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COMPLIANCE PROGRAMS

Unstacking and Unpacking U.S. Economic Sanctions Targeting Russia: Increasing Complexity and Uncertainty for U.S. Companies



BY MARIO MANCUSO, SANJAY MULLICK, AND JOSH THOMPSON

Kirkland & Ellis partner Mario Mancuso leads the firm's International Trade & National Security practice. Mario is a former U.S. Under Secretary of Commerce for Industry and Security and senior Defense Department official. He regularly represents clients on investigative, regulatory and transactional matters related to economic sanctions, export and import controls, anti-money laundering, and anticorruption.

Sanjay Mullick, another partner in Kirkland's Washington office, regularly represents clients on investigative, regulatory and transactional matters related to economic sanctions, export and import controls, anti-money laundering, and anticorruption.

Josh Thompson is an associate in Kirkland's International Trade and National Security practice. He regularly represents U.S. and foreign clients on sanctions and other trade and anticorruption topics across investment scenarios, including fundraising, M&A, minority investments, and exit.

U.S. companies doing business in Russia, whether via subsidiaries or third parties, have grappled with increasingly complex and strictly enforced economic sanctions targeting Russia since the Obama administration. Despite what had appeared to be a potential thaw in relations between the U.S. and Russia in the early days of the Trump administration, it is clear that since at least mid-year 2017, U.S.-Russian relations have cooled. In June 2017, Congress passed a broadly bipartisan bill (Countering America's Adversaries Through Sanctions Act ("CAATSA")) strengthening U.S. sanctions targeting Russia and in recent weeks, pursuant to CAATSA, the U.S. Department of Treasury Office of Foreign Asset Controls ("OFAC") has amended certain sanctions to become stricter and to apply additional sanctions pressure on Russia.

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During the last year, the U.S. Russia sanctions program has been significantly expanded. The Russia sanctions now involve a multi-layered set of regulations that target (i) dealings with the Crimea region; (ii) financing arrangements and debt extension for certain Russian fi-

nancial institutions, defense materiel producers, and other businesses; and (iii) the provision of goods and technology to certain oil exploration and extraction projects.

The complexity of the various Russia sanctions and the rapidly changing sanctions landscape requires U.S. companies doing business in Russia (whether directly or through third parties) to carefully think through how to ensure compliance with new U.S. sanctions regulations. As U.S. economic sanctions are a strict liability regime, even a minor “foot fault” in this area can cause major problems. Relatedly, it is important for U.S. companies to assess their compliance resources and written policies, procedures, and other protocols with regard to their Russia business to ensure that they continue to be sufficient, especially with regard to increasing need for restricted parties screening procedures and related “Know Your Customer” (“KYC”) due diligence on Russian counterparties.

Below we summarize key concepts of major U.S. Russia sanctions regulations and include an assessment of the status of U.S.-Russia relations, as well as provide practical takeaways for U.S. companies doing business in Russia.

Crimea

The clearest and most familiar sanctions targeting Russia are the continuing broad prohibitions on U.S. persons and entities having any sort of business dealings with parties located in the Crimea region of Ukraine claimed by Russia or with any projects or activities located in Crimea. The European Union also administers a strict sanctions program targeting Crimea, such that Crimea remains a “no go” region for most companies with a U.S. or EU nexus.

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As in other sanctions programs administered by OFAC, these prohibitions are construed broadly and even the tangential involvement of a U.S. citizen, wherever located, with a transaction or project related to Crimea can potentially violate U.S. sanctions. OFAC’s broad prohibition on U.S. person “facilitation” of transactions relating to Crimea, including, *e.g.*, financing, payment processing, or providing other services, further expands the prohibitions related to Crimea.

For companies approaching business in Russia solely through third party channels, much of the Crimea-related sanctions risk can be mitigated through (i) targeted diligence of all counterparties with which a business intends to transact in Russia, potentially including beneficial owners of distributors and customers; (ii) end use and end-user certifications prohibiting use of a company’s products or services in any way related to Crimea; and (iii) tailored economic sanctions and export control compliance provisions in all relevant agreements (*e.g.*, to address the significant risk of diversion of products sold in Russia to Crimea).

Companies conducting business in Russia via a wholly owned subsidiary or branch may face additional compliance hurdles, however, due to conflict of laws issues in Russia. Russian domestic law includes certain provisions that, as a general matter, prohibit Russian incorporated and/or domiciled entities from complying with the U.S. and EU sanctions targeting Crimea. Therefore, U.S. companies with subsidiaries or branches in Russia should consider working with and through their U.S. counsel to carefully assess their compliance risks and obligations under U.S. economic sanctions and to efficiently coordinate with local counsel regarding Russian laws related to Crimea.

Sectoral Sanctions

As part of the U.S. economic sanctions program targeting Russia, OFAC maintains so-called “sectoral sanctions” that aim to limit certain sectors of the Russian economy from gaining access to U.S. capital and credit, as well as certain U.S. technology related to oil exploration and extraction. These sectoral sanctions are implemented through four OFAC “Directives” pertaining to entities designated on OFAC’s Sectoral Sanctions Identifications (“SSI”) List, which add an additional layer of complexity to U.S. Russia sanctions. Instead of the more familiar blanket prohibition on dealings that traditionally applies to restricted parties such as “Specially Designated Nationals” (“SDNs”), U.S. persons and companies are permitted to transact with entities listed on the SSI List as a general matter, but subject to certain corresponding Directive-specific limitations on payment terms or end uses.

Payment Terms and Financing

OFAC Directives 1, 2, and 3 all relate to the issuing of “new debt . . . or equity” and “all transactions in, provision of financing for, and other dealings in new debt” for entities subject to these Directives. Directive 1, which is targeted at Russia’s financial sector, prohibits debt or financing arrangements of longer than (as of Nov. 28, 2017) 14 days maturity. Directive 2, which is targeted at Russia’s energy sector, prohibits similar debt or financing arrangements of longer than (as of Nov. 28, 2017) 60 days maturity. Directive 3 prohibits debt or financing arrangements of longer than 30 days maturity for certain defense and related materiel sectors of the Russian economy. Notably, these maturity periods had been longer, but recently were shortened pursuant to CAATSA, reflecting the increasing tensions between Washington and Moscow.

These Directives can have broad implications for U.S. companies doing business with SSI entities. For example, OFAC interprets “debt or financing arrangements” broadly. As a result, seemingly standard provisions in agreements (*e.g.*, penalties for late payments instead of an automatic non-negotiable breach) could, if exercised, potentially extend “debt” to an SSI entity outside of the permitted timeframe. Given that a “late” payment from an SSI could potentially trigger sanctions liability, many U.S. companies doing business with Russia are increasingly demanding payment in full prior to the delivery of any products or services and otherwise including in contracts hard date cut-offs for full payment.

U.S. companies engaging in business with SSI entities designated under the Directives should review the payment terms under agreements with SSI entities.

Such U.S. companies should also carefully consider any warranty, insurance, or similar guarantees to an SSI entity in light of the sectoral sanctions' restrictions. Those with Russian subsidiaries which use an SSI financial institution as its normal course bank such as for payment processing and payroll services should evaluate their arrangements and activities for compliance with U.S. economic sanctions. In all cases, U.S. companies doing business with Russia should closely monitor Russia sanctions developments, as it is possible OFAC may further amend these timeframes and otherwise impose additional restrictions.

Oil Exploration and Extraction

Directive 4 currently prohibits, with respect to any SSI entity designated under it:

The provision, exportation, or reexportation, 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. . . .

This prohibition applies to any activity (i) performed in the U.S. and (ii) performed by U.S. persons and entities wherever located. There are also related U.S. export controls administered by the U.S. Department of Commerce Bureau of Industry and Security ("BIS") that prohibit the export, reexport, or transfer of certain, controlled U.S.-origin products and technology for direct or indirect use in deepwater, Arctic offshore, or shale oil exploration and production. The BIS restrictions also apply (i) more broadly across the Russian economy, i.e., regardless of whether the Russian counterparty is an SSI entity, and (ii) to exploration and production activities with respect to natural gas in addition to oil.

On Oct. 31, 2017, OFAC amended Directive 4 to greatly increase its geographical scope. As of Jan. 29, 2018, its restrictions will expand from projects with the potential to produce oil in the Russian Federation and related maritime areas to projects "in any location" in the world, so long as any person or entity designated pursuant to Directive 4 has either (i) a 33 percent or greater ownership interest (i.e., equity interest whether active or passive), or (ii) ownership of a majority of the voting interests (i.e., ability to unilaterally control the project). This amendment is largely seen as a response to the increasing presence of Russian energy companies in international projects, including many in South America.

The practical implications of the expansion of the scope of Directive 4 are that for U.S. companies with SSI-listed customers, compliance is no longer only a "Russia" issue. After Jan. 28, 2018, companies will be at risk of potentially encountering "Russia" sanctions compliance problems by servicing or providing goods to projects in Brazil, Venezuela, or other countries with a large presence of Russian energy companies. The lowered ownership and control thresholds in the amended Directive 4 also create an additional imperative for KYC counterparty due diligence regarding the ownership structure of oil exploration and extraction projects throughout the world.

Additionally, even as currently in force, OFAC interprets the Directive 4 prohibitions broadly. U.S. companies who provide any sort of products or services to Di-

rective 4 SSI entities should consider carefully how their products and services may relate to such entities' oil exploration and extraction projects. Although it is clear from OFAC guidance that drilling services, geophysical services, geological services, logistical services, and mapping technologies clearly fit within the prohibitions of Directive 4, questions remain as to more tangential products and services sold to such SSI entities. Any Directive 4 compliance analysis is necessarily fact-specific and additional developments in U.S.-Russia relations could significantly alter any analysis.

Future SSI and SDN Designations in Russia

OFAC has the ability to make additional U.S. economic sanctions designations quickly and with limited to no advance public warning. Also, sanctions are a strict liability regime and generally there is no grandfathering of existing business or "wind down" period provided to cease it if a counterparty becomes newly designated as a restricted party. As tensions between the U.S. and Russia have increased, so have the number of persons and entities designated on OFAC's SSI and SDN Lists. Even if an entity itself is not designated as an SSI or SDN, OFAC's policy is that it will be treated as one, if it is majority-owned by one or more SSIs or SDNs, respectively. All this makes it important not only to monitor additions to the SSI and SDN Lists, but also to determine the beneficial owners of any Russian counterparties, as well as to generally stay aware of sanctions developments.

Key Takeaways

- U.S.-Russia relations are dynamic and currently turbulent. There is a non-trivial risk of additional or expanded U.S. Russia sanctions in the future.

- As a general matter, Russia remains a high-risk jurisdiction for U.S. economic sanctions compliance. U.S. companies doing business in Russia, whether directly or via subsidiaries or third parties, should carefully review their sanctions compliance framework, including, e.g.:

- o Maintaining sanctions compliance policies and procedures, including a restricted party screening procedure to identify whether any current or potential Russian counterparties may be SSI or SDN designated.

- o Reviewing the U.S. export control status of goods/services provided in Russia.

- o Staffing and empowering of expert compliance personnel.

- Payment terms and any financing arrangements with SSI entities should be reviewed in light of amended Directives 1 and 2.

- Companies involved in oil exploration or extraction projects, *wherever located*, should be aware of any Russian ownership of or involvement in such projects and potential SSI implications.

- As U.S. sanctions designations of Russian entities continue to grow, there is an increased risk of diversion and/or front companies. KYC and counterparty due diligence is increasingly important across most sectors of the Russian economy.