



WHITE PAPER

NAVIGATING THE COMPLEXITY OF
OWNERSHIP FROM THE LENS OF

SANCTION BY EXTENSION



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Introduction

In the framework of business compliance, UBO (Ultimate Beneficial Owner) refers to the individual or entity's ultimate beneficiary who owns or controls 25% or more shares or voting rights. Threshold and criteria for determining ownership and control could differ across jurisdictions. Identification of the UBO, is crucial during the due diligence process to assess the risk involved in dealing with the relevant counter-party, particularly for businesses and financial institutions engaged in international trade. Keeping up-to-date with recent regulatory developments is necessary for firms to comply with newly formulated regulations and avoid being flagged during the compliance process. Due to advanced regulatory compliance, high-risk entities have developed more sophisticated techniques to evade sanctions.

This document shall discuss in detail the pervasive concept of sanction by extension which is a very complex aspect of UBO. Due to this particular issue, many entities are getting flagged during the compliance process. It also elaborates on the basic understanding of the notion of sanction by extension and how it prevails within the entities in corporate structure, through case scenarios and a deeper view of challenges imposed due to sanction by extension in the light of OFAC 50% Rule.

“

OFAC urges caution when considering a transaction with an entity that is not a blocked person (a non-blocked entity) in which one or more blocked persons have a significant ownership interest that is less than 50 percent or which one or more blocked persons may control by means other than a majority ownership interest.

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Source: <https://ofac.treasury.gov/>

Current State of Affairs

In compliance and regulatory landscape, diverse implications of the Ultimate beneficiary of a business, have become a center of attention across the globe due to the complexity of nature. European Union's recent Anti-Money Laundering directive has put emphasis on making rules for beneficial ownership more harmonised and transparent. New rules also clarify that beneficial ownership constitutes two components, ownership and control with ownership threshold set at 25%.

According to the threshold set by the Office of Foreign Asset Control (OFAC)'s 50 Percent Rule, any entity owned or controlled by one or more blocked persons or entities making the aggregate of a total of 50% , in an entity associated with blocked entity, may be subject to sanctions by extension. Failure to abide by the OFAC rule will lead to an increased risk of being sanctioned directly or indirectly.

Such regulatory requirements render traditional and linear screening method of matching owner names against the official sanctions lists, insufficient. Effective regulatory compliance requires navigating the complex ownership structures to accurately identify the ultimate beneficial owner and then ensuring effective sanctions compliance.

Multi-layered ownership structures and complex legal arrangements that help conceal true owner, have often been often used for purposes such as money laundering, evading taxes and even evading sanctions.

“ The International Consortium of Investigative Journalists revealed 11.9 million files containing names suspected of being involved in money laundering and highlighted how offshore companies and shell companies can be misused. ”

(Source) <https://www.icij.org/investigations/pandora-papers/pandora-papers-reporting-from-across-asia/>

Case Scenario of Complex Ownership Structure Leading to Sanction by Extension

The case scenario below extensively elaborates on the overly complex structure of ownership that leads to the vagueness of knowing the ultimate beneficiary, eventually making sanctions compliance ineffective. The sanction tree in the figure below shows how an entity could be subjected to sanction by extension for holding ownership in another entity sanctioned by regulator such as OFAC.

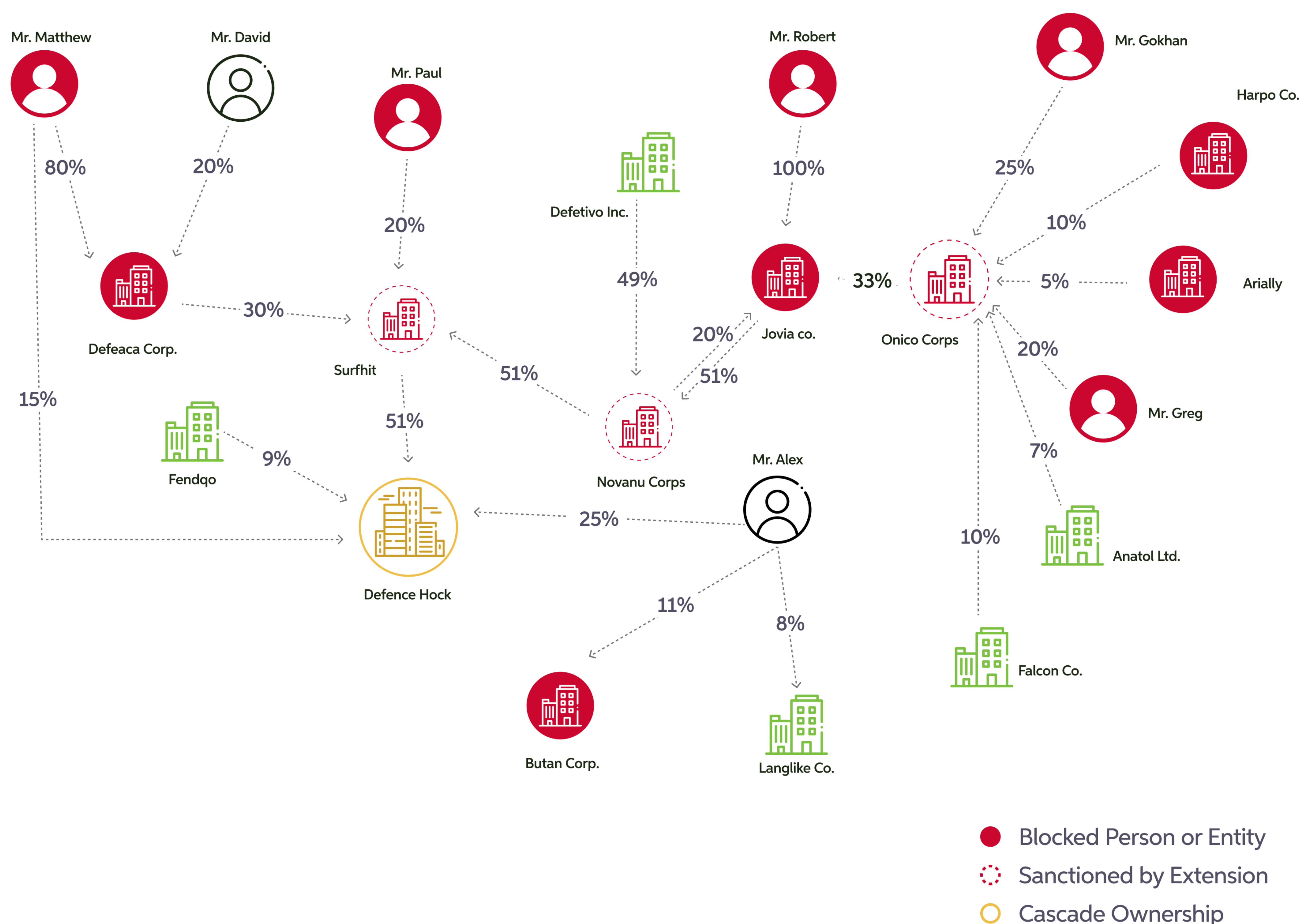
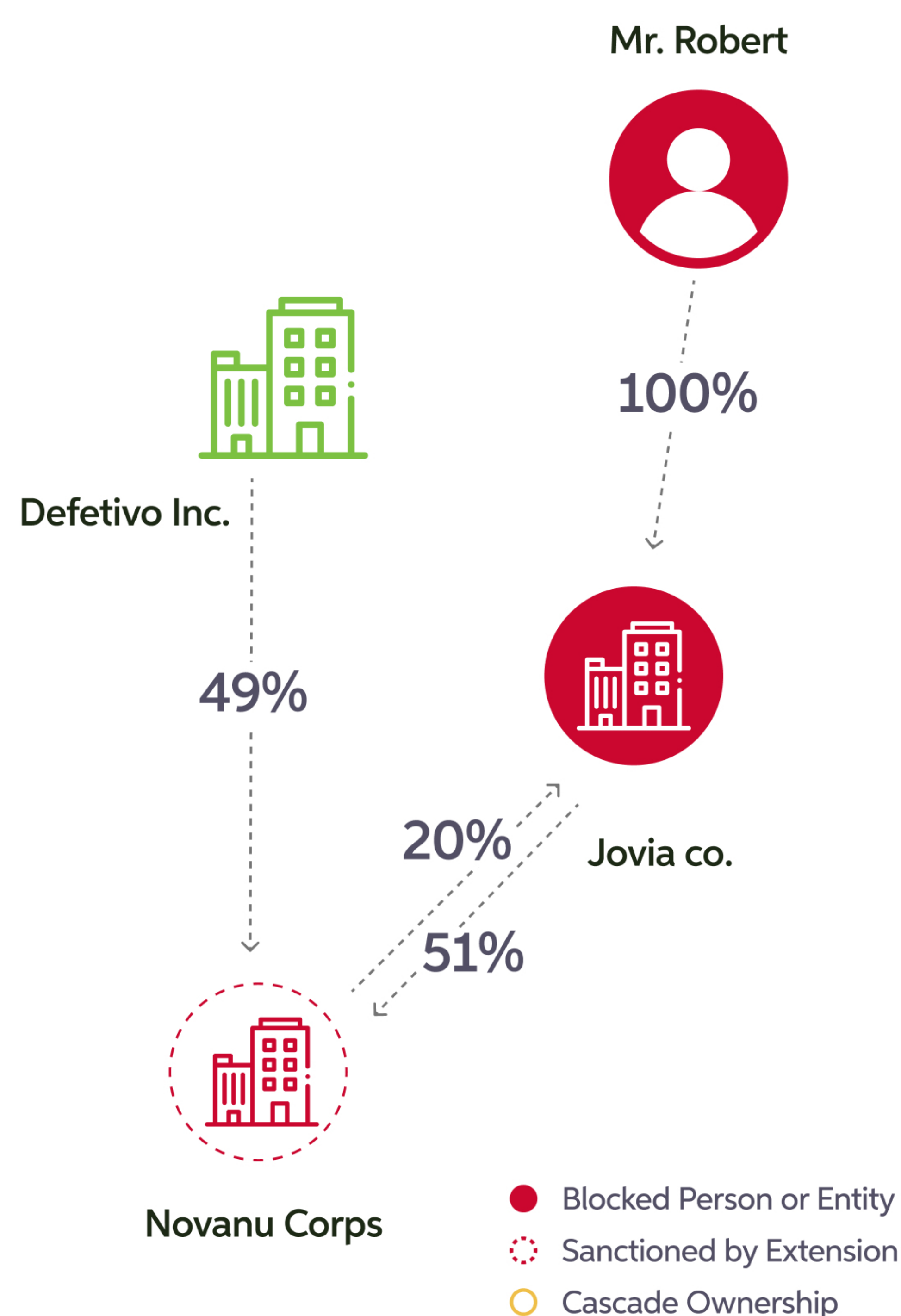


Figure: 1

01 Entity Under Sanction By Extension

According to the notion of sanction by extension, the target entity is not directly blocked but it is under sanction by extension due to the indirect partnership with the blocked entity or blocked person. Certain businesses such as financial institutions and even persons may face compliance failures, when they can't do the due diligence due to either unavailability of the data or lack of awareness about the true owners marked under the layers of complex ownership structure. Figure 1, shows the multi-level ownership of different companies from the defense industry in partnership with each other for the exchange of mechanical equipment. The companies named Surfit and Novanu Corps are embedded in the sanction by extension due to the ownership of more than the threshold set by the OFAC 50% Rule from Jovia Corp and Dafaeca Corp respectively, which are under direct sanction due to ownership from the sanctioned person. This leads to the subject of regulatory or enforcement action by OFAC in future compliance.

Figure: 2



• Addressing Circular Ownership In Sanction Enforcement

Circular or looped ownership is a form of indirect ownership used to obscure the true owner of the business. This complex hierarchy is exploited by owners to separate themselves from direct ownership, but they have control beyond legal ownership. The identification of a circular or looped ownership should be treated as a red flag in the vetting process and at the very least, an indication that further investigation is required. The entities shown in the figure 2 have vague ownership, the entity Novanu Corps. is owned directly by two entities Jovia Corp and Defetivo Inc., the rest is all circular ownership.

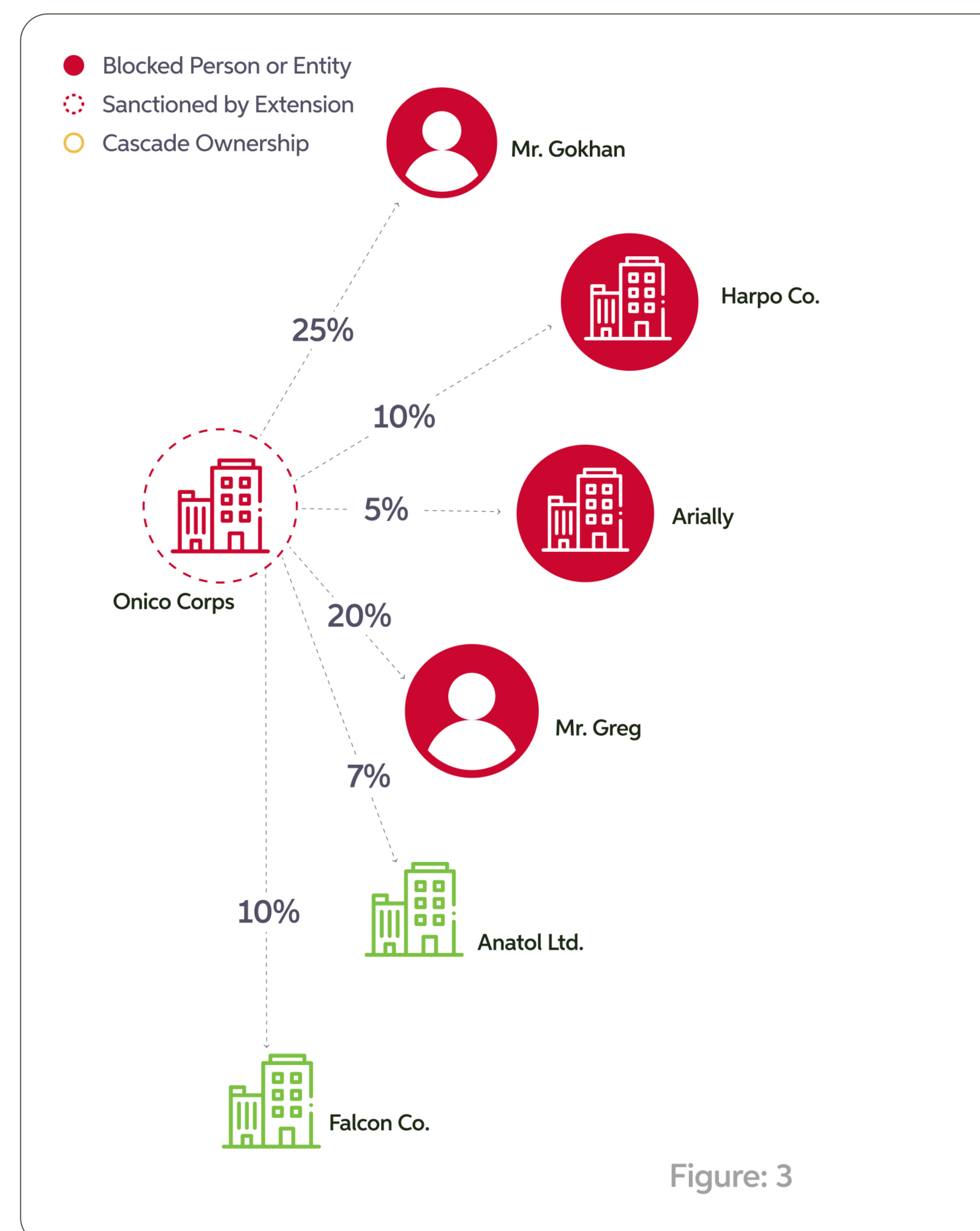
• Unraveling The Complexities Of Cascade Ownership

Cascade ownership is the use of opaque jurisdictions, and false divestment to other entities and close associates to obfuscate ownership. This creates an intricate structure that exerts

influence on multiple layers of ownership to ultimately conceal the true possession of the entity. When the beneficiary is vague due to the inclusion of multiple entities and persons in the corporate structure, it comes under cascade ownership. In Figure 1, the Defence hock is under cascade ownership. Various entities and individuals are forming the apparent connection to avoid sanctions detection by establishing complex ownership structures.

• Understanding The Challenges Of Aggregate Ownership

The concept of aggregate ownership is another crucial aspect of the sanction by extension. According to this, a person or entity having shares in multiple entities, if total aggregate surpasses the threshold set by OFAC (50%), either from multiple blocked entities that person or entity shall also be considered as blocked. In figure 3 of the ownership tree, Jovia Co. is under sanction because the aggregate of partnerships with blocked entities and persons hit the OFAC threshold which is 50%. So Jovia Co. is also subject to sanction by extension.



02 Resolving The Conundrum Of Shell Company And Shelf Company

While exploring the business information and verification process, difficult terms make it difficult to understand the whole procedure. For example terms associated with certain legal arrangements such as Shell Companies and Shelf Companies are pivotal in the business verification process, it is important to know the meaning, legal implication, and purpose of those terms i.e. shell company and shelf company. Shell Company is active in functionality while the shelf company is usually inactive but is well equipped to commence the business immediately.

Regarding the legitimacy of both subjects, shell companies are more prone to misuse or illicit activity due to which they face strict scrutiny and regulatory checks, unlike shelf companies.

	Shell Company	Shelf Company
Business Assets Ownership	✗	✓
Involvement In Illicit Activities	✓	✗
Regulatory Scrutiny	✓ (Strict)	✗ (Standard)

Table showing difference between shell company and shelf company.

03

Framework For The Course Of Action With The KYB

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Business Information

The KYB helps in business screening and quick KYB checks by helping the entities access the vital information of the businesses, ownership attributes, and also the legal status of the respective entity. The KYB gives information about 250+ countries and states, and 300M+ businesses which helps in business checks against vital risk, adverse media hits, and fraud detection. Accurate and valid business information is necessary to create trust and check credibility before business onboarding.

- **UBO Identification**

The KYB also provides the core feature of UBO verification which is a predominant element in business verification that helps in the active screening of the potential risk. The UBO identification with The KYB ascertains the accurate control structure and beneficiary details of the relevant individuals with the higher control and ultimate influence. The KYB ensures compliance with AML regulatory standards by screening credentials against sanctions and flags any entity with red.

- **Perpetual KYB**

Prior compliance while business onboarding is not enough to remain safe from the violation of sanctions regulation, but staying updated with the status of counterparty entities and individuals is required for complete compliance. To address this challenge, The KYB has developed the unique feature of Perpetual KYB. This allows the client to stay informed about the changes in business information like ownership structure by receiving alerts if any of their counterparties appear in the sanction list or regulatory watchlist. This ensures swift evasion of risks, while staying compliant with ever evolving regulations.

Conclusion:

Understanding the technical issues in UBO identification is pivotal in business verification. The process of breaking through the various ownerships mentioned in the document is complicated to interpret. The KYB is here to resolve this complicated process, revealing the correct and accurate UBO information and other aspects also with its large repository of data, all across the globe



READY TO OVERCOME AML CHALLENGES TO ACCELERATE TRUST AND SECURE BUSINESS OPERATIONS?

Contact our experts and see how they integrate AML-KYB solutions into your existing processes and secure business operations.

ABOUT THE KYB

The KYB is recognized for its in-depth financial services, RegTech expertise, and out-of-the-box rules engine, which ensures businesses are secured, advanced, and future proofed against evolving Anti Money-Laundering (AML), Know Your Business (KYB) across **250+ countries** and states in **170+ languages**. Through a user-friendly API or cloud integration, The KYB helps organizations ranging from start-ups to enterprises make informed decisions, meet compliance requirements, and mitigate risks.

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