

**ALERTS**

## Threatened Sectoral Sanctions Against Russia Become Reality

**July 30, 2014**

U.S. President Barack Obama laid the groundwork for sector-based sanctions on key areas of the Russian economy in Executive Order 13662, dated March 20, 2014 (E.O. 13662).[1] On July 16, 2014, the threatened sector-based sanctions became a reality with the adoption of the Sectoral Sanctions Identifications List (the “SSI List”) — a new sanctions regime — by the U.S. Treasury Department’s Office of Foreign Assets Control (OFAC).[2] That same day, OFAC also added 16 names to the Specially Designated Nationals and Blocked Persons List (the “SDN List”), [3] and the U.S. Department of Commerce’s Bureau of Industry and Security (BIS) added 11 of those same names to the Entity List.[4] On July 29, 2014, OFAC further expanded the names on both the SSI List and SDN List,[5] and BIS added a name to its Entity List and instituted a policy of denying export, re-export or foreign transfer of certain items for use in Russia’s oil sector.[6]

The European Union (EU) also added names to its existing sanctions regime, created new sector-based sanctions and established a framework for the further escalation of sanctions in the near future.

### The SSI List and Directives 1 and 2

As part of this new approach, on July 16, 2014, OFAC issued Directives 1 and 2 pursuant to E.O. 13662, prohibiting U.S. persons (wherever they are located) and persons within the United States from providing new financing to persons on the new SSI List, which currently applies to two

critical sectors of the Russian economy: (1) financial services; and (2) energy.[7]

Directive 1 targets the financial services sector of the Russian Federation economy, and the SSI List currently identifies five entities operating in this sector: (1) Gazprombank, a Russian bank that provides financial services to Russia's energy industry and other sectors of the economy; (2) Vnesheconombank, a Russian state-owned economic development bank and payment agent for the Russian government, chaired by the Russian prime minister; (3) Russian Agricultural Bank, a Russian state-owned bank which acts as a Russian government agent; (4) Bank of Moscow, a Russian state-owned financial institution and subsidiary bank of VTB Bank OAO; and (5) VTB Bank OAO, a Russian state-owned bank with shares traded on the Moscow Exchange and London Stock Exchange. Directive 1 prohibits "transacting in, providing financing for, or otherwise dealing in new debt of longer than 90 days maturity or new equity for these [SSI] persons, their property, or their interests in property." OFAC has indicated that "for" means "by, on behalf of, or for the benefit of." FAQ 370.[8]

Directive 2 targets the energy sector of the Russian Federation economy, and the SSI List currently identifies two entities operating in this sector: (1) Novatek, Russia's largest independent natural gas producer; and (2) Rosneft, Russia's largest petroleum company and third-largest gas producer. Directive 2 prohibits "transacting in, providing financing for, or otherwise dealing in new debt of longer than 90 days maturity for these [SSI] persons, their property, or their interests in property." Again, OFAC has clarified that "for" means "by, on behalf of, or for the benefit of." FAQ 370.

Directives 1 and 2 are expressly targeted at specified transactions. "All other transactions with these [SSI] persons or involving any property in which one or more of these [SSI] persons has an interest are permitted," so long as such transactions do not otherwise involve property or interests in property of a person blocked pursuant to Executive Orders 13660, 13661 or 13662 or any other OFAC sanctions programs.[9]

Directives 1 and 2 also extend to financing and services in support of prohibited transactions. The prohibitions in Directive 1 apply to "all financing in support of such new debt or new equity; and any dealing in, including provision of services in support of, such new debt or new equity." FAQ 371. The prohibitions in Directive 2 apply to "all financing in support of such new debt; and any dealing in, including provision of services in

support of, such new debt.” FAQ 371. OFAC has also specified that U.S. financial institutions may continue to maintain correspondent accounts and process U.S. dollar-clearing transactions for the persons identified in Directives 1 and 2, “so long as those activities do not involve transacting in, providing financing for, or otherwise dealing in prohibited transaction types identified by these directives.” FAQ 371.

## **SDN List Versus SSI List**

The brand-new SSI List is a departure from OFAC’s previous sanctions programs, which utilized the SDN List. With respect to SDNs, depending on the sanctions program that is involved, U.S. persons are prohibited from dealing with SDNs wherever they are located, and SDN assets are generally blocked. With respect to SSIs, only certain dealings with SSIs are prohibited. Moreover, the property and interests in property of persons identified on the SSI List are not blocked. OFAC has explained that the sectoral sanctions under E.O. 13662 require the rejecting of transactions rather than the blocking of transactions: “[T]o the extent required by Section 501.604 of the Reporting, Procedures and Penalties Regulations (31 C.F.R. part 501), U.S. persons must report to OFAC any rejected transactions within 10 business days.” FAQ 370.

Currently, there is no overlap between the SSI List and SDN List, but there could be future overlap if additional names are placed on the SSI List. According to FAQ 370, persons identified in Directives 1 and 2 will not be added to the SDN List. “[B]ut, persons sanctioned under E.O. 13662 and on the SSI List may also be persons whose property and interests in property are blocked pursuant to E.O. 13662 or pursuant to other authorities administered by OFAC [and such persons on the SSI List may also] ... appear on OFAC’s SDN list with program tags for relevant blocking authorities.” SSI List.

## **Permissible Versus Prohibited Transactions Regarding New Debt or New Equity**

Whereas Directive 1, applicable to Russia’s financial services sector, targets both “new debt” and “new equity,” Directive 2, applicable to Russia’s energy sector, targets only “new debt.” Accordingly, transacting in, providing financing for, or otherwise dealing in new equity instruments for entities operating in Russia’s energy sector is permissible under Directive 2. FAQ 371.

The adjective “new” means that Directives 1 and 2 only apply to debt or equity issued on or after July 16, 2014. *See* FAQ 372. Consequently, it is permissible to transact in, provide financing for, or otherwise deal in any debt or equity — issued prior to July 16, 2014 — by, on behalf of, or for the benefit of entities on the SSI List operating in the financial or energy sectors of the Russian economy. *See* FAQ 371.

The term “equity” includes stocks, share issuances, depositary receipts (“DRs”) or any other evidence of title or ownership. *See* FAQ 371. With respect to DRs, U.S. persons (including U.S. financial institutions) may issue and deal in DRs that are based on equity issued by an SSI entity prior to July 16, 2014 but cannot do so with respect to DRs that are based on equity issued by an SSI entity on or after July 16, 2014. *See* FAQ 391. In response to requests for clarification as to how financial institutions are expected to distinguish between transactions involving new versus old equity if entities on the SSI List issue new equity with the same identifying information as equity issued prior to the effective date of sanctions, OFAC simply reiterated that the U.S. person should “ensure that it is not transacting in, providing financing for, or otherwise dealing in, the newly issued equity.” FAQ 392.

The term “debt” includes “bonds, loans, extensions of credit, loan guarantees, letters of credit, drafts, bankers acceptances, discount notes or bills, or commercial paper.” FAQ 371. The prohibitions in Directives 1 and 2 only apply to “new debt” with a maturity of longer than 90 days (and to the rollover of existing debt if such rollover results in the creation of new debt with a maturity of 90 days). *See* FAQ 371. Consequently, it is permissible to transact in, provide financing for, or otherwise deal in debt instruments with maturities of 90 days or less issued by or on behalf of entities on the SSI List operating in the financial or energy sectors of the Russian economy, even if such debt is issued after July 16, 2014. *See* FAQ 371. OFAC has also issued detailed FAQs addressing drawdowns and disbursements from revolving credit facilities or long-term loan arrangements (*see* FAQ 394) and permissible versus prohibited letters of credit (*see* FAQ 395), stressing the importance of the July 16, 2014 effective date and the 90-day maturity threshold.

OFAC has authorized derivative transactions through the issuance of a general license — but OFAC has not yet defined “derivative” transactions. On July 16, 2014, OFAC issued General License No. 1 Authorizing Certain Transactions Related to Derivatives under Directive 1 and Directive 2 of

Executive Order 13662.[10] Specifically, General License No. 1 authorizes all transactions by U.S. persons, wherever they are located, and transactions within the United States involving derivative products whose value is linked to an underlying asset that constitutes: (1) debt with a maturity of longer than 90 days or equity issued on or after July 16, 2014 by a person identified in Directive 1; or (2) debt with a maturity of longer than 90 days issued on or after July 16, 2014 by a person identified in Directive 2. General License No. 1 makes clear that the “holding, purchasing, or selling of underlying assets” otherwise prohibited by Directives 1 and 2 is not authorized. Consistent with General License No. 1, OFAC does not consider normal counterparty credit exposure to be a prohibited extension of credit when a U.S. person enters into an otherwise permissible derivatives transaction. *See* FAQ 393.

## The ‘50 Percent Rule’ Extends to Sectoral Sanctions

The prohibitions under E.O. 13662 also extend to debt and equity issued by entities that are 50 percent or more owned by entities on the SSI List under Directives 1 and 2. *See* FAQ 373.[11] The so-called “50 Percent Rule” applies to persons named on the SSI List, their property, and their interests in property, which includes entities owned 50 percent or more by the persons identified under Directives 1 and 2 of E.O. 13662. OFAC explains the application of the 50 Percent Rule to the SSI List in FAQ 373: “As with the parent entities, the prohibition is limited to transacting in, providing financing for, or otherwise dealing in”: (1) new debt or new equity issued by, on behalf of, or for the benefit of entities owned 50 percent or more by persons identified under Directive 1; or (2) new debt issued by, on behalf of, or for the benefit of entities owned 50 percent or more by persons identified under Directive 2.

The application of the 50 Percent Rule to the SSI List will impose significant compliance obligations on companies because the names on the SSI List (e.g., Gazprombank and Rosneft) are large entities with substantial holdings in other entities. These other entities could become subject to the prohibitions of Directives 1 and 2 under the 50 Percent Rule. From a compliance standpoint, it is important to remember that entities owned 50 percent or more by entities on the SSI List will also be subject to sanctions, *even if these entities do not appear on the SSI List*.

## European Union

The EU Council has urged the Russian Federation to de-escalate the situation in the Ukraine by exerting influence over illegally armed groups and stopping the flow of weapons and militants across the border — but Russia has refused, and the EU has responded with escalated sanctions. On July 11, 2014, the EU Council issued Regulation 753/2014, adding 11 Ukrainian individuals to the EU equivalent of the SDN List.[12] On July 16, 2014, the EU Council agreed to expand the legal basis for targeting entities that are materially or financially supporting actions undermining or threatening Ukraine's sovereignty, territorial integrity and independence, including the possibility of sanctions against "Russian decision-makers" responsible for the annexation of Crimea or destabilization of Ukraine.[13]

Consistent with actions taken by the United States, on July 25, 2014, the EU Commission announced legislative proposals for sector-based sanctions with respect to "access to capital markets, defence, dual use goods, and sensitive technologies, including in the energy sector." [14] On July 29, 2014, the EU agreed on a package of significant additional restrictive measures, including: (1) expanding the list of individuals and entities subject to travel bans and asset freezes; (2) restricting Russian state-owned financial institutions from accessing EU capital markets (i.e., EU nationals and companies cannot buy or sell new bonds, equity or similar financial instruments with a maturity exceeding 90 days, issued by state-owned Russian banks, development banks, their subsidiaries and those acting on their behalf); (3) imposing an embargo on the import and export of arms and related material; (4) establishing an export ban on dual-use goods and technology for Russian military use or end-users; (5) curtailing Russia's access to sensitive energy-related technology and equipment, particularly in the oil sector; (6) severely restricting trade and investment in Crimea and Sevastopol; (7) suspending new financing operations in the Russian Federation by the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD); and (8) other diplomatic measures.[15]

## Conclusion

Since the annexation of Crimea, the United States and EU have moved gradually and cautiously in imposing sanctions against Russia and Ukraine separatists. However, the tragic loss of Malaysia Airlines Flight 17 represented a turning point for the United States and EU. This month, the United States and EU have steadily ratcheted up sanctions in a

coordinated manner. If relations between Moscow and the West continue to deteriorate, then broader sanctions may be imposed across other sectors of the Russian economy as well as against individuals and entities within those sectors.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Executive Order 13662, Blocking Property of Additional Persons Contributing to the Situation in Ukraine (March 20, 2014).

[2] See OFAC Sectoral Sanctions Identifications List (July 16, 23 and 29, 2014).

[3] See Treasury Press Release, Announcement of Treasury Sanctions on Entities Within the Financial Services and Energy Sectors of Russia, Against Arms or Related Material Entities, and those Undermining Ukraine's Sovereignty (July 16, 2014).

[4] See BIS Press Release, Commerce Department Announces Further Expansion of Export Restrictions on Russia (July 16, 2014).

[5] See Treasury Press Release, Announcement of Additional Treasury Sanctions on Russian Financial Institutions and on a Defense Technology Entity (July 29, 2014).

[6] See BIS Press Release, U.S. Commerce Department Expands Export Restrictions on Russia (July 29, 2014).

[7] See OFAC Directives 1 and 2 Pursuant to E.O. 13662 (July 16, 2014) (hereinafter Directives 1 and 2).

[8] See OFAC Frequently Asked Questions and Answers (FAQs).

[9] See Directives 1 and 2; see also SSI List.

[10] OFAC General License No. 1 (July 16, 2014).

[11] See also FAQ 116 ("On February 14, 2008, OFAC issued guidance stating that the property and interests in property of an entity are blocked if the entity is owned, directly or indirectly, 50% or more by a person whose

property and interests in property are blocked pursuant to an Executive Order or regulations administered by OFAC.”)

[12] See Council Implementing Regulation (EU) No 753/2014 (July 11, 2014) (EU Council Regulation 753/2014 of July 11, 2014 amends EU Council Regulation 269/2014, sanctions which impose travel bans and asset freezes on persons responsible for actions which undermine or threaten the territorial integrity, sovereignty and independence of Ukraine).

[13] See European Council conclusions on external relations (Ukraine and Gaza) (July 16, 2014).

[14] See European Commission adopts legislative proposals on restrictive measures (July 25, 2014).

[15] See EU Council Press Release, EU restrictive measures in view of the situation in Eastern Ukraine and the illegal annexation of Crimea.

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