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OFAC Due Diligence in Securities Offerings

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The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) oversees and enforces economic sanctions against certain countries, regions, entities, and individuals. It is important to have an understanding of these sanctions and conduct diligence because significant penalties can be imposed for violations of the OFAC sanctions, including on a strict-liability basis. Thus, a person or entity can be fined for violating the sanctions even though it did not know it was committing a violation. In general, the OFAC sanctions are designed to further the federal government's foreign policy and national security goals, including efforts to combat terrorism and narcotics trafficking.

Notwithstanding the direct risk of liability under these rules, parties participating in securities offering, particularly the issuing company and the underwriters in a public offering, bear additional risk that undisclosed sanctions or violations could lead to shareholder litigation and liability or securities laws violations. This practice note provides:

- An overview of OFAC regulations
- The entities and individuals that are subject to OFAC's jurisdiction
- The types of transactions prohibited by OFAC—and—
- Practical guidance for attorneys conducting due diligence on OFAC regulations in securities offerings

For a further discussion of due diligence in general, see *Managing the Due Diligence Process for an IPO and Due Diligence for Securities Offerings Resource Kit*.

Overview of OFAC Regulations

OFAC oversees sanctions programs aimed at specific countries or geographic regions along with their governments or quasi-governmental entities and entities and individuals acting on behalf of those entities or engaged in designated activities such as narco-trafficking or terrorism. These sanctions programs vary in both scope and comprehensiveness. Some programs include complete embargoes on all trade, financial-related transactions, and the provision of services to certain countries. Other programs target specific activities, industries, or individuals. For a list of current sanctions programs, see the U.S. Treasury Department's OFAC website: <https://www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx>.

OFAC's various sanctions programs are constantly subject to change; counsel should make sure to review the relevant section of OFAC's website for the latest information. Counsel may also register to receive updates regarding individual sanctions programs via the OFAC website: https://public.govdelivery.com/accounts/USTREAS/subscriber/new?topic_id=USTREAS_1027.

While all of OFAC's sanctions programs are important, the programs that are the relevant to all companies are the comprehensive country-based embargoes and the specific lists of sanctioned persons and entities. As to the embargoes, the OFAC sanctions programs include broad prohibitions relating to U.S. persons doing business with, directly or indirectly, or for the benefit of Iran, Cuba, Syria, North Korea, and the Crimea region of the Ukraine. As to lists of sanctioned persons, OFAC's most comprehensive list is its List of Specially Designated Nationals and Blocked Persons (SDN list). In general, the SDN list targets persons who act on behalf of nations and groups that are targeted by OFAC's sanctions programs or whom it believes are engaged in certain activities such as terrorism or narco-trafficking. For an up-to-date SDN list, see the OFAC website: <https://www.treasury.gov/resource-center/sanctions/SDN-List/>

[Pages/default.aspx](#). Importantly, if an SDN owns 50% or more of another entity (either directly or indirectly), then that entity is also subject to OFAC sanctions. OFAC provides additional guidance regarding these calculations on its website: https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_general.aspx#50_percent.

OFAC also implements and enforces the Sectoral Sanctions Identifications (SSI) list, which is a series of sanctions targeted at specific Russian entities. More specifically, the SSI list and prohibits certain types of transactions with Russian entities, particularly some financial transactions and transactions related to the energy and defense industries. The current SSI list is available at https://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/ssi_list.aspx.

Who Is Subject to the Jurisdiction of OFAC Regulations

OFAC primarily regulates the activities of U.S. persons. The following individuals and entities are subject to OFAC regulations as U.S. persons:

- U.S. citizens and permanent residents, regardless of location
- U.S. companies (including their foreign branches), as well as U.S. non-profits and government agencies –and–
- All persons and entities physically located within the United States

Under certain circumstances, OFAC regulations may apply to other entities, such as foreign subsidiaries controlled by U.S. companies or foreign persons possessing goods originating in the United States. Check the relevant section of the OFAC website for the specific terms of any sanctions program. <https://www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx>.

Prohibited Transactions

OFAC prohibits transactions between U.S. persons (as defined above) and sanctioned countries or entities and individuals. Prohibited transactions include, for example, providing financing or another service to an SDN or exporting to or importing goods from a sanctioned country or region. Keep in mind that each sanctions program is unique in scope and includes its own guidance regarding prohibited activities.

OFAC regulations may be implicated in the context of raising capital in the United States; for example, an issuer may be a sanctioned entity or may use the offering's proceeds to finance a sanctioned entity or business in a sanctioned country. These would both be considered prohibited transactions pursuant to OFAC regulations. Additionally, even if a securities offering does not directly give rise to a prohibited transaction, an issuer's activities outside of OFAC's jurisdiction may be related to sanctioned countries or listed entities and individuals and may be considered material to investors. Thus, conducting diligence in this area is important.

Some activities are exempt from the OFAC prohibitions—for example, many programs exempt the exchange of published materials, certain personal communications such as mail, or travel to and from a country. OFAC issues both general and specific licenses that permit what would otherwise be prohibited transactions. OFAC publishes general licenses for specified sanctions programs that permit certain types of transactions, such as publishing or Internet-related communications, depending on the program. In addition, individuals and entities may apply for specific licenses to conduct transactions with sanctioned entities. For more information regarding OFAC licenses, see https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_general.aspx#licenses.

U.S. persons may face significant penalties for violations of OFAC's sanctions programs. The U.S. Department of Justice prosecutes criminal cases for willful violations of these regulations, and OFAC prosecutes the administrative cases, including strict-liability violations. Criminal penalties can range from substantial monetary fines to imprisonment for individuals. OFAC imposes civil penalties, and these penalties typically include substantial fines and vary depending on the sanctions program in question. Penalties are determined on a case-by-case basis and certain mitigating factors may help lower the potential penalties. The mitigating factors include the quality and comprehensiveness of compliance programs or due diligence conducted, as well as whether the violation was voluntarily disclosed.

OFAC Due Diligence in Securities Offerings

Attorneys working on any securities offering should conduct due diligence to ensure the transaction complies with OFAC regulations. In addition, attorneys should include any material disclosure related to OFAC compliance in the registration statement or offering memorandum and consider filing any appropriate voluntary self-disclosure with OFAC. An entity will only get the mitigation for filing

a voluntary self-disclosure with OFAC if it notifies OFAC of the potential violations prior to a public release of the potential violations or OFAC learning about the potential violations from another source.

The level of due diligence conducted with respect to OFAC sanctions will vary depending on the offering. Overall, attorneys conducting due diligence for a securities offering should take a risk-based approach, focusing in particular on issuers operating in certain geographic regions and/or doing business in certain locations and industries. Depending on the circumstances, more or less comprehensive due diligence may be necessary to ensure that the offering is not itself a prohibited transaction or that the proceeds from the offering are not utilized, either directly or indirectly, to conduct a prohibited transaction. OFAC due diligence is particularly important with respect to foreign issuers and companies that operate in a wide range of jurisdictions. Furthermore, issuers that are not subject to OFAC jurisdiction prior to the transaction may become so afterwards or there may be differences between what activities an issuer can conduct and what activities can have funded.

For example, an issuer that carries out significant oil exploration may have customers in regions subject to OFAC sanctions programs or conduct other transactions with entities in those jurisdictions or targeted industry. An attorney conducting due diligence for the offering of such an issuer should try to ensure, in particular, that the proceeds are not being used to conduct any prohibited transactions with sanctioned entities or activities. Similarly, entities engaged in the import/export business are more likely to come into contact with sanctioned entities and should be subject to additional scrutiny. Other industries that are subject to particular scrutiny by OFAC include the insurance and finance industries. OFAC provides specific guidance for industry groups: <https://www.treasury.gov/resource-center/sanctions/Pages/regulations.aspx>.

Business diligence conversations and other discussions with the issuer should focus on the following topics:

- Past or present OFAC sanctions against the issuer
- Anticipated use of proceeds
- Prior or anticipated transactions (or other business) with a sanctioned country, region, or SDN –and–
- Internal procedures, if any, with respect to OFAC compliance

Keep in mind that these questions and inquiries should apply not just to the issuer, but also to any subsidiaries, directors, officers, agents, employees, or affiliates. For example, below is a standard diligence question confirming that the issuer and other relevant parties are not subject to OFAC sanctions:

Is the issuer, any of its subsidiaries or, to the knowledge of the issuer, any director, officer, agent, employee or affiliate of the issuer or any of its subsidiaries currently subject to any U.S. sanctions administered by the Office of Foreign Assets Control of the U.S. Department of the Treasury (OFAC)?

To determine if a person is subject to OFAC sanctions, the name can be screened using the U.S. Government’s free online screening tool at <https://www.export.gov/csl-search>. To avoid prohibited transactions, attorneys should also focus on the use of proceeds and request confirmation that the proceeds from an offering will not be used, either directly or indirectly, in a transaction with a sanctioned entity.

Describe the expected use of proceeds from this offering. Please confirm that the proceeds of this offering will not be used, directly or indirectly, to finance a loan to, investment in, or other transaction with an entity sanctioned by OFAC.

When compiling a documentary due diligence request list, include specific requests related to OFAC compliance. Attorneys should consider requesting some or all of the following items, depending on the risk profile of the issuer:

- Any correspondence between the issuer and OFAC
- Any documents related to internal OFAC compliance –and–
- Customer and vendor lists

Keep in mind that any due diligence requests should be tailored to the issuer in question. For more information regarding the due diligence process in general, see *Managing the Due Diligence Process for an IPO*.

Additional Diligence for High-Risk Transactions

Depending on the context, attorneys may need to dig deeper into how the issuer conducts business.

Ascertaining whether the issuer or an affiliate conducts business with a sanctioned entity is an important part of the diligence process. Attorneys should consider including the following types of questions in both the business and documentary due diligence for higher risk securities offerings:

Has the issuer, any of its subsidiaries, or any director, officer, agent, employee or affiliate sold, transferred, or exported, directly or indirectly, products, technology, or services to or otherwise conducted any business with any individuals or entities identified on applicable sanctioned or denied party lists, such as the U.S. Specially Designated Nationals (SDN) list?

If the answer is yes, counsel should conduct further inquiries about the nature of the business, any specific or general licenses or exemptions, the export or import of goods to or from those parties, and any other relevant information, such as the revenues associated with that business. This information may help the underwriters avoid any prohibited transactions, ensure effective screening procedures are in place, and may also be included in the disclosure if material.

In particular, additional inquiries will likely be warranted for issuers with a variety of international customers and/or vendors. Below are sample questions regarding sales to and purchases from sanctioned entities:

Has the Company sold, transferred, or exported, directly or indirectly, any products, technology, or services or conducted any other activities with, the governments, entities or individuals in countries or regions subject to sanctions (Sanctioned Countries), including, without limitation, Cuba, Iran, North Korea, Sudan and Syria and the Crimea Region of the Ukraine. Please include in your response descriptions of any direct and indirect (such as through distributors and agents) sales, purchases and/or activities, including those of affiliates and subsidiaries whether it had employees or operations in or from the Sanctioned Countries?

Please describe any policies or procedures in place to ensure to prevent any unauthorized transactions with individuals and entities in these countries.

If the issuer is a large international bank or financial entity, attorneys should conduct similar inquiries into whether loans or other forms of financing have been provided to any sanctioned entities.

SSI Directives and Due Diligence

For certain types of securities offerings, particularly those for Russian and Eastern European issuers, it may be necessary to conduct extra diligence to comply with current SSI directives, which target specified Russian entities, individuals, and industries. There are currently four directives in place with restrictions on raising capital in those industries. Because the SSI program changes frequently, check with OFAC for the most up-to-date regulations at <https://www.treasury.gov/resource-center/sanctions/Programs/Pages/ukraine.aspx>.

Additional Disclosure Obligations

In general, business dealings with sanctioned entities, individuals, and countries are considered material by the Securities and Exchange Commission (SEC) and by investors. There are also annual and quarterly disclosure requirements for companies filing with the SEC under Section 13(r) (15 U.S.C. § 78m) of the Securities Exchange Act of 1934, as amended (the Exchange Act) which cover certain transactions with Iran and/or the Iranian government. For more details, see A Guide to SEC Disclosure Obligations under the Iran Threat Reduction and Syria Human Rights Act of 2012. These activities would likely be considered material in the context of a securities offering as well.

OFAC Representations in the Underwriting Agreement

Underwriters often require issuers to include a representation affirming their compliance with OFAC regulations in the underwriting agreement. This is part of the due diligence process as well, particularly since the issuer will bring down its representations in an officer's certificate at closing.

A standard representation reads as follows, mirroring the key components of the due diligence process and confirming both that the issuer is not currently subject to OFAC sanctions and also that the proceeds from the offering will not be used to finance any transactions prohibited by OFAC:

Neither the company nor any subsidiary nor, to the knowledge of the company, any director, officer, agent, employee or affiliate of the company or any subsidiary, is currently subject to any sanctions administered by the Office of Foreign Assets Control of the U.S. Treasury Department (OFAC); and the company will not directly or indirectly use the proceeds of the offering of the securities contemplated by this agreement, or lend, contribute or otherwise make available such proceeds to any subsidiary, joint venture partner or other person or entity, for the purpose of financing the activities of any person currently subject to any sanctions administered by OFAC.

For more information regarding drafting representations in an underwriting agreement, see Understanding the Key Agreements in an IPO .

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