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WHITE PAPER

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U.S. Government Takes Steps Toward Implementation of Sanctions on Russia

The United States has taken significant steps toward fully implementing the sanctions imposed on Russia pursuant to the Countering America's Adversaries Through Sanctions Act of 2017, which codifies and strengthens certain existing sanctions on Russia.

Although the Act was enacted in August 2017, the full scope of the sanctions it imposes on Russia recently have come into greater focus with issuance of formal guidance from the U.S. Department of the Treasury's Office of Foreign Assets Control and the U.S. Department of State. U.S. and non-U.S. companies and financial institutions should continue to review their business activities involving Russia to ensure ongoing compliance with applicable U.S. sanctions.

TABLE OF CONTENTS

Over the past few weeks and, most significantly, at the end of October, the United States has taken significant steps toward fully implementing the sanctions imposed on Russia pursuant to the Countering America's Adversaries Through Sanctions Act of 2017, P.L. 115-44 ("CAATSA"). As we previously reported here, CAATSA codifies and strengthens certain existing sanctions on Russia and imposes an array of new sanctions with extraterritorial effect—or "secondary sanctions"—targeting certain categories of transactions, involving, among other things, the Russian energy, intelligence, and defense sectors, persons that violate sanctions on Russia and human rights abusers, and the privatization of Russian state-owned assets.

Although CAATSA was enacted in early August 2017, the full scope of the sanctions it imposes on Russia have come into greater focus in the past weeks with issuance of formal guidance from the U.S. government agencies responsible for administering and enforcing these new measures—namely, the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") and the U.S. Department of State ("State").

Below, we explore the recently implemented provisions of CAATSA and summarize the key guidance provided by OFAC and State regarding those provisions.

SECTORAL SANCTIONS

Since the inception of the sanctions program targeting Russia, the United States has maintained so-called "sectoral sanctions" targeting certain transactions involving Russia's energy, defense, and finance sectors. Parties subject to those sanctions are designated on the Sectoral Sanctions Identifications List ("SSI List") maintained by OFAC. Prior to CAATSA, sectoral sanctions were implemented through four directives issued pursuant to Executive Order 13662, each of which imposed varying restrictions on designated persons. As we previously reported, CAATSA, through Section 223, codified these directives and, more significantly, strengthened the restrictions imposed by three of the directives. Revised versions of the three directives, which were amended in accordance with Section 223 of the CAATSA, have now been published by OFAC. Also, since the beginning of October, OFAC has progressively issued guidance regarding the application and effective date for these strengthened sectoral sanctions.

First, on September 29, 2017, OFAC issued, for the third time, revised versions of Directives 1 and 2, which, variously, prohibit U.S. persons from engaging in or facilitating certain dealings involving debt or equity issued by designated persons. With implementation of these revised directives on November 28, 2017, U.S. persons will face increasingly restrictive prohibitions on dealing in debt and/or equity issued by designated persons based on date of issuance and tenor. Accordingly, U.S. persons should carefully review any dealings that trigger the restrictions imposed by these directives in advance of implementation at the end of November.

Second, on October 31, 2017, OFAC issued a revised version of, and guidance regarding CAATSA's modifications to, Directive 4. Through the guidance issued by OFAC, which was in the form of frequently asked questions ("FAQs"), OFAC clarified that the amended version of Directive 4 prohibits certain transactions with designated persons in support of exploration or production for deepwater, Arctic offshore, or shale projects that have the potential to produce oil in Russia or in maritime area claimed by Russia and extending from its territory, and that involve any person determined to be subject to Directive 4, but also any such projects that meet the following criteria: (i) are initiated on or after January 29, 2018; (ii) have the potential to produce oil in *any* location; and (iii) any person determined to be subject to Directive 4 either has a 33 percent or greater ownership interest in the project or owns a majority of the voting interests in the project. As a result, the amended version of Directive 4 significantly expands the geographic scope of the prohibitions; although it still does not apply to projects that only have the potential to produce natural gas.

Finally, Section 223 of CAATSA expressly reinforces OFAC's authority, as set out in Executive Order 13662, to designate state-owned entities operating in the railway, mining, and metals sectors pursuant to sectoral or blocking sanctions. OFAC has, however, noted that this provision does not *require* the imposition of sanctions and implied that, at this point, it does not intend to impose any sanctions on persons operating in those sectors.

SECONDARY SANCTIONS

Pursuant to CAATSA, the United States has imposed an array of sanctions measures with extraterritorial effect—so-called

"secondary sanctions—intended—similar to the secondary sanctions implemented in respect of Iran—to discourage foreign persons from engaging in certain types of activities involving Russia. Although discretionary secondary sanctions on Russia were introduced by the Ukraine Freedom Support Act of 2014, P.L. 113-272 ("UFSA") (but never enforced), CAATSA marks an expansion of the approach in respect of Russia and, accordingly, may have substantial impact on the business activities and decisions of foreign companies.

At the end of October, OFAC and State issued, for the first time, guidance regarding certain of these secondary sanctions, bringing their potential application into greater focus.

Financial Institutions. Pursuant to Section 226 of CAATSA (which amends Section 5 of UFSA), the United States has strengthened its as-yet unused secondary sanctions targeting Russia's financial sector and imposed restrictions similar to those implemented in respect of Iran through the Iranian Financial Sanctions Regulation, 31 C.F.R. Part 561 ("IFSR"). Specifically, foreign financial institutions are now subject to the *mandatory* (rather than discretionary) imposition of sanctions if they are determined to have knowingly engaged in or facilitated significant transactions involving (i) certain defense- and energy-related activities or (ii) certain Russian parties, including parties designated on OFAC's list of Specially Designated Nationals and Blocked Persons pursuant to Ukraine-related sanctions authorities.

In keeping with its practice in other sanctions programs, OFAC has indicated that, for purposes of this and other CAATSA provisions, it will broadly interpret the terms "facilitate" and "financial transaction," including, in the case of the latter, to capture most financial transactions. However, as has been the case for the IFSR, OFAC will consider the totality of the facts and circumstances in determining whether a transaction is "significant," including:

- The size, number, and frequency of the transactions;
- The nature of the transactions;
- The level of awareness of management and whether the transactions are part of a pattern of conduct;
- The nexus between the transactions and a sanctioned person;
- The impact of the transactions on sanctions objectives;
- Use of deceptive practices; and
- Any other factors deemed relevant on a case-by-case basis.

Moreover, notwithstanding these factors, foreign financial institutions will not be subject to the imposition of sanctions solely on the basis of knowingly facilitating significant financial transactions on behalf of persons designated on the SSI List.
In addition to being subject to restrictions on opening and maintaining correspondent accounts or payable-through accounts in the United States, any foreign financial institutions sanctioned pursuant to Section 226 of CAATSA will be identified on a new list, which will be established and maintained by OFAC.

Energy Sector. Pursuant to CAATSA, the United States has implemented two significant secondary sanctions measures in respect of Russia's energy sector, which, based on State's recent guidance, appear designed to extend existing U.S. sanctions and export controls on Russia's energy sector to foreign persons.

First, pursuant to Section 225 of CAATSA (which amends Section 4 of UFSA), the United States has, in effect, extended the prohibitions of Directive 4 to foreign persons. Specifically, pursuant to Section 225, foreign persons are now subject to the imposition of *mandatory* sanctions if, on or after September 1, 2017, they knowingly make a significant investment in a "special Russian crude oil project," which is defined as any project intended to extract crude oil from: (i) the exclusive economic zone of the Russian Federation in waters more than 500 feet deep; (ii) Russian Artic offshore locations; or (iii) shale formations located in Russia. Pursuant to State's October 31, 2017, guidance, an investment may include arrangements where goods or services are provided in exchange for equity in an enterprise or rights to a share of the revenue or profits of an enterprise. Moreover, similar to OFAC's approach, an investment will be considered "significant" for purposes of Section 225 of CAATSA based on a totality of the circumstances, which will be assessed on a case-by-case basis and consider factors such as the nature and magnitude of the investment and the significance of the investment to U.S. national security and foreign policy interests (including the possibility of an adverse impact on these interests). Notably, an investment will not be considered "significant" if U.S. persons would not require specific licenses from OFAC to make or participate in it, which complements OFAC's approach to implementation of Directive 4.

Second, pursuant to Section 232 of CAATSA, the United States has implemented *discretionary* sanctions that appear to expand,

albeit narrowly, on U.S. efforts to restrict Russia's energy exports. Specifically, Section 232 allows for the imposition of *discretionary* sanctions on any person that knowingly engages in certain transactions related to the construction of energy export pipelines. State has indicated that implementation of this provision will focus on energy export pipelines that originate in the Russian Federation and transport hydrocarbons across an international land or maritime border for delivery to another country. Implementation will not, however, focus on pipelines that originate outside Russia and merely transit through Russian territory. Further, the State guidance clarifies that, for the purposes of these sanctions, a project is considered to have been initiated only when a contract for the project is signed. As a result, neither investments and loan agreements made prior to August 2, 2017, nor investments or other activities related to the standard repair and maintenance of existing pipelines will be sanctionable. More significantly, State has indicated that the intent of this provision is "to impose costs on Russia for its malign behavior, such as in response to aggressive actions against" the United States and its allies and partners. Accordingly, the United States will work, in implementing sanctions under this provision, with the European Union to "promote energy security through developing diversified and liberalized energy markets that provide diversified sources, suppliers, and routes."

Intelligence and Defense Sectors. Section 231 of the CAATSA extends existing U.S. efforts to isolate Russia's intelligence and defense apparatus. Specifically, pursuant to Section 231, all persons are subject to the imposition of *mandatory* sanctions if they knowingly engage in significant transactions with persons that are part of, or operating for or on behalf of, the Russian defense and intelligence sectors. As noted above, State will determine whether a transaction is "significant" for the purposes of this provision based a totality of the facts and circumstances. However, consistent with general licenses issued by OFAC, State has indicated that a transaction will generally not be considered "significant" for purposes of Section 231 if it: (i) relates to goods or services with purely civilian end-uses and/or civilian end-users, and does not involve entities in the intelligence sector; or (ii) is necessary to comply with rules, regulations, actions, or investigations administered by or involving the Federal Security Service, including rules and regulations for the importation, distribution, or use of information technology products in the Russia and the payment of any fees to the Federal Security Service for such licenses, permits, certification, or notifications.

On October 27, 2017, State published a long-expected and delayed list of persons that are part of, or operating for or on behalf of, the Russian defense and intelligence sectors, some of whom have already been sanctioned under other U.S. sanctions authorities. According to State, initial implementation of Section 231 is expected to focus on significant transactions of a defense or intelligence nature with these listed persons, and will only begin on or after January 29, 2018.

Privatization of State-Owned Assets and Dealings with Designated Persons. Finally, OFAC has provided hoped-for guidance regarding the application of CAATSA's two relatively unique and potentially broadest provisions.

First, OFAC has provided some focus to the potential implications of CAATSA's sanctions in respect of the privatization of Russia state-owned assets. Specifically, Section 233 requires the *mandatory* imposition of sanctions on any person that, with actual knowledge, makes or facilitates an investment over certain monetary thresholds that directly and significantly contributes to Russia's ability to privatize state-owned assets in a manner that unjustly benefits officials of the Russian government or close associates or family members of those officials. As elsewhere, OFAC will, for the purposes of this provision, broadly interpret the scope of applicable investments and "facilitation." Nevertheless, OFAC's guidance may indicate that enforcement of the provision will be relatively focused and require a substantial burden of proof. Specifically, OFAC's interpretations of other key terms—namely, "unjust benefits" (which include activities, such as public corruption, that result in any direct or indirect advantage, value, or gain, whether the benefit is tangible or intangible, by specified persons) and "close associates" and "family members"—indicate that implementation of this provision may focus primarily on countering corruption, rather than privatization. Further, the use of an *actual knowledge* standard for this provision—as opposed to the *knowingly* standard employed in all other CAATSA provisions—appears to indicate that a higher burden of proof will be required to impose sanctions; although it remains unclear how the standard will be applied in practice.

Second, OFAC provided greater clarity regarding the potential imposition of sanctions pursuant to Section 228 of CAATSA on foreign persons that knowingly (i) materially violate, attempt to violate, conspire to violate, or cause a violation of U.S.

sanctions or (ii) facilitate significant transactions, including deceptive or structured transactions, for or on behalf of any person subject to Russia sanctions or their immediate family members. While, as elsewhere, OFAC will broadly interpret the scope of sanctionable "facilitation," OFAC has indicated that there will be limitations on its interpretation of other key terms. In particular, OFAC has indicated that it will interpret the term "materially violate" to refer only to "egregious" violations of U.S. sanctions. Further, while OFAC will, as elsewhere, assess whether a transaction is "significant" based on a totality of the facts and circumstances, in consideration of its standard factors, transactions will not generally be considered significant where: (i) U.S. persons would not require a license to participate; and/or (ii) they merely involve a person designated on the SSI List, in the absence of deceptive practices. Nevertheless, as OFAC's assessment of significance will be assessed based on a totality of the circumstances, caution will be warranted under all circumstances.

LOOKING AHEAD

In light of the recent guidance from OFAC and State, U.S. and non-U.S. companies and financial institutions should continue to review their business activities involving Russia to ensure ongoing compliance with applicable U.S. sanctions and update or refine their sanctions compliance policies and procedures to account for these developments. Jones Day will continue to monitor and report U.S. efforts to implement and impose sanctions under the CAATSA.

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