate their existing programs, identify existing components of the OFAC Framework, and establish a record for their compliance file regarding the evaluation and any enhancements. With respect to the five components of the OFAC Framework, we offer below some examples of basic steps advisers should consider.

- **Management Commitment and Support**. A statement of commitment in the compliance manual is not likely to be viewed as sufficient. Management presence at trainings and documented examples of investment opportunities that were declined due to sanctions concerns can go a long way to demonstrating commitment. In addition, this commitment to compliance should become part of the adviser's communication plan with respect to third parties.
- **Risk Assessments**. Investment advisers should perform periodic risk assessments of existing clients and investments at funds they advise for compliance with the evolving US sanctions regime. Advisers should periodically evaluate investments and investors for ties to sanctioned regimes, persons, or industries in order to be in position to act should US foreign policy dictate a change in status for such persons or entities. Advisers can use the risk factors identified in the OFAC Securities Guidance as a starting place, but then should tailor any assessment to their business.
- **Internal Controls**. Establishing and maintaining controls reasonably designed to mitigate the risk of dealing with sanctioned persons or blocked property is a basic step in establishing compliance with the OFAC Framework. Sanctions screening should be part of KYC process to onboard clients or evaluate transactions.
  - OFAC has provided guidance on the extent to which investment advisers should screen names and addresses against OFAC sanctions. As part of a sanctions compliance program, investment advisers should screen: (i) new customers and (ii) investments or transactions by or on behalf of such clients.[24] Periodic screening on non-account holders, such as beneficial owners, guarantors, and principals, also may be appropriate depending upon the firm's risk profile. However, advisers must go beyond simple sanctions screening. The challenge for many advisers will be to assure that they have developed a holistic program in which investor relations, portfolio managers, finance, and back office personnel understand the control environment and necessary information flows to stakeholders effectively and efficiently. Foreign investment advisers should think strategically about the role of US persons in overseas investments without a US nexus.
- **Testing and Auditing**. Periodic testing and auditing of the compliance infrastructure and controls provides opportunity for risk mitigation, continuous improvement, and a record that can operate as a shield in the event a violation occurs. Such testing should be not be conducted by those who operate the program on a daily basis. Using outside counsel in this role allows for the potential maintenance of attorney-client privilege over aspects of the work while providing the opportunity to build a disclosable compliance record. Third-party consultants are another alternative.
- **Training**. It is important to provide training that amounts to more than a recitation of general principles regarding SDNs and blocked property. Sanctions risk is often nuanced and is reliant on ever-evolving views at OFAC and in the US foreign policy and national security infrastructure. It often is helpful to be able to engage personnel in discussions of recent sanctions decisions and emerging trends in the market. In addition, it is critical to identify the appropriate

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group for training. Simply telling investor relations personnel that SDNs cannot invest is not enough. Portfolio managers, finance, and back office personnel will need to understand the issue, the compliance process, and the controls in place to effectively mitigate risk.

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NOTES

1 US Treasury Department Office of Foreign Assets Control (OFAC), "Opening Securities and Futures Accounts from an OFAC Perspective" (Nov. 5, 2008) (hereinafter OFAC Accounts Guidance), *https://www.treasury.gov/resource-center/international/standards-codes/Documents/securities_future_accounts_11052008.pdf*; OFAC, "Risk Factors for OFAC Compliance in the Securities Industry" (Nov. 5, 2008) (hereinafter OFAC Securities Guidance), *https://www.treasury.gov/resource-center/sanctions/Documents/securities_risk_11052008.pdf*.

2 Investment Advisers Act of 1940, Rule 206(4)-7.

3 *Id.* Rule 204-2(a).

4 *Id.* Section 206.

5 *Id.* Section 207.

6 *See* OFAC Accounts Guidance, *supra* n.1.

7 Property and accounts owned or held by SDNs (*i.e.*, blocked persons) are also referred to as "blocked property" or "blocked accounts." Those terms refer to any account or property "held in the name of a person whose property and interests in property are blocked pursuant to [a sanctions program], or in which such a person has an interest, and with respect to which payments, transfers, exportations, withdrawals, or other dealings may not be made or effected except pursuant to an authorization or license from OFAC expressly authorizing such action." *See* 31 CFR § 589.301 (Ukraine-related sanctions regulations). The term "property" is "very broadly defined, including present, future or contingent interests." OFAC FAQ 53, *https://www.treasury.gov/resource-center/faqs/sanctions/pages/faq_compliance.aspx*.

8 OFAC, "Revised Guidance on Entities Owned by Persons Whose Property and Interest in Property Are Blocked" (Aug. 13, 2014) (hereinafter OFAC Blocked Property Guidance), *https://www.treasury.gov/resource-center/sanctions/Documents/licensing_guidance.pdf*.

9 *See* 31 C.F.R. § 560.208.

10 *See* OFAC Securities Guidance, *supra* n.1.

11 *Id.*

12 OFAC, "A Framework for OFAC Compliance Commitments" (May 2, 2019), *https://www.treasury.gov/resource-center/sanctions/Documents/framework_ofac_cc.pdf*.

13 Mengqi Sun and Mark Maurer, "SEC Questions More Companies About Sanctions Disclosures," *Wall Street Journal*, Aug. 28, 2019, *https://www.wsj.com/articles/sec-questions-more-companies-about-sanctions-disclosures-11567018243*.

14 OFAC Blocked Property Guidance, *supra* n.8.

15 OFAC Accounts Guidance, *supra* n.1.

16 *Id.*

17 OFAC, Directive 1 under Executive Order 13662 (as amended Sept. 29, 2017), *https://www.treasury.gov/resource-center/sanctions/Programs/Documents/eo13662_directive1_20170929.pdf*.

18 OFAC, Directive 2 under Executive Order 13662 (as amended Sept. 29, 2017), *https://www.treasury.gov/resource-center/sanctions/Programs/Documents/eo13662_directive2_20170929.pdf*.

19 OFAC, Directive 3 under Executive Order 13662 (Sept. 12, 2014), *https://www.treasury.gov/resource-center/sanctions/Programs/Documents/eo13662_directive3.pdf*.

[20] Executive Order 13808 (Aug. 24, 2017), *https://www.treasury.gov/resource-center/sanctions/Programs/Documents/13808.pdf*.

[21] Executive Order 13884 (Aug. 5, 2019), *https://www.treasury.gov/resource-center/sanctions/Programs/Documents/13884.pdf*.

[22] *See generally* OFAC FAQs, *https://www.treasury.gov/resource-center/faqs/Sanctions/Documents/faq_all.html*.

[23] *See* "Treasury Designates Russian Oligarchs, Officials, and Entities in Response to Worldwide Malign Activity," *https://home.treasury.gov/news/press-releases/sm0338*; "United States Sanctions Human Rights Abusers and Corrupt Actors Across the Globe," *https://home.treasury.gov/news/press-releases/sm0243*.

[24] OFAC Accounts Guidance, *supra* n.1.

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