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Recent U.S. Government Actions Reaffirm the Importance (and Difficulty) of "Knowing Your Customer"

Soo-Mi Rhee, Baruch Weiss, Nicholas L. Townsend, Tal R. Machnes, Tom McSorley, and Junghyun Baek*

In a time of record-high fines against companies that, even inadvertently, deal with prohibited parties in a commercial transaction, the message is clear: notwithstanding the difficulties associated with robust compliance procedures, the U.S. government expects companies to screen, identify, and refuse to deal with prohibited parties, or else risk large civil, or even criminal, fines. The authors of this article discuss recent enforcement actions that underscore the importance of knowing your customers and suppliers.

On November 25, 2019, the United States issued an enforcement action against a private company for, in part, failing to identify a prohibited counterparty in a commercial transaction; *and* at the same time acknowledged—in a government accountability report—the difficulties that government agencies themselves are facing in precisely the same area. In a time of record-high fines against companies that, even inadvertently, deal with prohibited parties, the message is clear: notwithstanding the difficulties associated with robust compliance procedures, the U.S. government expects companies to screen, identify, and refuse to deal with prohibited parties, or else risk large civil, or even criminal, fines.

The first of these two actions was announced by the U.S. Department of Treasury, Office of Foreign Assets Control ("OFAC"). That day, OFAC issued

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an enforcement action against Apple, Inc. ("Apple") based, in part, on the company's alleged failure to properly screen a commercial counterparty that had restructured itself several times, apparently to hide its connection to an OFAC-sanctioned owner.[1] As a result, Apple apparently implicated OFAC sanctions regulations that prohibit companies from doing business with certain Specially Designated Nationals ("SDN") (in this case, designated narcotics traffickers), and entered into a settlement agreement that included a $466,912 civil penalty.

Second, and later that same day, the Government Accountability Office ("GAO") published a report recognizing that even the U.S. government is facing difficulty in understanding the sometimes opaque ownership structure of *its own* contractors.[2]

Although the U.S. government appears to recognize the difficulty of screening certain counterparties, these dual actions and high enforcement activity throughout 2019 continue to suggest that the U.S. government expects end-to-end visibility into suppliers, customers, and any other counterparties for compliance with its many regulatory regimes.

THE GAO REPORT: DIFFICULTY OF UNDERSTANDING OPAQUE OWNERSHIP STRUCTURES

On November 25, 2019, the GAO published a public version of a report titled *Defense Procurement: Ongoing DOD Fraud Risk Assessment Efforts Should Include Contractor Ownership* (the "GAO Report"). The GAO Report discusses the national security threat posed by companies that use shell companies with opaque ownership structure to disguise the beneficial owner or owners, who own, control, or benefit financially from the business.

The GAO Report discusses the challenges that the Department of Defense ("DOD") faces in identifying and verifying contractor ownership. The GAO specifically notes the lack of centralized information source or registry on company ownership information in the United States. Although some states collect information during company formation, it is generally minimal. As a

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[1] OFAC Enforcement Information for November 25, 2019, *Apple, Inc. Settles Potential Civil Liability for Apparent Violations of the Foreign Narcotics Kingpin Sanctions Regulations, 31 C.F.R. part 598* (hereinafter "OFAC Enforcement Information Against Apple"), *available at* https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20191125_apple.pdf.

[2] U.S. Government Accountability Office, Report to Congressional Committees (Nov. 2019), GAO-20-106, Defense Procurement: Ongoing DOD Fraud Risk Assessment Efforts Should Include Contractor Ownership (hereinafter "GAO Report"), *available at* https://www.gao.gov/assets/710/702890.pdf.

result, DOD contracting officers face "challenges in time-consuming efforts to verify contractor ownership."[3] The GAO Report also notes that "workload and resource constraints limit the extent to which they can verify contractor ownership."[4] Moreover, the difficulty in identifying and verifying contractor ownership may be amplified when "the contractor is actively seeking to misrepresent its ownership."[5]

Even beyond the U.S. government's *direct* contractors, the GAO Report notes that there is additional risk involved further down the supply chain, given that a *contractor's* suppliers may use prohibited suppliers even when the contractor itself is an entirely permissible counterparty. Indeed, during this past year, OFAC, too, has highlighted potential supply chain risks in the sanctions area.

Ultimately, the GAO Report recommends that the DOD assess the "risks related to contractor ownership as part of its ongoing efforts to plan and conduct a department-wide fraud risk assessment."[6] The GAO Report further recommends that the DOD "involve relevant stakeholders with knowledge of emerging risks and use this information to help inform other types of risk assessments across the department, including for national security concerns."[7]

Although the scope of the GAO Report (and its recommendations) is limited to government agencies and does not extend to private entities, it is notable that the U.S. government itself is facing the same difficulties as private companies when dealing with compliance issues.

Moreover, the GAO Report provides some indication to private companies as to what the U.S. government expects in this area. For example, the lack of centralized information source or registry on company ownership information affects not just government agencies, but also private entities.

Yet, the GAO Report illustrates that the US government expects its agencies to dig into ownership even in the absence of such centralized information. This sends a message to private companies, too, both small and large—that they must engage in "time-consuming efforts"[8] to verify the ownership structure of

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[3] *Id.* at 35.

[4] *Id.*

[5] *Id.*

[6] GAO Report, *supra* note 2, at 43.

[7] *Id.*

[8] *Id.* at 35.

their counterparties. This will undoubtedly pose challenges for small companies whose "workload and resource constraints" limit their efforts to verify counterparty ownership.[9]

However, in a year of record-high OFAC enforcement, the risk of any company implicating U.S. regulatory regimes by failing to undertake such efforts has become all-too-clear.

OFAC SETTLEMENT WITH APPLE: MORE ENFORCEMENT FOR FAILURE TO IDENTIFY AND VERIFY OWNERSHIP STRUCTURES

Despite recognizing the difficulty of identifying and verifying ownership structure in the GAO Report, the announcement of OFAC's settlement with Apple, on the same day that report was released, was a message that the U.S. government continues to expect extensive screening of counterparties whose connection to an OFAC prohibition may not be immediately obvious.

As noted above, on the same day the GAO Report was published, OFAC announced a $466,912 settlement agreement with Apple for alleged violations of the Foreign Narcotics Kingpin Sanctions Regulations ("FNKSR").[10] According to OFAC, Apple violated the FNKSR by hosting, selling, and facilitating the transfer of software applications and associated content of SIS, d.o.o. ("SIS"), a Slovenian software company that was identified—*after* Apple had already been dealing with that company for many years—as a significant foreign narcotics trafficker ("SDNTK") on OFAC's List of Specifically Designated Nationals and Blocked Persons ("SDN List"). Because of certain alleged weaknesses in Apple's screening systems, in addition to steps that SIS took to alter its corporate structure and mask its new SDN status, Apple continued to deal with the prohibited party for several years following OFAC's designation.

More specifically, prior to the designation of SIS as SDNTK, Apple had entered into an app development agreement with SIS. On February 24, 2015, OFAC designated SIS and its majority owner, Mr. Savo Stjepanovic ("Stjepanovic"), as SDNTK.[11]

However, according to the enforcement information, Apple's compliance screening process did not catch that these existing counterparties had been added to the SDN List. With respect to SIS, and although Apple *did* have an

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[9] *Id.*

[10] 31 C.F.R. Part 598.

[11] Press Release, U.S. Department of Treasury, Treasury Sanctions Network of Slovenian Steroid Trafficker Mihael Karner (Feb. 24, 2015), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl9980.aspx.

OFAC screening system in place that screened all existing developers against any new SDNs, Apple indicated that its system failed to catch the SIS designation because SIS was in Apple's customer database with upper-case letters (i.e., SIS DOO), which prevented its screening software from identifying any match to SIS with its lower-case suffix (i.e., "SIS d.o.o."), as written on the SDN List.

With respect to Stjepanovic, whose full name was stored in Apple's customer records because Stjepanovic was an "account administrator" in Apple's "App Store development account," OFAC determined that Apple failed to identify him upon the February 2015 designation because Apple's "compliance process screened individuals identified as 'developers,' but did not screen all of the individual users" against the SDN List at the time.[12] Because Apple's screening tools were not set up in a way that identified either of these new SDNs, the company continued to deal with them despite being prohibited to do so under the FNKSR.

In addition to Apple's initial screening tool issues, the enforcement action against Apple incorporated a separate component, stemming from SIS's later efforts to alter its corporate structure, thereby seeking to evade U.S. sanctions laws, and Apple's failure to identify such evasion. Specifically, according to OFAC, on two separate occasions in 2015 after OFAC's addition to SIS to the SDN List, SIS set up two new software companies, transferring the ownership of SIS's apps to those entities. These are precisely the type of opaque ownership risks that had been identified in the GAO Report discussed above.

In Apple's case, OFAC stated that one of these new companies "took over the administration of SIS's App Store account and replaced SIS's App Store banking information with his own banking information," but that those "actions were all conducted without personnel oversight or additional screening by Apple."[13]

Thus, Apple continued to process payments associated with these entities' blocked apps, including 47 payments directly to SIS, over a period of 54 months after SIS's designation; in total, collecting $1,152,868 from customers who downloaded SIS apps during that period. In reducing the potential base fine ($576,434) to the settlement amount of $466,912, OFAC cited as a mitigating factor the fact that Apple has since expanded its compliance screening to include designated payment beneficiaries and associated banks of the app developers.

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[12] OFAC Enforcement Information Against Apple, *supra* note 1, at 2.

[13] *Id.*

CONCLUSION

OFAC's enforcement action against Apple, together with the GAO Report released the same day, make clear that the U.S. government expects, even for itself, comprehensive and effective screening against restricted party lists, including of beneficial owners and related parties, to determine where a counterparty may be subject to sanctions.

Nor are these actions the first indication of the U.S. government's expectations in these areas. Other recent regulatory developments have similarly demanded careful supply chain diligence, such as the actions the government has taken to limit the use of certain Chinese-made equipment in the government contracting supply chain,[14] as well as other enforcement actions from earlier this year, focused on OFAC's expectations for companies' comprehensive screening and end-to-end visibility into their supply chain and customer base.[15]

In a time of such aggressive enforcement, companies should assess their current screening and diligence processes and consider whether additional and more powerful diligence is "due" in light of the government's continued focus on know your supply chain and know your customer requirements.

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[14] Federal Acquisition Regulation: Prohibition on Contracting for Certain Telecommunications and Video Surveillance Services or Equipment, 84 Fed. Reg. 40216 (Aug. 13, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-08-13/pdf/2019-17201.pdf.

[15] *See, e.g.*, OFAC Enforcement Information for January 31, 2019, *e.l.f. Cosmetics, Inc. Settles Potential Civil Liability for Apparent Violations of the North Korea Sanctions Regulations*, *available at* https://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20190131_elf.pdf; *see also, e.g.*, OFAC Advisory to the Maritime Petroleum Shipping Community (Mar. 25, 2019), *available at* https://www.treasury.gov/resource-center/sanctions/Programs/Documents/syria_shipping_advisory_03252019.pdf.