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New US Economic Sanctions Create Risks for Non-US Financial Institutions

The US Treasury Department has issued new regulations implementing provisions of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (the "Sanctions Act"). The new rules are effective immediately and prohibit or severely restrict non-US financial institutions that knowingly engage in certain activities involving Iran from having US correspondent accounts. The rules also prohibit any person or entity owned or controlled by a US financial institution from engaging in transactions involving the Islamic Revolutionary Guard Corps (the "Revolutionary Guard") or related entities.

What's Critical

- New US regulations prohibit activities that facilitate Iran's proliferation of weapons of mass destruction ("WMDs") and transactions with the Revolutionary Guard.
- Sanctions include placement on a list that prohibits or severely restricts a financial institution from holding US correspondent accounts.
- Prohibitions apply to non-US subsidiaries of US financial institutions.
- A financial institution can be subject to sanctions on the basis of what its personnel knew, or what they should have known under the circumstances.

Introduction

President Obama signed the Sanctions Act into law on July 1, 2010. Among other things, the Sanctions Act strengthened existing US sanctions against Iran by adding mandatory penalties for firms that invest in (including financing) Iran's domestic production of refined petroleum products. The Sanctions Act also requires the Treasury Department to prohibit or restrict the opening or maintaining of US correspondent accounts for non-US financial institutions that knowingly engage in certain activities involving Iran, and to prohibit persons or entities owned or controlled by US financial institutions from engaging in transactions with the Revolutionary Guard or related entities. This note briefly describes the political context of the Sanctions Act and summarizes the new regulations and their implications for US and non-US financial institutions.

At the outset, it is important to note that the Sanctions Act and the new regulations are distinct from, and in addition to, the existing "country-based" sanctions targeting Iran under the Iranian Transactions Regulations (31 CFR part 560), which

generally prohibit US persons, including US branches of non-US financial institutions, from engaging in or facilitating most types of transactions involving Iran. The new US legislation is also intended to complement the existing "list-based" sanctions targeting certain Iranian persons or entities, which require US persons to block (*i.e.*, freeze) all property in their possession belonging to persons or entities identified on Treasury's Specially Designated Nationals and Blocked Persons List (the "SDN List"), available online at http://www.treas.gov/offices/enforcement/ofac/sdn/index.shtml.

As discussed below, the new regulations set forth a framework within which the Treasury Department's Office of Foreign Assets Control ("OFAC") will designate certain "foreign financial institutions" for whom US correspondent accounts are either prohibited or severely restricted. Although no such firms have been designated under the new regulations yet, it is important for both US and non-US financial institutions to be aware of the types of conduct that can trigger a designation by OFAC, determine how such a designation would impact their business, and be prepared to take appropriate steps if such a designation occurs. Additionally, US financial institutions with non-US subsidiaries should take immediate steps to ensure that those subsidiaries do not engage in transactions with the Revolutionary Guard or related entities that are prohibited by these new regulations.

Background

To properly understand its political context, the Sanctions Act must be viewed in conjunction with the recent global escalation of sanctions against Iran, particularly UN Security Council Resolution 1929 ("Resolution 1929"). Adopted in June 2010, Resolution 1929 calls upon nations to restrict new banking relationships with Iran within their jurisdictions, including the opening of new branches, offices, joint ventures or correspondent accounts with Iranian banks, if there is a suspected link to Iran's proliferation of nuclear weaponry. Shortly after Resolution 1929 was passed, the European Union adopted sanctions which, among other things, prohibit EU member states and nationals from providing loans or credit to enterprises engaged in the key sectors of the Iranian oil and gas industry and require the freezing of assets of certain Iranian banks.

In signing the Sanctions Act, President Obama expressly invoked the "strong foundation for new multilateral sanctions" embodied by Resolution 1929. Notably, however, the Sanctions Act goes beyond Resolution 1929 and the EU sanctions by targeting financial institutions *outside the United States* that engage in a range of activities involving Iran. Specifically, section 104(c) of the Sanctions Act requires Treasury to prohibit or severely restrict US financial institutions from opening or maintaining correspondent accounts for non-US financial institutions that knowingly engage in activities that facilitate Iran's efforts to acquire or develop WMDs or to provide support to terrorist organizations or acts of international terrorism. Section 104(d) of the Sanctions Act requires Treasury to prohibit any entity *owned or controlled* by a US financial institution, including subsidiaries located outside the US, from knowingly engaging in transactions with the Revolutionary Guard or its agents or affiliates listed on the SDN List. Both sections require the Secretary of Treasury to issue implementing regulations by September 29, 2010.

The New Regulations

On August 16, 2010 – well in advance of the 90-day deadline set forth in the Sanctions Act – OFAC issued the Iranian Financial Sanctions Regulations (the "Regulations"), which implement sections 104(c) and 104(d) of the Sanctions Act. By relying on the "foreign affairs" exception to the Administrative Procedures Act, OFAC issued the Regulations as a final rule, effective immediately, with no prior notice of proposed rulemaking (although comments will be accepted for 60 days following their publication).

The Regulations are divided into two main sections containing the key provisions, with ancillary sections that define or interpret those provisions. The first section (31 CFR § 561.201) prohibits or restricts a US financial institution from opening or maintaining a correspondent account or payable-through account for any "foreign financial institution" found by OFAC to

knowingly engage in one or more of the activities specified in the section. The second section (31 CFR § 561.202) prohibits persons or entities owned or controlled by a US financial institution from knowingly engaging in transactions with the Revolutionary Guard or related entities on the SDN List. Key terms such as "US financial institution," "foreign financial institution," "correspondent account" and "payable-through account" are defined in a subpart of the Regulations.[1]

Correspondent Accounts

Under the Regulations, OFAC will either prohibit or impose strict conditions on the opening or maintaining of a US correspondent account for a non-US financial institution found by OFAC to knowingly engage in one or more of the following activities:

- WMDs: Facilitating the efforts of the Government of Iran or the Revolutionary Guard (i) to acquire or develop WMDs or delivery systems for WMDs, or (ii) to support terrorist organizations or acts of international terrorism;
- Assisting named persons/entities: Facilitating the activities of a person or entity subject to UN Security Council Resolutions 1737, 1747, 1803 or 1929 imposing sanctions with respect to Iran;[2]
- Engaging in money laundering, or facilitating efforts by the Central Bank of Iran or any other Iranian financial institution, to carry out either of the above activities; or
- Revolutionary Guard: Facilitating a significant transaction with, or providing significant financial services (including loans, transfers, accounts, insurance, investments, securities, guarantees, foreign exchange, letters of credit, and commodity futures or options) for, (i) the Revolutionary Guard or any of its agents or affiliates on the SDN List, or (ii) any other financial institution added to the SDN List in connection with Iran's proliferation of WMDs or delivery systems for WMDs or Iran's support for international terrorism.[3]

[1] The term "**US financial institution**" includes, but is not limited to, US depository institutions, banks, savings banks, money service businesses, trust companies, insurance companies, securities brokers and dealers, commodity futures and options brokers and dealers, forward contract and foreign exchange merchants, securities and commodities exchanges, clearing corporations, investment companies, employee benefit plans, and the US holding companies, affiliates, or subsidiaries of any of the foregoing. It includes the branches, offices and agencies of foreign financial institutions located in the US, but not such institutions' foreign branches, offices, or agencies. The term "**foreign financial institution**" includes, but is not limited to, the same categories of entities as in the definition of US financial institutions (excluding insurance companies) that are located outside the US. The term "**correspondent account**" means "an account established by a US financial institution for a foreign financial institution to receive deposits from, or to make payments on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution." The term "**payable-through account"** means "a correspondent account maintained by a US financial institution for a foreign financial institution by means of which the foreign financial institution permits its customers to engage, either directly or through a subaccount, in banking activities usual in connection with the business of banking in the United States." Full definitions for these and other terms are set forth in subpart C to the Regulations. Because a payable-through account is defined as a type of correspondent account, the latter term is used herein to encompass both types of accounts.

[2] Such persons and entities are identified in annexes to the specified Security Council resolutions, which can be found at http://www.un.org/docs/sc/.

[3] The Sanctions Act also imposes mandatory penalties on non-US companies and persons that invest (including financing) more than $20 million in a twelve-month period that directly and significantly contributes to the enhancement of Iran's ability to develop its petroleum resources, but the Regulations do not directly relate to or implement this section of the Sanctions Act.

Significantly, to be designated under the Regulations, a financial institution must "knowingly" engage in the specified activity, which is defined to include either actual or constructive knowledge. Thus, a financial institution will be found to have the requisite level of knowledge if its personnel *knew or should have known* that its conduct involved one of the above activities.

The names of the financial institutions found by OFAC to knowingly engage in such activities, and for whom US financial institutions may not open or maintain correspondent accounts, will be published in the Federal Register and listed in Appendix A to the Regulations. Alternatively, if OFAC chooses to impose "strict conditions" on the opening or maintaining of a correspondent account for such financial institution, those conditions will be set forth in the order or regulation identifying the financial institution for whom such conditions must be imposed, and may include the following:

- Prohibiting the provision of trade finance through the correspondent account;
- Restricting the types of transactions that may be processed through the correspondent account;
- Placing monetary limits on the transactions that may be processed through the correspondent account; or
- Requiring pre-approval from the US financial institution for all transactions processed through the correspondent account.

As noted above, Appendix A is currently "reserved" by OFAC and does not yet list any foreign financial institutions designated pursuant to the Regulations. However, as explained in the notes to the Regulations, entities previously designated by OFAC who appear on the SDN List are expressly "incorporated into" Appendix A, which includes the following Iranian banks that have been previously designated by OFAC: [4]

- Bank Keshahvarzi Iran
- Bank Kargoshaee
- Bank Maskan
- Bank Mellat
- Bank Melli
- Bank Refah Kargaran
- Bank Saderat
- Bank Sepah
- Bank Tejarat
- Bank Sanad Va Madan

[4] Because US financial institutions were already prohibited from engaging in business with these entities, their incorporation into Appendix A does not create additional burdens from a compliance perspective. Nonetheless, US financial institutions will need to monitor both sources going forward, as financial institutions added to Appendix A of the Regulations will not necessarily be added to the SDN List, and vice-versa.

- Central Bank of Iran
- Export Development Bank of Iran
- Post Bank of Iran
- SINA Bank

In addition, OFAC has also designated several non-Iranian banks based on their perceived ties to the Government of Iran and its proliferation of WMDs, most recently Deutsch-Iranische Handelsbank in Germany, Banco Internacional de Desarrollo in Venezuela, and Persia International Bank in the United Arab Emirates.

Transactions Involving the Revolutionary Guard and Related Entities

The Regulations also prohibit any person or entity owned or controlled by a US financial institution from knowingly engaging in transactions with or benefitting the Revolutionary Guard or any of its agents or affiliates on the SDN List. Unlike the pre-existing sanctions under the Iranian Transaction Regulations, which generally apply only to persons and entities located in the United States (and US citizens anywhere), this section of the Regulations applies to non-US subsidiaries of US financial institutions.

Thus, effective immediately, all such non-US subsidiaries are prohibited from knowingly engaging in transactions with the Revolutionary Guard or related entities on the SDN List (which currently number well over one hundred).[5] According to previous guidance issued by OFAC, and as reinforced in these Regulations, this prohibition also applies to any property in which such entity owns a 50 percent or greater interest, regardless of whether such property appears independently on the SDN List.

Significant Implications for Financial Institutions

The Regulations carry several implications for US and non-US financial institutions:

1. *Focus on non-US financial institutions*. The direct target of the Regulations is not Iran or Iranian entities, but rather financial institutions located *outside the US* that do business with Iran. This extraterritorial focus is reflected by the Regulations' two-pronged structure, which corresponds to the two types of non-US financial institutions that are the targets of the sanctions. The first prong of the Regulations is expressly aimed at "foreign financial institutions" whose involvement with Iran may prevent them from holding US correspondent accounts. To maintain their access to the US banking system, therefore, non-US financial institutions should take immediate steps to determine whether they currently engage in any of the specified activities, and create and implement internal policies and procedures designed to avoid being designated by OFAC under the Regulations.

The second prong of the Regulations targets non-US subsidiaries of US financial institutions that engage in prohibited transactions with the Revolutionary Guard or related entities. The onus is on both the US financial institution and their

[5] Designated entities related to the Revolutionary Guard are identified by the tag "IRGC" following their entry on the SDN List.

non-US subsidiaries to investigate whether the subsidiaries engage in transactions with prohibited entities on the SDN List, which may be a difficult task for financial institutions with complex organizational structures, and to create and implement internal policies and procedures designed to prevent such transactions in the future, including ongoing monitoring of the SDN List for additional designations related to the Revolutionary Guard.

Taken together, the two prongs of the Regulations clearly demonstrate the focus of the new legislation on non-US firms, which was not characteristic of previous US sanctions programs involving Iran.

2. *Actions for US financial institutions*. Another class affected by the Regulations are financial institutions located in the US that provide correspondent accounts for non-US financial institutions (*e.g.*, US banks and US branches of non-US banks). Such institutions should establish due diligence procedures to monitor and detect whether their correspondents are engaged in any of the prohibited activities, and take appropriate steps to close accounts for correspondents that are designated by OFAC under the Regulations. In addition, US financial institutions are required under the Sanctions Act to report any prohibited activities to the Treasury Department and to certify that, to the best of their knowledge, their non-US financial institution customers are not engaged in any of the prohibited activities. The regulations detailing these requirements have not yet been issued; however, internal procedures should be put in place to detect and report any prohibited activity.

3. *No requirement of US-dollar denominated transactions*. The Regulations expressly provide that the conduct which can trigger a designation by OFAC under the Regulations can occur *in any currency*. Historically, the reach of US sanctions – and in many respects, the influence of US foreign policy in the global financial system – depended on the use of the dollar. In years past, this was a small limitation in scope, as many large cross-border transactions were conducted in US dollars and cleared at US banks that use automatic filters to detect (and reject) transactions involving entities sanctioned by the US. However, the increasing use of the euro and yen in global commerce has limited the reach of US sanctions to some degree, with many of the world's largest cross-border transactions now occurring without ever entering the US financial system.[6] The Regulations attempt to address this limitation by specifically targeting activities in any currency. Thus, for instance, a German bank that conducts Iran-related business exclusively in euros may nonetheless be prevented from opening or maintaining a US correspondent account if OFAC finds that its conduct falls into one of the activities specified in the Regulations.

Conclusion

The Regulations effectively force non-US firms that engage in certain activities to make a choice between doing business with the US, or with Iran. It is clear that the real goal of the Regulations, and of the Sanctions Act itself, is to pressure Iran through its business partners. As noted above, the critical assumption is the non-US firms targeted by the Regulations will consider access to the US financial system more important than their Iran-related business.

[6] Moreover, even where US dollars are used, some banks have avoided detection by US filtering software by stripping information from wire transfers that would otherwise cause the transaction to be rejected by the US clearing bank, as illustrated by the recent series of "stripping" cases involving Barclays, Credit Suisse and Lloyds TSB.

The Sanctions Act and the Regulations have particularly significant implications for non-US financial institutions, which must now act to review institutional diligence, communications and compliance procedures in order to avoid becoming a target for Treasury restrictions.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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