December 11, 2014

Adam J. Szubin, Esq.
Director
Office of Foreign Assets Control
U.S. Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220

Re: Ukraine-Related Sectoral Sanctions

Dear Mr. Szubin:

The Clearing House Association L.L.C., the American Bankers Association, the Institute of International Bankers, and the Securities Industry and Financial Markets Association (together, the "**Associations**")[1] write regarding the Ukraine-related sectoral sanctions[2] (the "**Sectoral Sanctions**"). We recognize and support the important foreign policy objectives of the Sectoral Sanctions. We also greatly appreciate the efforts of the Office of Foreign Assets Control ("**OFAC**") to engage with the industry both formally and informally over the last several months as the government and the private sector both work through the implementation of this new and complex sanctions program.

As public-private cooperation is critical to the success of the Sectoral Sanctions, we are sending this letter to highlight the core compliance challenges that the sanctions present to the industry. We also offer our suggestions addressing these challenges so that financial institutions can more effectively comply with the Sectoral Sanctions. In particular, to balance the policy goals of the Sectoral Sanctions with the need for effective and practical compliance programs, we respectfully request that OFAC:

- Recognize through published FAQ or other guidance that
    - Controls at the initiation of a debt or equity transaction and due diligence on direct customers are the most effective means of complying with the Sectoral Sanctions and thus should be the primary focus of financial institutions' compliance efforts;
    - Consistent with a risk-based approach to OFAC compliance, financial institutions may evaluate the effectiveness of payment screening in identifying transactions

[1] Please see Appendix 1 for a description of the trade associations.
[2] Office of Foreign Assets Control Directives 1 through 4 and the Sectoral Sanctions Identifications List (first issued on July 16, 2014), pursuant to Executive Order No. 13662.

prohibited by the Sectoral Sanctions and determine to what extent such screening should be used in their compliance programs; and

- Financial institutions are only expected to apply the Sectoral Sanctions to a subsidiary of a person listed on the Sectoral Sanctions Identifications List when there is a reason to know that the entity is a majority-owned subsidiary of a listed person, such as when the subsidiary (i) is a customer of the financial institution that has been identified as a majority-owned subsidiary as part of the financial institution's due diligence procedures, or (ii) is listed as a subsidiary on an OFAC list; and

- Extend the application of FAQ #116[3] to entities identified under the Sectoral Sanctions.

I. The Sectoral Sanctions are Unprecedented and Present Unique Compliance Challenges

The Sectoral Sanctions present unique compliance challenges for the industry, which stem from the size of the Russian economy and the tailored—yet complex to implement—nature of the sectoral prohibitions.

A. The Russian Economy and Sectoral Sanctions Identifications

Not since World War II has the international community seen sanctions against a country as economically significant as Russia.[4] As you know, Russia is the world's eighth largest economy, third largest oil producer and second largest producer of natural gas, in addition to being the largest country by territory. The Sectoral Sanctions have targeted the key pillars of this enormous economy by imposing restrictions on the debt and equity activities of some of Russia's largest financial institutions, energy companies and defense companies (the "sectoral sanctions identifications" or the "**SSIs**").[5] OFAC has also applied the "50% Rule" to SSIs, which means that entities that are majority-owned by one or more SSIs are also subject to the Sectoral Sanctions prohibitions.[6]

The SSIs are themselves large, multinational organizations that are prominent participants in global markets. Moreover, the SSIs have extensive ownership interests in other entities that are located in many jurisdictions. To date financial institutions have identified more than 2,000 entities in more than 40 jurisdictions that appear to fall under the 50% Rule. *This number is roughly 1/3 the size of the entire Specially Designated Nationals list.*

[3] FAQ #116 was issued by OFAC in 2009 in response to industry concerns regarding application of OFAC's 2008 Guidance on Entities Owned by Persons Whose Property and Interests in Property Are Blocked (the original "50% Rule") to financial institutions that act as intermediaries in financial transactions. *See* Letter from The Clearing House to Adam Szubin, Esq., Director, Office of Foreign Assets Control (July 2, 2008). The FAQ provides that when a U.S. bank (i) is operating solely as an intermediary; (ii) does not have a direct relationship with a majority-owned subsidiary of a blocked person; and (iii) does not know or have a reason to know the entity's ownership or other information demonstrating the blocked status of the entity's property, OFAC would not expect the bank to research the non-account parties listed in a wire transfer that do not appear on the Specially Designated Nationals list. Available at http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/answer.aspx#116.

[4] Sanctions programs since World War II include countries such as Cuba, Iraq, Iran, and Burma with much smaller economies and less integration with global trade and commerce.

[5] The complete list of SSIs is available at http://www.treasury.gov/ofac/downloads/ssi/ssi.pdf.

[6] FAQ #373; Revised Guidance on Entities Owned by Persons Whose Property and Interests in Property Are Blocked (the current "50% Rule"), issued August 13, 2014 and available at http://www.treasury.gov/resource-center/sanctions/Documents/licensing_guidance.pdf.

B. Tailored Nature of the Sanctions

The Sectoral Sanctions' focus on specific types of prospective debt and equity transactions introduces a new level of complexity to financial institutions' compliance efforts. First, identifying new debt or equity issuances of the SSIs and their subsidiaries across multiple jurisdictions and markets, and then further distinguishing these issuances from pre-existing issuances in a real-time trading environment, presents extraordinary challenges. Second, as further explained below, the industry has found that the tailored nature of the prohibitions does not translate easily into the payment screening programs financial institutions have traditionally used in their sanctions compliance programs.

II. The Sectoral Sanctions Require Different Methods of Compliance than Prior Sanctions Programs

Financial institutions have undertaken a number of measures to implement the Sectoral Sanctions and prevent SSIs from accessing prohibited equity or medium-term and long-term debt. Based on their experience with these measures, financial institutions believe that in order to practically and effectively carry out the Sectoral Sanctions, different methods of compliance are more appropriate than those that have been historically used for prior sanctions programs.

A. Controls at the Initiation of a Transaction and Due Diligence on Direct Customers Are the Most Effective Ways to Implement the Sectoral Sanctions.

To identify prohibited debt and equity transactions at their source within the financial system, financial institutions have implemented various measures. For example, financial institutions have provided detailed guidance and training to front-line relationship managers in their relevant business lines to ensure that these personnel understand the requirements of the sanctions and are able to identify potentially prohibited transactions. In parallel, specialized due diligence processes and escalation protocols have been developed to ensure that new transactions and deals involving SSIs are subject to appropriate review by compliance and risk personnel. These personnel subject potential SSI equity and debt transactions to a range of checks including, but not limited to, identifying whether the new equity or debt would be prohibited under the sanctions program, whether credit extensions fall within permissible ranges and whether other services provided would be in support of prohibited new debt or equity.

We believe that measures taken to prevent prohibited transactions at the initiation of debt and equity transactions as well as due diligence by financial institutions on their own customers to determine whether the customers are SSIs or majority-owned subsidiaries of SSIs are the most effective ways for financial institutions to implement the Sectoral Sanctions. By extension, we further believe that these controls are the most effective way to advance the stated policy goals of denying identified participants in Russia's financial, energy, and defense sectors access to U.S. capital markets. Hence, we ask that OFAC recognize through FAQ or other guidance that controls at the initiation of debt and equity transactions and due diligence on financial institutions' own customers should be the primary focus of financial institutions' compliance with the Sectoral Sanctions.

B. Transaction Screening by Financial Institutions Should Be Applied in a Manner Commensurate with Its Effectiveness.

Financial institutions acting as intermediaries have also implemented traditional screening controls for cross-border, clearing payments in an attempt to identify transactions related to prohibited debt or equity.[7] However, despite extensive efforts, individual financial institutions have identified very few transactions that would be prohibited under the Sectoral Sanctions. In addition, financial institutions have discovered that traditional screening cannot be meaningfully applied to payments under the Sectoral Sanctions as, unlike previous sanctions programs that apply to ***all*** activities of designated persons, the Sectoral Sanctions apply to ***certain*** activities.

Determining whether a payment relates to certain activities is very difficult for intermediary financial institutions as they are not involved in the underlying commercial activity giving rise to a payment. Thus, typically intermediaries have no direct knowledge of a payment's purpose. The information contained in payment messages also generally does not enable financial institutions to determine whether a payment is related to an activity prohibited by the Sectoral Sanctions, as it is not common business practice to specify whether transactions relate to underlying debt or equity dealings within the confines of a SWIFT message or other payment order. Hence, when a payment is identified as involving an SSI, intermediary financial institutions must often attempt to gather information about the underlying purpose of the payment from other financial institutions involved in the funds transfer.

Furthermore, the addition of the SSIs, which are prominent actors in global markets, to screening mechanisms has caused a surge in false positives. These false positives require time-consuming manual review and the involvement of senior compliance and business personnel for disposition. While the total number of false positives is unknown, based on responses from five large financial institutions to an informal survey by The Clearing House, there have been more than one million Sectoral Sanctions "hits" since July. Of these more than one million hits, approximately 300,000 required manual or senior-level review. Based on this information, we believe that the impact industry wide is far greater. Further, as stated above, despite these labor-intensive efforts, individual financial institutions have identified very few transactions.

We observe that the Sectoral Sanctions are intended to be tailored such that they only impact specific activities for certain sectors of the Russian economy. Yet the difficulty that financial institutions experience in trying to disposition the many thousands of payments that are caught in screening systems each day inevitably causes delays and sometimes rejections of transactions that fall outside the targeted activities. Additionally, the enormous numbers of false positives put added stress on compliance resources, making it more likely that mistakes, such as missing true positives under other sanctions regimes, may be made. In practice, therefore, payment screening when applied to the Sectoral Sanctions results in an overly inclusive, rather than tailored, impact and tends to detract from, rather than enhance, OFAC compliance.

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[7] Some financial institutions have developed multi-factor screening mechanisms that include (i) keywords, developed in coordination with industry peers, which may indicate potential debt/equity dealings ***and*** (ii) references to SSIs. Other financial institutions, due to the technical capabilities of their screening systems, cannot implement multi-factor screening and instead review all transactions involving SSIs.

In its *Risk Matrices*, OFAC has counseled financial institutions to employ a risk-based approach when considering the likelihood of encountering sanctions-related issues.[8] Financial institutions have found transaction screening in the context of the Sectoral Sanctions to be inconsistent with a risk-based approach as it demands an extraordinary amount of resources yet yields negligible positive results. We also believe that transaction screening works against the intended tailored impact of the Sectoral Sanctions. Accordingly, we request that OFAC recognize through FAQ or other guidance that, consistent with a risk-based approach to compliance, financial institutions should evaluate transaction screening, based on its effectiveness in identifying prohibited Sectoral Sanctions transactions, and apply it in their programs in a manner commensurate with its effectiveness.

C. The 50% Rule Should Apply on a "Reason to Know" Basis.

Due to the unprecedented nature of the Sectoral Sanctions and uncertainty regarding OFAC's compliance expectations, during the initial stage of implementation of the Sectoral Sanctions and in an abundance of caution due to the lack of clarity, financial institutions extended screening controls beyond SSIs to include entities identified as *possibly* majority-owned by SSIs. As neither OFAC nor financial institution vendors could provide lists of these majority-owned subsidiaries at the time that the Sectoral Sanctions were issued, many financial institutions implemented open source, intelligence programs to identify (or attempt to identify) entities majority-owned by SSIs. The research has consumed significant financial institution resources. Moreover, the addition of the thousands of SSI subsidiaries to screening filters has further exacerbated the large number of false positives that financial institutions must review and resolve every day.

Although financial institutions have identified many entities that are (or appear to be) majority-owned by SSIs, they cannot be confident, despite several months of effort, that they have identified all SSI subsidiaries. We believe that it is ineffective and impractical to expect financial institutions to comply with the 50% Rule for all possible transactions. Instead, we suggest that OFAC clarify by FAQ or other guidance that financial institutions are only expected to apply the Sectoral Sanctions to an SSI subsidiary when there is a reason to know that the entity is a majority-owned subsidiary of the SSI. Further, to avoid any misunderstanding, we think the terms *know* and *reason to know* should be defined as they are in the Uniform Commercial Code, where *know* or *knowledge* refers to actual knowledge. An organization would have knowledge of a fact when it comes to the attention of an individual conducting a transaction or when it would have come to his or her attention if the organization had exercised due diligence.[9] Examples of instances in which a financial institution would have a reason to know that an entity is majority-owned by an SSI would be if a majority-owned subsidiary is a direct customer of the financial institution or is listed as such on a published OFAC list.

D. FAQ #116 Should Apply to SSIs.

Lastly, we note that while OFAC has clearly exempted intermediary financial institutions in wire transfers from having to proactively identify non-customer majority-owned entities of Specially

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[8] Risk Matrices (for financial institutions as of June 2005). Available at http://www.treasury.gov/resource-center/sanctions/Documents/matrix.pdf. *See also* Risk Matrix (for the Securities Sector as of November 2008) (encouraging the securities industry to develop proactive, risk-based compliance programs), available at http://www.treasury.gov/resource-center/sanctions/Documents/securities_risk_11052008.pdf.

[9] U.C.C. § 1-202(b), (f). "An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines."

Designated Nationals under FAQ #116, this determination has, to date, not been extended to the subsidiaries of SSIs. To the extent that financial institutions determine, based on their risk-based analyses, to perform transaction screening, we ask that FAQ #116 be extended to SSIs as we see no functional or policy difference between majority-owned subsidiaries of Specially Designated Nationals and majority-owned subsidiaries of SSIs for purposes of the scenario described in FAQ #116.

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The Sectoral Sanctions are unprecedented and as complex as the geopolitical dynamics they address. It is therefore not surprising that compliance implementation is complex and necessarily something of a "work in progress." We would welcome the opportunity to meet with you and your team at your convenience to discuss the suggestions we have made in this letter. Thank you again for your consideration.

Sincerely,

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Appendix 1
Description of Trade Associations

The Clearing House

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively hold more than half of all U.S. deposits and which employ over one million people in the United States and more than two million people worldwide. The Clearing House Association L.L.C. is a nonpartisan advocacy organization that represents the interests of its owner banks by promoting and developing policies to support a safe, sound and competitive banking system that serves customers and communities. Its affiliate, The Clearing House Payments Company L.L.C., which is regulated as a systemically important financial market utility, owns and operates payments technology infrastructure that provides safe and efficient payment, clearing and settlement services to financial institutions, and leads innovation and thought leadership activities for the next generation of payments. It clears almost $2 trillion each day, representing nearly half of all automated clearing-house, funds transfer and check-image payments made in the United States. *See* The Clearing House's web page at www.theclearinghouse.org.

The American Bankers Association

The American Bankers Association is the voice of the nation's $15 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $11 trillion in deposits and extend more than $8 trillion in loans.

The Institute of International Bankers

The Institute of International Bankers (IIB) is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from over 35 countries around the world doing business in the United States. The IIB's mission is to help resolve the many special legislative, regulatory, tax and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. Through its advocacy efforts the IIB seeks results that are consistent with the U.S. policy of national treatment and appropriately limit the extraterritorial application of U.S. laws to the global operations of its member institutions. Further information is available at www.iib.org.

The Securities Industry and Financial Markets Association

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.