

# SECURITIES LITIGATION & REGULATION

Litigation News and Analysis • Legislation • Regulation • Expert Commentary

VOLUME 20, ISSUE 12 / OCTOBER 16, 2014

## EXPERT ANALYSIS

### Sanctions Update: Sectoral Sanctions Against Russia Escalate

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The United States and European Union implemented increased Ukraine-related sanctions against the Russian Federation on Sept. 12. The U.S. Treasury Department and its Office of Foreign Assets Control imposed new sanctions and strengthened existing sanctions in Russia's financial and energy sectors. They also determined that persons operating within Russia's defense and related materiel sector may now be subject to targeted sanctions under Executive Order 13662.<sup>1</sup>

In this regard, the OFAC issued new directives and general licenses in connection with the sectoral sanctions regime and added several entities to the Sectoral Sanctions Identifications List, or SSI list, including Sberbank — Russia's largest bank.

In addition, the OFAC added five Russian defense firms to the Specially Designated Nationals and Blocked Persons List, known as the SDN list, for operating in the arms and related materiel sector in Russia under Executive Order 13661.<sup>2</sup>

The prohibitions recently imposed by the OFAC complement restrictions administered by the U.S. Commerce Department's Bureau of Industry and Security and similar measures published by the European Union.

#### RUSSIA'S FINANCIAL SERVICES SECTOR: DIRECTIVE 1

The OFAC issued Amended Directive 1 under Executive Order 13662, prohibiting the following in the financial services sector of the Russian economy:

- "(1) all transactions in, provision of financing for, and other dealings in new debt of longer than 30 days maturity or new equity of persons determined to be subject to this directive, their property, or their interests in property; and
- (2) all activities related to debt or equity issued before the date of this Directive 1 (as amended) that would have been prohibited by the prior version of this Directive 1."

Amended Directive 1 supersedes the prior version of Directive 1 issued July 16. The amended directive tightens the debt financing restrictions for the financial services sector by prohibiting any new debt with a maturity period over 30 days, when issued by financial institutions subject to such restrictions.

Pursuant to Amended Directive 1, the entities on the SSI list in the financial services sector now include six Russian banks: Bank of Moscow, Gazprombank OAO, Russian Agricultural Bank, Sberbank, VEB and VTB Bank.



*The Directive 3 listing could have a substantial impact on the Russian economy, and perhaps on foreign policy, because subsidiaries held by Rostec manufacture and export military products valued in the billions.*

## **RUSSIA'S ENERGY SECTOR: DIRECTIVES 2 AND 4, AND GENERAL LICENSE NO. 2**

The OFAC issued Amended Directive 2 under Executive Order 13662, prohibiting the following in the energy sector of the Russian economy:

- “(1) all transactions in, provision of financing for, and other dealings in new debt of longer than 90 days maturity of persons determined to be subject to this directive, their property, or their interests in property; and
- (2) all activities related to debt issued before the date of this Directive 2 (as amended) that would have been prohibited by the prior version of this Directive 2.”

Amended Directive 2 supersedes the prior version of Directive 2 issued July 16, which prohibited the same activities for debt issued on or after July 16.

Pursuant to Amended Directive 2, the entities on the SSI list currently include:

- Novatek, Russia’s largest independent natural gas producer.
- Rosneft, Russia’s largest petroleum company and third-largest gas producer.
- Gazprom Neft (majority-owned by Gazprom), an integrated Russian oil company engaged in the exploration, development, production, transportation and sale of crude oil and gas, and also involved in oil refining, marketing of petroleum products, oil field services, and construction and development of exploration wells.
- AK Transneft OAO, a Russian government-owned pipeline company that provides oil transport services via trunk pipeline systems within Russia and abroad.

The OFAC issued Directive 4 under Executive Order 13662, prohibiting certain technology, goods and services in the energy sector, with respect to so-called frontier or unconventional oil resources: “the provision, exportation, or re-exportation, directly or indirectly, of goods, services (except for financial services), or technology in support of exploration or production for deepwater, Arctic offshore, or shale projects that have the potential to produce oil in the Russian Federation, or in maritime area claimed by the Russian Federation and extending from its territory, and that involve any person determined to be subject to this directive, its property, or its interests in property.” Under General License No. 2, U.S. persons had until Sept. 26 to wind down all activities subject to the prohibitions of Directive 4.<sup>3</sup>

Pursuant to Directive 4, the entities on the SSI list currently include:

- Rosneft (see above).
- Gazprom Neft (see above).
- Gazprom OAO (one of the largest joint stock companies in Russia), a Russian government-owned global energy company engaged in gas exploration, production, transportation, storage, processing and sales.
- Lukoil OAO, a Russia-based integrated oil and gas company in the business of oil exploration, production, refining, marketing and distribution, and also the owner of refineries, gas processing, petrochemical plants and gas station networks located in Russia and abroad.
- Surgutneftegas, a Russian oil company involved in oil and gas production and exploration, gas processing, power generation, output and marketing of petroleum products, petrochemicals and gas products.

## **RUSSIA'S DEFENSE AND RELATED MATERIEL SECTOR: DIRECTIVE 3**

OFAC issued Directive 3 under Executive Order 13662, prohibiting the following with respect to the defense and related materiel sector of the Russian economy: “all transactions in, provision

of financing for, and other dealings in new debt of longer than 30 days maturity of persons determined to be subject to this directive, their property, or their interests in property.”

At this point, the SSI list only includes one entity under Directive 3: Rostec, a Russian government-owned “conglomerate” holding company for Russia’s defense industry that produces, develops, manufactures and exports civil, military and dual-purpose high-technology goods. This listing could have a substantial impact on the Russian economy, and perhaps on foreign policy, because subsidiaries held by Rostec manufacture and export military products valued in the billions.

### GENERAL LICENSE NO. 1A

General License No. 1A, dated Sept. 12, replaces and supersedes General License No. 1, dated July 16. The new license authorizes all transactions by U.S. persons, wherever located, and transactions within the United States, involving derivative products whose value is linked to an underlying asset that constitutes:

- “(1) new debt with a maturity of longer than 30 days or new equity issued by a person subject to Directive 1 under Executive Order 13662,
- (2) new debt with a maturity of longer than 90 days issued by a person subject to Directive 2 under Executive Order 13662, or
- (3) new debt with a maturity of longer than 30 days issued by a person subject to Directive 3 under Executive Order 13662.”<sup>4</sup>

General License No. 1A only allows specified derivative transactions and does not authorize the holding, purchasing or selling of underlying assets otherwise prohibited by Directives 1, 2 or 3 under Executive Order 13662.

### COMPLIANCE CONSIDERATIONS

Directives 1 through 4 are targeted in scope, explicitly permitting “[a]ll other activities with these persons or involving their property or interests in property” — as long as such activities are not prohibited by any other executive order or the OFAC sanctions program.

Although the sectoral sanctions regime only prohibits specified activities, the OFAC has made clear that the U.S. government will not tolerate inchoate offenses relating to entities on the SSI list. Accordingly, all four of the directives described above also prohibit: “(1) any transaction that evades or avoids, has the purpose of evading or avoiding, causes a violation of, or attempts to violate any of the prohibitions contained in this directive; and (2) any conspiracy formed to violate any of the prohibitions in this directive.”

For compliance purposes, it is important to remember that the OFAC’s so-called 50 percent rule applies to persons named on the SSI list, their property and their interests in property, including their 50 percent-or-more-owned subsidiaries.<sup>5</sup> The application of the 50 percent rule to the SSI list imposes significant compliance obligations on U.S. persons and companies, because the names on the SSI list (*e.g.*, Rostec) are large entities with substantial holdings in other entities.

### BUREAU OF INDUSTRY AND SECURITY EXPANDS EXPORT RESTRICTIONS

The Bureau of Industry and Security adjusted its export licensing policies toward Russia alongside the OFAC’s tightening of economic sanctions. Over the months, as the OFAC added individuals and entities to the SDN list and SSI list, the BIS added similar names to the BIS entity list. Designation on the entity list imposes a license requirement for the export, re-export or foreign transfer of items subject to export administration regulations on the designated entities, with a presumption of denial.

The BIS entity list includes entities located in Russia, Ukraine and occupied Crimea, Russian defense and technology entities, and other entities involved in activities contrary to the national security and foreign policy interests of the United States.

Regarding the defense sector, the BIS implemented a policy of denying pending applications for licenses to export or re-export any high technology items subject to export administration regulations to Russia or occupied Crimea that contribute to Russia's military capabilities. The BIS is also revoking existing licenses that meet such criteria, and evaluating all other pending applications and existing licenses on a case-by-case basis to determine their contribution to Russia's military capabilities.<sup>6</sup>

On Sept. 12 the BIS added several defense and technology entities to the entity list and announced that the bureau will require licenses for certain items destined to military end users or end users in Russia.<sup>7</sup>

In August, the BIS implemented aggressive licensing restrictions on the export, re-export or transfer of items subject to export administration regulations and intended for use in the exploration or production of deepwater, Arctic offshore or shale projects.<sup>8</sup> This is meant to stunt the production of oil and gas in Russia.

To enhance these restrictions, on Sept. 12 the BIS added five energy companies to the entity list: Gazprom, Gazpromneft, Lukoil, Rosneft and Surgutneftegas. They are the same five energy companies subject to Directive 4 of the SSI list.<sup>9</sup>

### **EU ESCALATES SANCTIONS**

The European Union has taken restrictive measures similar to the United States', including but not limited to:

- Subjecting additional persons to asset freezes and visa bans.
- Subjecting additional entities to asset freezes.
- Prohibiting EU nationals and companies from buying or selling new bonds, equity or similar financial instruments with a maturity of 30 days, issued by designated Russian state-owned banks or major Russian energy and defense companies, as well as services related to issuing such financial instruments.
- Prohibiting EU nationals and companies from providing new loans to designated Russian state-owned banks.
- Restricting the import and export of dual-use goods and technology, arms, and related military equipment.
- Restricting the export of certain energy-related equipment and technology, and prohibiting the provision of services necessary for deepwater oil exploration and production, Arctic oil exploration and production, or shale oil projects.
- Restricting imports originating from Crimea and Sevastopol and prohibiting certain investments in these non-recognized regions.
- Other diplomatic measures.<sup>10</sup>

### **CONCLUSION**

The United States and European Union have demonstrated, with this recent round of sanctions, that they are closely cooperating in dealing with the crisis in Ukraine. Unless Russia pulls its troops out of Ukraine, it is likely that the U.S. and EU will escalate sanctions further, deepening the impact of sanctions in sectors that are currently targeted and expanding into additional strategic sectors. Accordingly, U.S. and EU companies should continue to carefully monitor these increasing sanctions.

## NOTES

- <sup>1</sup> Exec. Order No. 13,662, Blocking Property of Additional Persons Contributing to the Situation in Ukraine (Mar. 20, 2014).
- <sup>2</sup> Exec. Order No. 13,661, Blocking Property of Additional Persons Contributing to the Situation in Ukraine (Mar. 16, 2014).
- <sup>3</sup> Gen. License No. 2, Authorizing Certain Activities Prohibited by Directive 4 under Exec. Order No. 13,662 Necessary to Wind Down Operations (Sept. 12, 2014).
- <sup>4</sup> Gen. License No. 1A, Authorizing Certain Transactions Related to Derivatives Prohibited by Directives 1, 2, and 3 under Exec. Order No. 13,662 (Sept. 12, 2014).
- <sup>5</sup> See U.S. Dep't of Treasury, Resource Center, OFAC FAQs, Question 373 (the prohibitions under Executive Order No. 13662 also extend to debt and equity issued by entities owned 50 percent or more by the identified entities).
- <sup>6</sup> See Press Release, Bureau of Indus. & Sec., Commerce Department Announces Expansion of Export Restrictions on Russia (Apr. 28, 2014).
- <sup>7</sup> See Press Release, Bureau of Indus. & Sec., U.S. Commerce Department Expands Export Restrictions Aimed at Russia's Defense Sector (Sept. 12, 2014).
- <sup>8</sup> Russian Oil Industry Sanctions and Addition of Person to the Entity List. 79 Fed. Reg. 45,675 (Aug. 6, 2014).
- <sup>9</sup> See Press Release, *supra* note 7.
- <sup>10</sup> See European Union External Action, Fact Sheet: EU-Ukraine Relations (Sept. 12, 2014).



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