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Analysis of Sanctions Enforcement Actions

DOES OFAC PLAY FAVORITES?

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EXECUTIVE SUMMARY

This paper will discuss recent changes to the United States (U.S.) sanction laws, increased enforcement penalties in U.S. law, the Office of Foreign Assets Control (OFAC) Enforcement Guidelines published in November 2009, as well as discuss other factors that may be driving the apparent discrepancy in U.S. sanctions enforcement of U.S. and non-U.S. financial institutions.

BACKGROUND

Ever since the $619,000,000 Civil Monetary Penalty (CMP) imposed on ING Bank by the U.S. Treasury's OFAC in June 2012, there seems to be a steady drumbeat of "mega-fines" imposed on foreign financial institutions, while there are few, if any, of size imposed on U.S. firms. Has the playing field been unfairly tilted against non-U.S. financial institutions, or are other factors at work that just make it appear that way? The unsatisfying answer is that the outsized penalties are due to a combination of geography, timing and legislative oddities, in addition to the different nature of the behaviors reported in the recent enforcement actions.

TWEA, IEEPA & FNKDA

While there are many pieces of U.S. sanctions-related legislation that are in force, three, in particular, are the most prominent in understanding CMPs: the Trading with the Enemy Act of 1917 (TWEA),[1] the International Emergency Economic Powers Act of 1977 (IEEPA),[2] and the Foreign Narcotics Kingpin Designation Act of 1999 (FNKDA, or the "Kingpin Act").[3]

TWEA is a law that gives the president the powers to impose sanctions when the country is at war. It was originally passed with a maximum civil penalty, per violation, of $50,000. Subsequent adjustments for inflation (under the auspices of the Federal Civil Penalties Inflation Adjustment Act of 1990)[4] have raised that cap to $65,000 per violation. After North Korea was removed from TWEA sanctions in 2008 for meeting its nuclear inspection obligations (and simultaneously redesignated under IEEPA),[5] the Cuban sanctions program was left as the only program subject to the TWEA penalty caps.

IEEPA also provides sanctioning powers to the president, although these can be imposed during other "emergencies" that do not correspond with the U.S. being at war. Currently, the maximum CMP under TWEA (which covers all sanctions programs other than the Cuban and narcotics programs) is $250,000 or twice the transaction value, whichever is larger, per violation.

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The implication is clear. Violations of the Cuban sanctions program will draw a base penalty of only 26% of that for one of the other non-narcotics sanctions programs. That fact alone makes the August 2011 penalty imposed on JPMorgan Chase Bank[6] undersized —the $111 million base penalty would have ballooned past $400 million had the TWEA maximum penalty been identical to that of IEEPA. It also explains why the base penalty for Bank of America's July 2014 fine[7] was seemingly so large (because the violations were of the Kingpin Act, which had a much higher statutory minimum).

IEEPA PENALTY ADJUSTMENTS

When IEEPA was originally passed in 1977, the maximum civil penalty per violation was $10,000. After an adjustment for inflation, it rose to $11,000 by March 2006, and it increased to $50,000 when the USA PATRIOT Improvement and Reauthorization Act[8] passed. This brought the cap on IEEPA civil penalties roughly in line with TWEA penalties. On October 16, 2007, the IEEPA Enhancement Act[9] again radically increased the maximum fine to its current level of $250,000, twice the transaction amount, per violation. In addition, criminal penalties were raised from $250,000 to $1 million per violation.

As U.S. law does not apply ex post facto, which implies that violating activities prior to the 2006 passage of the USA PATRIOT Improvement and Reauthorization Act would only draw a maximum base penalty of $11,000 per violation, the violations between that date and October 16, 2007 would be capped at $50,000 per item.

However, that assumption is faulty. It is fairly apparent that, subsequent to the publication of the OFAC Enforcement Guidelines on November 9, 2009, the most recent figures were used in base penalty calculations for IEEPA violations.

For example, Barclays Bank was assessed a base penalty of $218,971,000 for "at least" 1285 violations of both TWEA-based and IEEPA-based sanctions programs.[10] Even had all of the violations been that of the Cuba program, the base penalty would not have exceeded $84 million, much less $218 million.

Similarly, the arithmetic used in Agar Corporation's July 2010 case does not comport with the dates of the violating conduct (April through June 2005).[11] The settlement states, for Agar's violations of the Sudanese Sanctions Regulations (SSR – an IEEPA-based program), that the "total transaction value for the seven transactions settled with OFAC was $444,887, and the base penalty amount for ACI's alleged violations was $1,967,098, the maximum applicable penalty."

While one can arrive at a base penalty of $1,967,098 for 7 violations committed after the 2007 changes to IEEPA (6 small transactions generating $250,000 each, plus one transaction of about $233,500 generating the balance), the same cannot be said in 2005, when the maximum civil penalty under IEEPA was $11,000 per violation. Had the civil penalties been applied, the base penalty for Agar's conduct would have been $77,000. Even if the penalties were considered criminal (as stated in the enforcement action text), rather than civil, the base penalty could not have exceeded $1,750,000.

The reason for the difference lies in the Interim Policy issued November 27, 2007[12] (emphasis added):

> On October 16, 2007, the President signed into law the International Emergency Economic Powers Enhancement Act ("IEEPA Enhancement Act" or "Act"), Pub. L. No. 110-96, which, inter alia, increased the maximum civil penalty applicable to violations of orders or regulations issued under IEEPA. The new maximum civil penalty is the greater of $250,000 or an amount that is twice the amount of the transaction that is the basis of the violation with respect to which the penalty is imposed.

> *These amounts are applicable to all violations with respect to which enforcement action is pending or commenced on or after October 16, 2007. OFAC interprets this provision to mean that the new civil penalty provisions apply to all violations with respect to which a Final Penalty Notice had not been issued as of October 16, 2007.*

This explains why, with some exceptions for proceedings already in progress (noted in the Interim Policy statement), all civil monetary penalties for IEEPA-based sanctions programs rose as of late 2007.

OFAC published a detailed set of enforcement guidelines in November 2009[13] that provided much-needed transparency to the enforcement and civil process. It detailed 11 General Factors considered when determining the final CMP amount, as well as factors that can cause the final figure to be further discounted.

The General Factors can factor in as either aggravating or mitigating contributions to the resulting settlement amount.

Of the factors, 4 are mentioned to be of more significant weight than the others:

- Willful or Reckless Behavior
- Awareness of Conduct at Issue
- Harm to Sanctions Program Objectives
- Individual Factors (including Commercial Sophistication, Size of Operations and Financial Condition, Volume of Transactions, and Sanctions History)

Of the remaining General Factors, the actions taken by the person or firm being investigated to cooperate with OFAC's investigation, as well as steps taken to correct the conditions that led to the violations, are the actions most frequently mentioned in settlements that have significant reductions from the base penalty.

The publication and use of the Enforcement Guidelines, in conjunction with the increasing of the maximum civil monetary penalties possible under the IEEPA-based sanctions programs, had a dramatic effect on the average amount of penalties. Even excluding the "mega-fines," the average fines more than doubled after the changes:

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OFAC ENFORCEMENT GUIDELINES
TOTAL ANNUAL MONETARY PENALTIES

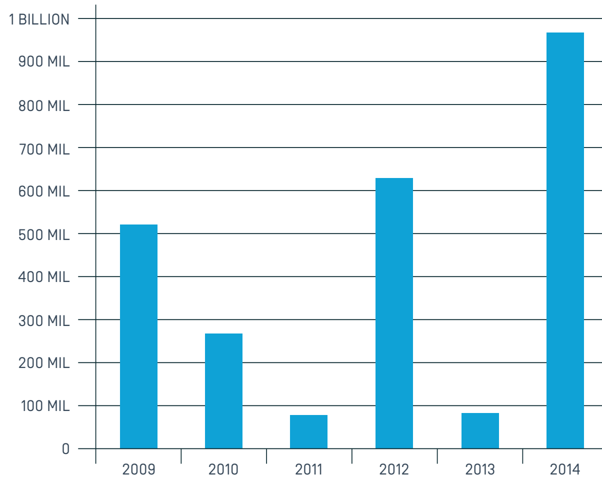

CHART 1
Largest Annual Penalties
Since 2009, the largest penalties have risen more than 48,000% from $2,000,000. to $963,619,900.

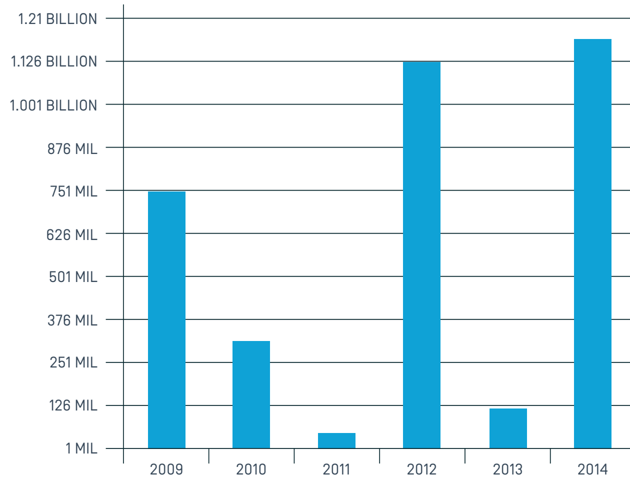

CHART 2
Total Annual Penalties
Since 2009, the total amount of penalties have risen more than 27,700% from $4,344,686.25. to $1,209,298,807.

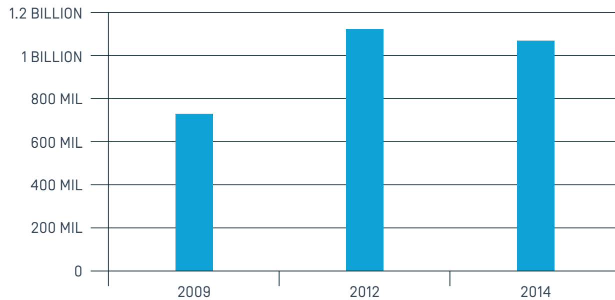

CHART 3
Total Annual Mega-Fines
Since 2009, the total amount of penalties has risen more than 3,250% from $753,000,000. to $1,115,521,900.

**Excluding actions with no civil monetary penalty*

Analysis of the enforcement actions is complicated by a number of factors. If one reviews items prior to the June 29, 2011 penalty imposed on Gen Re[14], one notices a significant difference in the quality of the enforcement notices. There is significantly less detail as to the factors contributing to penalties prior to this date, in general. This is due, in part, to investigations in process prior to the publication of the Enforcement Guidelines. In fact, enforcement notices prior to the Gen Re action contain an explanatory comment noting that the pre-2009 Enforcement Guidelines may have been used in the imposition of any penalties. To that extent, a more valid analysis of enforcement actions to determine the relative importance of the General Factors should exclude these earlier penalties, which include the August 2010 action against Barclays Bank, and the first "mega-fines" in December 2009 against Lloyds TSB and Credit Suisse.

Complicating things further is the fact that not all enforcement notices have the same level of detail. How does an enforcement action that does not mention a General Factor be treated? If the recitation of aggravating or mitigating factors does not mention that a firm had actual knowledge of the conduct at issue, does that imply that it did not – or that it should be discounted in the analysis, as it is a nonfactor to OFAC?

It should also go without saying that multivariate analyses are invariably tricky. Consider, for example, the December 2013 penalty levied against HSBC.[15] The actual penalty levied was 61% larger than the base penalty, which skews all the data for similar cases, given: there were only three violations that were nonegregious, the violations were not willful and voluntarily self-disclosed and, finally, the firm had a suitable remedial response. However, the firm had actual knowledge of the actions, harmed sanctions objectives (despite such low value involved) and, perhaps most notably, did not cooperate fully with OFAC's investigation.

While it should be noted that amounts involved were very small for a firm of HSBC's size ($40,166 total value, $20,083 base penalty and $32,400 final penalty), the penalty imposed is actually the largest, as a percentage of the base penalty, since the Gen Re enforcement action. Subsequently, the HSBC case has been excluded from all data analysis of enforcement actions. In a similar fashion, the September 2014 penalty imposed on Zulutrade[16] was excluded from the analysis, as it was substantially smaller, on a proportional basis, than all other fines.

If we remove the HSBC, Zulutrade and pre-Gen Re penalties, and assume a nonmention of a General Factor (unless it can be inferred from the notice) means

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that it is a non-factor, some patterns in the data become clearer.

– Willful or reckless behavior significantly raises the fine. The average CMP for non-willful/non-reckless violations was less than 26% of the base penalty, while that of willful or reckless violations exceeded 64% of the base figure.

– Knowledge of the conduct at issue noticeably increases the penalty. Firms that had or should have had knowledge that violations were being committed paid almost 65% of the base penalty, as opposed to the 45% paid by those who did not.

– Commercially sophisticated firms pay higher fines. Larger, more sophisticated firms pay almost 60% of the base amount vs. 47% for violations made by smaller, unsophisticated ones.

–Cooperation pays. The average fine paid by firms that cooperate with OFAC investigations was just shy of 54% of the base amount. This compares very favorably with the almost 84% of the base penalty paid by uncooperative firms.

– When OFAC makes an example of a firm, it costs. The average fine paid by firms for whom OFAC mentions the importance of the Future Compliance or Deterrence General Factor is over 85%, the highest percentage of any statistic revealed during the analysis.

– OFAC is not out to cripple firms. The four firms for whom OFAC agreed to adjust the penalties so they were "proportionate to the nature of violations" paid, on average, less than 7% of the base penalty. These cases include the 2014 CMPs imposed on

Clearstream Banking[17] and BNP Paribas.[18] And OFAC reduces penalties in large cases when the firms agree to settle; the firms where this wording appears in the enforcement action paid just over 58% of the base penalty, which is well within the range between the averages paid by firms with the aforementioned aggravating factors, and those paid by firms whose settlements mentioned the corresponding mitigating factors.

OTHER CONSIDERATIONS

Since the American Express Travel Related Services and JPMorgan Chase enforcement actions are the only US-based firms to draw fines of note, one must look to non-regulatory reasons to determine why foreign financial firms seem to draw more civil monetary penalties of higher amounts.

– Compared to the number of foreign financial institutions with U.S. operations, the number of U.S. firms with foreign operations is very small. There are only a handful of U.S. banks with significant overseas business, with Bank of America, JPMorgan Chase, BNY Mellon, Citibank, Northern Trust and State Street Bank being the most prominent. Therefore, purely as a mathematical issue, penalties on foreign firms would normally outweigh those on domestic ones.

– The Cuban sanctions program is a sanctions program enforced by the U.S. alone. Additionally, until 2012, the sanctions imposed on Iran were, almost exclusively, a U.S.-only effort as well. To that extent, while U.S. firms needed to comply with these programs in order to survive audits and regulatory reviews, no such ongoing need existed internationally. Regardless of the correctness of the view, these "foreign" sanctions programs, and OFAC's zealousness in enforcing them, was likely underappreciated by foreign firms, leading to less stringent controls and oversight.

– In a similar fashion, the lack of sanctions enforcement actions outside the U.S. (other than a relative handful of penalties meted out as a result of regulatory examinations that found program deficiencies) likely caused foreign firms to underplay the importance of sanctions compliance efforts.

– Because of the prior two points, the behaviors of foreign financial firms involve significantly larger numbers of violations, as the lack of oversight and focus allowed patterns of behavior to develop and persist over an extended period of time. This increased the likelihood that they would cause significant harm to sanctions objectives and therefore will be more likely to be considered egregious, which can significantly increase the amount of any penalties. Only JPMorgan Chase's 1711 violations and American Express Travel Related Services' 14487 violations are in the same neighborhood as those of the penalized foreign firms – and those were almost exclusively violations of the Cuban sanctions program, with its much lower maximum penalty.

– While the OFAC Enforcement Guidelines lump willful behavior and reckless behavior together, it is likely that they are not considered equally egregious. While the bulk of foreign firms' "megafines" reference willful attempts to evade detection of sanctions violations, the penalties against Bank of America, Citibank, Wells Fargo, JPMorgan Chase and American Express Travel Services in the last few years do

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not. The violations committed by the domestic firms are either a result of program deficiencies (systems, training or procedures) and/or negligence in addressing identified sanctions exposures. It is likely that willful behavior is regarded as significantly more serious than recklessly negligent behavior, which would raise the overall penalty amount.

When behavior by American firms was particularly egregious, the penalties reflected that fact, to the extent available under the regulations. The penalty meted out to American Express Travel Related Services, for example, was 44% higher than the base penalty.[19] And the Bank of America CMP, while only around 20% of the base penalty, was still over 18,000 times larger than the amount of the underlying transactions. None of the largest penalties to foreign financial firms showed either of those characteristics (although ING Bank's final penalty in 2012[20] was almost as large as the base amount).

WHAT'S NEXT?

Beyond the March 2015 enforcement action against Commerzbank AG, which drew a combined $1.45 billion penalty paid to a mix of federal and state agencies, and any other investigations already in progress, it is likely that the age of outsized civil monetary penalties is either behind us, or drawing to a close.

Future fines will likely focus on smaller patterns of conduct that are due to program deficiencies (such as the training issue that formed part of the 2014 enforcement action against Citibank)[21] or technical ones (e.g. the Deutsche Bank[22] and Wells Fargo[23] actions) and therefore likely to be smaller in size. This is likely due to three unrelated factors:

–Sensitization to OFAC compliance that the "megafines" have drawn

–The general harmonization of the Iran and Ukraine/Crimea related sanctions regimes in the U.S. and the E.U.

–The likely diminution or elimination of the Cuban sanctions regime within the next few years

To the first point, while there may be investigations of prior year conduct, the impact of the massive "mega-fines" is very likely to have caused reexamination of sanctions compliance policies, processes and procedures. These reviews would be intended to identify and eliminate evasive conduct similar to those identified in the larger civil monetary penalties. Thus, it is likely that any ongoing patterns of sanctions-evading conduct will be stamped out in short order, if not already terminated.

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Secondly, as noted earlier, one of the likely underlying reasons for large penalties against European financial institutions is that the Iranian sanctions program, among others, was a U.S.-only program until recent years. As this sanctions regime, and the equally prominent sanctions against Russia, are now very similar in both the U.S. and E.U., it can be reasonably assumed that European firms will better adhere to sanctions requirements that are now "their" requirements.

Lastly, while the fines for violations of the Cuban sanctions program are less severe, the likelihood of a pattern of conduct intended to evade the loosened sanctions regulations are less likely to be necessary in order to capture Cuban business as the program is tapered off and, potentially, eliminated.

This does not imply that some firms won't, in the pursuit of profits, attempt to find ways to evade detection. However, it is highly unlikely that firms of size in sectors under the microscope (e.g. financial services, energy, military goods, transportation) will run the gauntlet of regulatory and reputational liability any time soon.

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