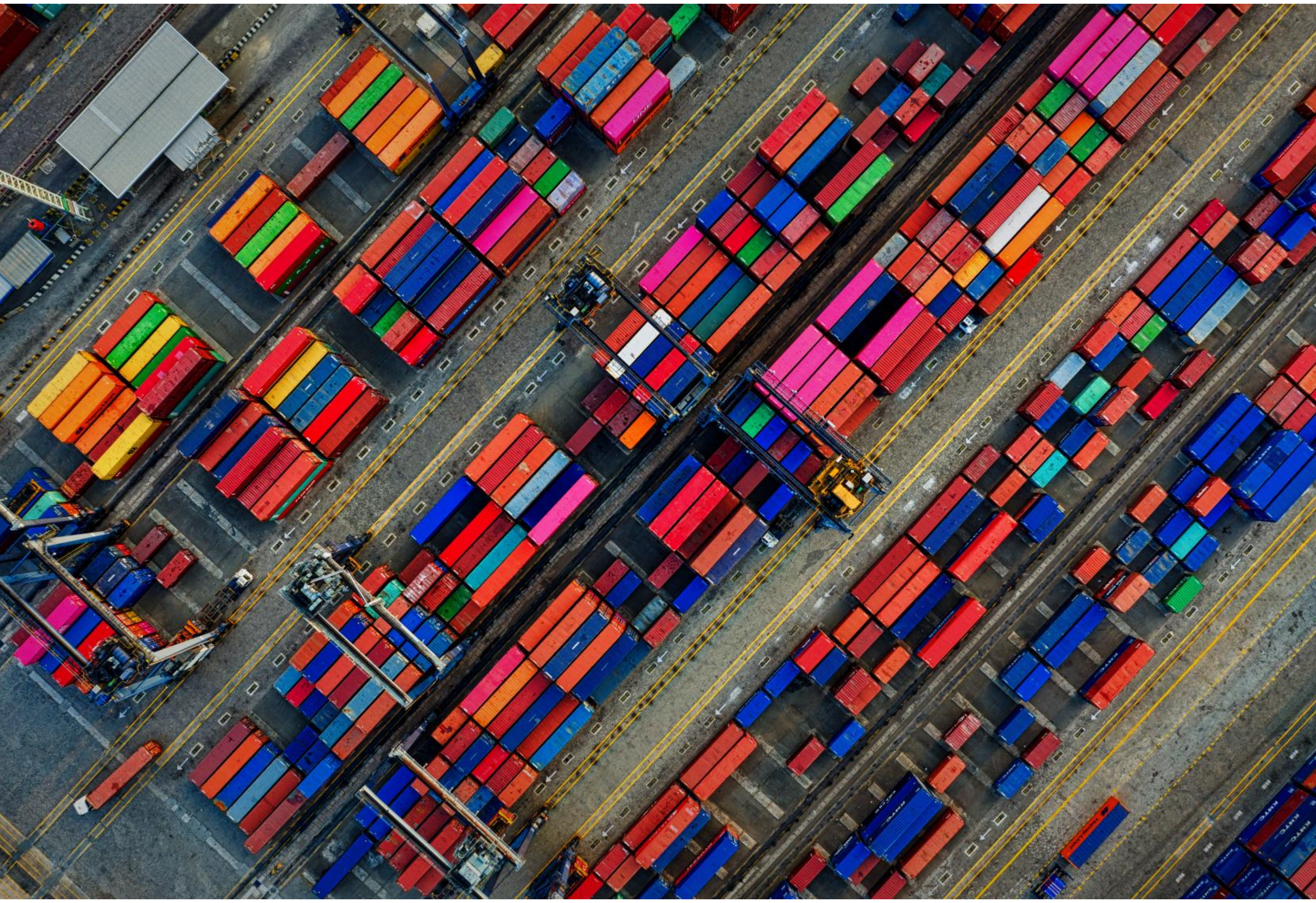
Due Diligence
Investigations
Advisory

PSA BRIEF:

SUPPLY CHAIN DUE DILIGENCE AND OFAC



Supply Chain Due Diligence and OFAC

On January 31, 2019, e.l.f. Cosmetics, Inc. ("ELF"), a US cosmetics company, agreed to a USD 996,080 settlement with the US Treasury Department's Office of Foreign Asset Control ("OFAC") for 156 apparent violations of OFAC's North Korea Sanctions Regulations ("NKSR"), which ELF voluntarily self-disclosed to OFAC. Between April 2012 and January 2017, ELF reportedly received 156 shipments of false eyelash kits from two Chinese suppliers, the total value of which was USD 4,427,019, and contained materials sourced from North Korean companies.

OFAC reported that at the time of the violations, ELF's OFAC compliance program was either inadequate or did not exist. ELF's supply chain review efforts focused on assessing quality assurance issues related to the production process, raw materials, and end-products. As a result, ELF did not discover until January 2017 that nearly 80% of the false eyelashes procured from the two Chinese suppliers were sourced from North Korea.

Penalty Explanation

The range of civil monetary penalties for ELF's apparent NKSR violations was between USD 2,213,510 and USD 40,833,633, however OFAC ultimately imposed a reduced penalty. In determining the relevant penalty, OFAC identified several aggravating factors for ELF's OFAC's compliance violations, including the company's size and sophistication (ELF's 2016 reported revenue was over USD 229 million) as well as its experience conducting overseas business in a region susceptible to NKSR violations, among other factors. However, it also pointed to several mitigating factors, including that the company appeared to have no knowledge the sourced goods violated NKSR, that the shipments did not constitute a significant portion of ELF's business, and that the company immediately disclosed the apparent violations upon discovery.

OFAC also noted that ELF had terminated the conduct that led to the NKSR violations and implemented a compliance program to mitigate similar future risks, including supply chain audits, requiring suppliers to sign compliance certificates pledging to adhere to US sanctions and export controls, conducting advanced supplier audits of financial information related to production materials and suppliers, and engaging outside counsel to conduct compliance trainings for ELF employees in the US and China.

OFAC

OFAC, an agency within the US Treasury Department, administers and enforces US imposed economic and trade sanctions which are primarily against countries and groups of individuals, including terrorists and narcotics traffickers. If an entity is found to have violated US sanctions, OFAC is able to levy large penalties, including imposing fines, freezing assets, and banning entities from operating within the US. OFAC publishes a list of entities that US citizens are prohibited from doing business with; the Specially Designated Nationals (SDN) list – which includes companies, organizations, individuals, and vessels.

For NKSR specifically, OFAC's requirements were underlined in "Risks for Businesses with Supply Chain Links to North Korea," a July 2018 advisory issued by OFAC and other federal agencies stipulating that companies are expected to mitigate all potential NKSR violations, both direct and indirect, in their supply chain due diligence.

PSA Note: *As is standard practice, OFAC did not disclose how it weighed these factors in determining the final settlement amount.*

Significance of This Case

This case is significant in that it provides insight into OFAC's current priorities. While OFAC has tended to focus its investigations on US banks and institutions, this case signals the increasing importance for companies to be OFAC-compliant, even when the violations in question constitute a small fraction of a company's overall revenues.

This case also shows the need for companies to have a thorough due diligence program, particularly for dealing with international suppliers operating in regions with high risk of OFAC violations. This means not only investigating every node in its international supply chains, but also each supplier's own affiliates and business partners, to avoid indirectly violating sanctions and export controls. In ELF's case, OFAC highlights that a more robust program might have prevented these apparent violations altogether.

Finally, the case demonstrates that supply chain due diligence needs to be comprehensive in scope. By focusing mainly on quality issues, ELF's supply chain review processes failed to identify repeated sanctions violations over the course of several years, exposing them to significant, preventable risk. ELF's experience highlights the need for companies to develop comprehensive risk profiles of their international supply chains, and to carry out recurring supply chain audits to ensure compliance.

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