Trump Administration Sets Approach to Implementation of New Russia Sanctions

11/09/17

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

Four Times Square
New York, NY 10036
212.735.3000

1440 New York Ave., N.W.
Washington, D.C. 20005
202.371.7000

skadden.com

In recent weeks, the U.S. government has taken a number of significant steps to implement sanctions on Russia under the Countering America's Adversaries Through Sanctions Act (CAATSA), which President Donald Trump signed into law on August 2, 2017. The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) and the U.S. Department of State have issued guidance that answers a number of the implementation questions that arose from broad and often vague language in CAATSA and which we discussed in our August 4, 2017, client alert on CAATSA. As required by CAATSA, OFAC has also amended the directives issued pursuant to Executive Order 13662 to tighten the sectoral sanctions on Russia's financial and energy sectors. While the U.S. government retains broad discretion to impose sanctions under the new law, the recent guidance offers increased clarity for both U.S. and non-U.S. companies on the U.S. government's principal areas of concern and implementation priorities.

Modification of Sectoral Sanctions

Since 2014, OFAC has instituted narrowly tailored prohibitions on U.S. persons and transactions within the United States with respect to identified companies in Russia's financial (Directive 1), energy (Directives 2 and 4) and defense (Directive 3) sectors, and companies in which the identified companies hold a 50 percent or greater interest (collectively, "SSI entities"). As required by Section 223 of CAATSA, OFAC has amended Directives 1, 2 and 4 targeting Russia's financial and energy sectors. The amendments have not yet become effective. OFAC also indicated that it would not — at least for the time being — exercise its delegated authority under Section 223 to impose sanctions on Russian state-owned entities operating in the railway or metals and mining sector.

Amended Debt Restrictions Under Directives 1 and 2

Directive 1 imposes restrictions on dealings in new debt and new equity of identified entities in Russia's financial sector, while Directive 2 impose similar restrictions on new debt of identified entities in Russia's energy sector. Amended Directive 1 reduces the permitted tenor (*i.e.*, the permitted maturity) of new debt of Directive 1 SSI entities from 30 days to 14 days. Similarly, amended Directive 2 reduces the permitted tenor of new debt of Directive 2 SSI entities identified from 90 days to 60 days. The revised restrictions on dealing in new debt will apply to debt issued on or after November 28, 2017. Debt issued prior to that date will continue to be subject to earlier applicable restrictions unless the debt is modified after that date, in which case the new maturity periods may apply.

The restrictions under the two directives are otherwise the same, and they continue to only apply to activities involving U.S. persons or another U.S. nexus. OFAC guidance on what constitutes "debt" remains unchanged and continues to be interpreted broadly. Under these directives, debt includes bonds, loans, extensions of credit, loan guarantees, letters of credit, drafts, bankers acceptances, discount notes or bills, or commercial paper, and can apply to payment terms.

Directive 4 Restrictions on Nonconventional Oil Exploration Projects Go Global

Since September 2014, Directive 4 has imposed restrictions on the provision of goods, services (except for financial services) and technology in support of nonconventional — *i.e.*, Arctic offshore, deepwater and shale — oil exploration and production projects in Russia or Russian maritime waters involving SSI entities identified under the directive. As amended on October 31, 2017, Directive 4 represents a significant expansion of these sanctions. Layered on top of the restrictions that have already been in place, Directive 4 prohibits certain activities in support of new nonconventional projects (i) that are initiated

on or after January 29, 2018, (ii) that have the potential to produce oil anywhere in the world, and (iii) in which an SSI entity identified under Directive 4 has either a 33 percent or greater ownership interest or owns a majority of the voting rights.

Significantly, OFAC has clarified that it considers a new project to be "initiated" when "a government or any of its political subdivisions, agencies, or instrumentalities (including any entity owned or controlled directly or indirectly by any of the foregoing) formally grants exploration, development, or production rights to any party." Therefore, to the extent a project outside of the Russian Federation or maritime waters claimed by Russia has received a grant of such rights prior to January 29, 2018, it would appear to fall outside the scope of the Directive 4 restrictions, regardless of the equity interest or voting rights held by a Directive 4 SSI entity. A project inside Russia or Russian maritime waters that received a grant of exploration, development or production rights before January 29, 2018, would continue to be captured under the original Directive 4 restrictions.

OFAC has clarified that nothing in the Directive 4 amendment is intended to displace the "50 percent rule," whereby the restrictions applicable to dealings with sanctioned persons automatically apply by operation of law to entities owned 50 percent or more by sanctioned persons. OFAC has advised that the "33 percent rule" in the amended Directive 4 context serves as an additional prerequisite for triggering the restrictions on new nonconventional projects — *i.e.*, there must be (i) a Directive 4 entity (or a 50 percent-or-more owned subsidiary of Directive 4 entities), and (ii) that entity must own at least 33 percent or a majority of the voting rights in the relevant new project. OFAC has further clarified that ownership and voting interests in the project are aggregated. If multiple Directive 4 entities hold a combined 33 percent or greater interest in — or hold a majority of the voting shares in — a certain new project, the restrictions would apply to that new project.

Secondary Sanctions

As discussed in our August 4, 2017, client alert, CAATSA introduced certain new secondary sanctions and made certain existing discretionary secondary sanctions mandatory. Under these measures, a foreign person can be sanctioned for engaging in specific activities, and no U.S. jurisdictional nexus (*e.g.*, no U.S. person involvement, no U.S. origin items, no U.S. dollar payments, etc.) is required. The sanctions that can be imposed on the individual or entity engaging in the conduct can vary depending on the specific CAATSA provision and can range from relatively minor (*e.g.*, restricting access to services provided by the Export-Import Bank of the United States) to very severe (*e.g.*, blocking the sanctioned person).

President Trump has divided the authority to administer and implement secondary sanctions under CAATSA between the Treasury and State departments. The Treasury Department measures will be implemented by OFAC. None of these secondary sanctions is self-executing —for an individual or entity to be sanctioned, the Treasury or State department must affirmatively impose the sanction.

Secondary Sanctions Administered by OFAC

Section 226: Banking Sanctions Related to Transactions With Specially Designated Nationals

Section 226 of CAATSA amends Section 5 of the Ukraine Freedom Support Act of 2014 (UFSA). Under Section 226, a foreign financial institution will risk the loss of its U.S. correspondent account or payable-through account access if it knowingly (i) engages in certain "significant transactions" involving certain defense-related activities by certain sanctioned persons, (ii) engages in "significant transactions" involving investment in special Russian crude oil projects by persons sanctioned for that activity, or (iii) facilitates a "significant financial transaction" on behalf of any Russian person included on OFAC's Specially Designated Nationals and Blocked Persons List (SDN List) under UFSA or any of the Ukraine/Russia-related executive orders.

The Section 226 guidance issued by OFAC explicitly states that foreign financial institutions will not be sanctioned for facilitating "significant transactions" with SSI entities subject to Directives 1 through 4. However, such institutions engaged in "significant transactions" on behalf of SDNs sanctioned under the Ukraine/Russia-related sanctions will face potential sanctions.

The guidance leaves OFAC broad discretion to determine what constitutes a "significant transaction" or "significant financial transaction" based on the "totality of the facts and circumstances." OFAC has provided a list of factors it will consider, including, among others, the size, number and frequency of the transactions; the nature of the transactions; the level of awareness of management; the impact of the transactions on statutory objectives; and whether the transactions involve deceptive practices. The term "financial transaction" will be interpreted broadly to encompass any transfer of value involving a financial institution.

Section 228: Transactions With Sanctioned Individuals and Entities

Section 228 amends the Support for the Sovereignty, Integrity, Democracy and Economic Stability of Ukraine Act of 2014 and requires the imposition of sanctions on a "foreign person" that knowingly (i) materially violates — or attempts, conspires or causes a violation of — any license, order, regulation or prohi-

bition contained in specific Ukraine/Russia-related executive orders or statutes, or (ii) "facilitates a significant transaction or transactions, including deceptive or structured transactions, for or on behalf of ... any person subject to sanctions imposed by the United States with respect to the Russian Federation," or any child, spouse, parent or sibling thereof.

OFAC's guidance explains that "persons subject to sanctions" includes both persons on the SDN List and SSI entities, as well as entities owned 50 percent or more by such sanctioned entities. Significantly, however, a transaction involving only an SSI entity would only be "significant" — and therefore sanctionable — if the following three conditions are met:

1. a U.S. person requires a specific license from OFAC to participate in the transaction (for example, because the transaction is prohibited for a U.S. person under the sectoral sanctions);
2. the transaction involves "deceptive practices" (*i.e.*, the transaction "attempts to obscure or conceal the actual parties or true nature of a transaction, or to evade sanctions"); and
3. the totality of circumstances make it a "significant transaction."

The statutory definition provided for "foreign person" in Section 228 is broader than the definition that is often applied to that term in most sanctions and includes "any entity not organized solely under the laws of the United States, or existing solely in the United States."[1] OFAC's definition of "significant transaction" in its Section 228 guidance closely tracks the definition of the same term in the Section 226 guidance.

Section 233: Privatization of State-Owned Assets

Section 233 requires sanctions on any person — U.S. or non-U.S. — if (i) the person, with actual knowledge, makes or facilitates an investment of $10 million or more (or any combination of investments of no less than $1 million each, which in the aggregate equals or exceeds $10 million in a 12-month period), (ii) the investment "directly and significantly contributes" to Russia's ability to privatize state-owned assets, and (iii) the privatization of state-owned assets "unjustly benefits" Russian government officials, their close associates or family members.

OFAC's guidance provides clarification regarding how it anticipates interpreting certain key terms in Section 233. OFAC clarifies that the term "investment" should be understood broadly as "a transaction that constitutes a commitment or contribution of funds or other assets or a loan or other extension of credit to an enterprise." As a result, "investment" could extend to a wide range of activities and products, including lines of credit, guarantees, currency swaps and purchases of debt securities issued by the government of Russia.

OFAC's guidance also provides that "unjustly benefits" refers to activities such as "public corruption" — including the misuse of Russian public assets or the misuse of public authority — where there is a "direct or indirect advantage, value, or gain" by Russian government officials, their close associates or family members.

Secondary Sanctions Administered by the State Department

Section 225: Investment in Special Crude Oil Projects

Section 225 amends the UFSA to require the imposition of sanctions on any foreign person who is determined to knowingly make a "significant investment" in a "special Russian crude oil project." The definition of a special Russian crude oil project generally tracks the focus on Arctic offshore, deepwater and shale projects in Directive 4. However, unlike amended Directive 4, Section 225 is limited to such nonconventional projects in the Russian Federation, its exclusive economic zone, and Russian Arctic offshore locations.

The State Department's Section 225 guidance clarifies that the "investment" could include arrangements where goods or services are provided in exchange for equity in an enterprise, or for rights to a share of the revenue or profits of an enterprise. Similar to its approach with other secondary sanctions and that taken by the Treasury Department, the State Department explains it will decide whether a particular investment is "significant" by considering the "the totality of the facts and circumstances surrounding the investment" and weighing various factors on a case-by-case basis. These factors may include, but are not limited to, the adverse impact of a transaction on U.S. national security and foreign policy interests; the nature and magnitude of the investment, including relative to the project's overall capitalization; and the relation and significance of the investment to the Russian energy sector. An investment will not be considered "significant" if U.S. persons would not require a specific license from OFAC to participate in it.

Section 231: Russia's Defense and Intelligence Sectors

Section 231 requires the imposition of sanctions on a person — U.S. or non-U.S. — who engages in a "significant transaction" with a person that is "part of, or operates for or on behalf of, the defense or intelligence sectors of the Government of the Russian

[1] See 31 C.F.R. 595.304.

Federation, including the Main Intelligence Agency of the General Staff of the Armed Forces of the Russian Federation or the Federal Security Service of the Russian Federation."

The State Department's Section 231 guidance clarifies what constitutes a "significant transaction" and lists the specific entities and government bodies that for purposes of Section 231 are part of Russia's military or intelligence sectors ("identified entities"). The State Department could potentially add names to this list in the future.

The State Department here, too, provides that it will consider the "totality of the facts and circumstances" in determining whether a transaction is significant and reserves for itself broad discretion to make that assessment on a case-by-case basis. Like its approach in Section 225, the State Department may consider a range of factors, including the adverse impact of the transactions on U.S. national security and foreign policy interests, the nature and magnitude of the transaction, and the significance of the transaction to Russia's defense sector.

Significantly, the guidance states that "in this initial implementation stage," the State Department's focus will be on transactions of a defense or intelligence nature. The guidance indicates that if a transaction for goods or services has purely civilian end uses and/or end users, then as long as entities in the intelligence sector are not involved, these factors will weigh "heavily" against a determination that the transaction is significant for purposes of Section 231.

The guidance expressly states that identified entities are not themselves being sanctioned (*i.e.*, they are not being added to any other U.S. sanctions lists). The list of identified entities, however, includes certain companies as well as government bodies that have already been sanctioned under other U.S. sanctions. Notably, entities owned 50 percent or more by identified entities would not invoke secondary sanctions under Section 231 unless they are independently listed.

Section 232: Energy Export Pipelines

Section 232 authorizes the imposition of sanctions on any person — U.S. or non-U.S. — who knowingly (i) makes "an investment that directly and significantly contributes to the enhancement of the ability of the Russian Federation to construct energy export pipelines"; or (ii) "sells, leases or provides to the Russian Federation, for the construction of Russian energy export pipelines" certain goods, services, technology, information or support that (a) have a fair market value of $1 million or more, or (b) that, during a 12-month period, have an aggregate fair market value of $5 million or more.

The State Department's guidance affirms that the Section 232 sanctions are discretionary, not mandatory. Consistent with the text of Section 232, the guidance explains that the secretary "will coordinate with allies of the United States in imposing these sanctions" and that any implementation of these measures "would seek to avoid harming the energy security of [U.S.] partners or endangering public health and safety." Furthermore, the guidance provides that "the intent of such sanctions would be to impose costs on Russia for its malign behavior, such as in response to aggressive actions against the United States and our allies and partners."

The guidance indicates that implementation will be focused on energy export pipelines that (i) originate in the Russian Federation, and (ii) transport hydrocarbons across an international land or maritime border for delivery to another country. Pipelines that originate outside Russia and transit through Russian territory will not be the focus of the State Department's use of Section 232.

Importantly, the guidance grandfathers energy export pipeline projects initiated prior to August 2, 2017, the date CAATSA was signed into law. According to the guidance, a pipeline project is considered to have been initiated for purposes of Section 232 "when a contract for the project is signed." This is a different standard for the initiation of a project than was applied by OFAC in the Directive 4 context (discussed above). This Section 232 definition of "initiated" is potentially very broad and would appear to exclude from the scope of Section 232 sanctions early-stage projects, as long as there was some contractual execution prior to August 2, 2017. For added clarity, the guidance states that investments and loan agreements made prior to August 2, 2017, and investment and activities related to the standard repair and maintenance of pipelines capable of transporting commercial quantities of hydrocarbons in existence as of August 2, 2017, would not be targeted by the Section 232 sanctions.

Trump Administration Sets Approach to Implementation of New Russia Sanctions

Contacts

Jamie L. Boucher
Partner / Washington, D.C.
202.371.7369
jamie.boucher@skadden.com

Eytan J. Fisch
Partner / Washington, D.C.
202.371.7314
eytan.fisch@skadden.com

William J. Sweet, Jr.
Partner / Washington, D.C.
202.371.7030
william.sweet@skadden.com

Ondrej Chvosta
Associate / Washington, D.C.
202.371.7579
ondrej.chvosta@skadden.com

James E. Perry
Associate / Washington, D.C.
202.371.7652
james.e.perry@skadden.com

Greg Seidner
Law Clerk / Washington, D.C.
202.371.7014
greg.seidner@skadden.com