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Sanctions

Measures Against Russia Pose Serious Compliance Challenges

By David Hill, *Anti-Corruption Report*

For some companies engaged in business with Russia, it has proven pragmatic to act as if the country were under more wide-ranging U.S. sanctions than is actually the case. While not as comprehensive as the sanctions against Iran or North Korea, the U.S. measures affect fundamental aspects of the local economy such as the banking system, making any kind of business in Russia effectively difficult to accomplish without violations. Over 1,000 U.S. companies have ceased or curtailed operations in Russia since the sanctions started.

Moreover, U.S. authorities have adopted positions that give them a wider potential field of maneuver than they have, in practice, implemented, leaving much to public officials' own discretion. The U.S. has coordinated its sanctions ever more closely with those of partners such as the E.U. and the U.K. to close off circumvention opportunities. Business with Russia is likely to become more limited as regulators become more proactive and prohibitive.

This article distills insights offered by Davis Polk attorneys during a firm webinar addressing sanctions and similar measures taken against Russia by the U.S. Office of Foreign Assets Control, DOJ, Department of Commerce, Financial Crimes Enforcement Network and Europe, noting compliance challenges and enforcement efforts.

See “Russian Trade Under a Microscope: How to Adapt to the Shifting Export Controls and Sanctions Landscape” (Jun. 8, 2022).

Even Permissible Business Is Harder

“Many companies effectively treat Russia as if it were under comprehensive territorial sanctions,” counsel Will Schisa commented. “There are operational challenges for companies with operations in Russia. Even ordinary banking activities are hard now because of the sanctions on banks.”

Current estimates from the Department of the Treasury are that more than 80 percent of Russia's banking sector, measured according to assets, is subject to U.S. sanctions. This includes the 10 biggest Russian-owned banks.

Schisa noted that sanctions by the U.S., the E.U. and the U.K. have blocked Russia's largest banks since spring 2022. Calling the sanctions against Russia "unprecedented," he said they are "designed to cut off Russia's access to international finance."

Since the spring of 2022, there have been restrictions on exports of services, though Russia has not been subjected to such comprehensive territorial sanctions as those applying to Iran, Cuba and North Korea. Recently, the sanctions have been more specifically targeting certain sectors. Nonetheless, Schisa said, for companies from the U.S. seeking to pursue activity in Russia, "significant compliance challenges remain."

De-risking efforts, and the prevailing market conditions, put a chill on even permissible activities, Schisa explained.

In February 2023, "the U.S. Treasury Department stated that over 1,000 companies had reportedly ceased or curtailed their operations in Russia" since the imposition of sanctions last spring, Schisa stated. "We expect this trend to continue in the near future."

Do Not Deal With the Central Bank

Key U.S. measures against Russia also include reporting requirements under Directive 4 of Executive Order 14024, partner Paul Marquardt said. This stipulates that U.S. persons are prohibited from participating in any transaction – including any transfer of assets or foreign exchange – with the Russian Central Bank, National Wealth Fund or Ministry of Finance.

Consistent with a similar measure adopted by the E.U., the Office of Foreign Assets Control (OFAC) amended that directive to require that all people subject to U.S. jurisdiction must report to OFAC any property in their possession in which those three Russian entities have an interest.

These new requirements are intended to allow OFAC to better identify and quantify immobilized Russian government assets held by U.S. persons, Marquardt explained.

In February 2023, OFAC released new guidance on whether it is permissible for U.S. business to pay Russia's "exit tax." The Russian government imposes this on foreign entities divesting their assets in Russia.

Marquardt noted that, since paying this tax may require a transaction with Russia's central bank and finance ministry, both of which were mentioned in Directive 4, Americans are prohibited from paying this tax. Instead, if they need to divest Russian assets that would make them subject to that tax, they should seek a specific license from OFAC.

Additional Sectors

The U.S. measures, though initially focused especially on banking and oil, have lately designated additional sectors of the Russian economy, including construction, engineering, architecture, manufacturing, transportation, metals and mining, Schisa reported. There has been a price cap on

Russian oil and energy products, and new sanctions on Russian financial institutions and key sources of supply.

Moreover, U.S. measures have, in recent months, pursued an expanded focus on facilitators of sanction evasion and private-sector compliance.

“The situation has settled since last spring,” Schisa said, with the sanctions framework becoming somewhat more stable. However, he added, the U.S., E.U. and U.K., along with other allies, continue to impose sweeping sanctions, **export controls restrictions** and other measures targeting Russia, as they have been continuously doing since the spring 2022 invasion of Ukraine.

The international allies have increasingly coordinated on enforcement to prevent the evasion and circumvention of sanctions.

See our three-part series on sanctions: “How Sanctions Regimes Work” (Aug. 3, 2022); “Their Impact on Private Fund Investors and Investments” (Aug. 17, 2022); “How to Comply With Them” (Sep. 14, 2022).

OFAC Has Discretionary Range

OFAC, an agency of the Treasury Department, has given itself considerable discretionary power to focus its practical decisions against business involving Russia, Schisa observed.

OFAC has the authority to sanction individuals and entities operating in the sectors designated, but that does not mean sanctions are automatically imposed on all entities present in those sectors. “While the authority is broad, imposing sanctions under the designation is ultimately a discretionary matter for OFAC, which is likely to carefully calibrate any decision,” Schisa said.

OFAC’s ban in May 2023, under Executive Order 14071, adding Russia’s architecture, engineering, construction, manufacturing and transportation sectors to the list of designated sectors, applies to the export, re-export, sale, or supply of architecture and engineering services to any person located in Russia. The definition of engineering services includes advisory, consultative and design services on any engineering matter, and the architecture services are similarly defined to include advisory or any other services requiring architects’ expertise. “OFAC’s authority extends to entities that either provide or receive such services,” Schisa said, noting that the sanctions are especially meant to target activities linked to Russia’s defense sector.

In May 2023, OFAC and the State Department designated almost 300 individuals, entities, vessels and aircraft, covering various sectors and jurisdictions. They include Russian sources of supply for advanced technology, materials and financing.

See “E.U.’s Proposed Directive and CFSP Expansion to Strengthen Anti-Corruption and Sanctions Regimes” (May 24, 2023).

European Sanctions Go Further

While America has generally worked in close coordination with its British and E.U. allies on imposing sanctions on Russia since the spring 2022 invasion, the E.U. and U.K. measures go further in some ways, Marquardt noted.

“In 2022, the E.U. and U.K. imposed bans together that went beyond the scope of U.S. sanctions,” Marquardt said.

E.U. and U.K. measures have expanded restrictions on the export of certain services, including Information Technology consultancy, certain legal advice, and architecture and engineering services. They have tightened restrictions on imports of iron and steel and revenue-generating goods.

“Another way in which the E.U. and U.K. went further than the U.S. was the targeting of certain regions of Ukraine in October of last year,” Marquardt added. The E.U. and the U.K. have placed broad restrictions on trade and investment, targeting the non-government-controlled areas of the Kherson and Zaporizhzhia regions of Ukraine.

E.U. and U.K. measures ban the import, acquisition, supply and delivery of Russian oil and oil products and associated ancillary services. Many measures have been imposed in conjunction with the U.S., but there is not complete alignment, Marquardt said.

DOJ Taking Steps Too

The DOJ’s role in U.S. measures against Russia has included public statements by Deputy Attorney General Lisa Monaco, emphasizing that American businesses should comply with sanctions, partner Uzo Asonye noted.

“The Deputy Attorney General has made it clear that companies, and not just financial institutions, need to pay particular attention to their sanctions and anti-money laundering programs,” Asonye said.

The DOJ has also issued guidance showing a concern about intermediaries that some businesses use to evade sanctions. The U.S. administration has increasingly focused on facilitators of sanctions evasion and emphasized the importance of vigilance by the private sector.

Asonye cited Monaco as saying last year that “sanctions are the new FCPA,” reflecting the DOJ’s general position at this time that sanctions are a priority.

“There is an increasing intersection of corporate crime and national security,” Asonye said. “We’ve seen the trend playing out in the sanctions space, where much of the department’s attention has been focused on individuals and oligarchs attempting to skirt Russian sanctions.”

This year, DOJ has announced a surge of resources, including more than 25 new prosecutors in its National Security Division who will focus on sanctions evasion, export control violations and similar economic crimes.

Monaco remarked in 2023 that corporate crime has taken on more of a national security dimension, Asonye observed. Things that might have once been merely technical concerns for certain businesses should now be high compliance priorities for all companies, according to Monaco's statements.

"Although we've already seen the departments' increased focus on national security play out in the sanction enforcement space, particularly when it comes to Russia sanctions enforcement, we expect there will be an even greater activity around export control and anti-money laundering violations, and other crimes with foreign policy implications, in the year ahead," said Asonye.

See "Progress and Challenges in Implementation of Anti-Money Laundering Act of 2020" (Jun. 21, 2023).

Department of Commerce Examining Cross-Border Business

Another federal governmental agency underlining sanctions is the Department of Commerce's Bureau of Industry and Security (BIS), Asonye said.

"The BIS assistant secretary for export enforcement, Matthew Axelrod, has said the risk of getting sanctions and export controls wrong is no longer some sort of technical regulatory risk, but rather represents an enterprise risk for companies," Asonye continued.

BIS has expanded export control restrictions in recent months, imposing licensing requirements for exports of most items on the Commerce Control List to Russia and Belarus.

In February 2023, BIS, in conjunction with U.S. allies, issued a final rule expanding the scope of the Russian and Belarusian industry sector restrictions and imposing licensing requirements on numerous commercial and industrial items.

The rule modified the codes that must be used to classify items for exports to Russia or Belarus to determine when licensing requirements apply. In May, BIS expanded these restrictions to impose licensing requirements on certain electronics, instruments and advanced fibers.

Throughout 2023, BIS has added numerous entities to the Entity List for providing support to Russia's military and defense sector and undermining export control restrictions.

Tri-Seal Efforts on the Rise

This year has seen a new trend of compliance notes being issued jointly by the DOJ, OFAC and BIS. The first such tri-seal issuance highlighted the common tactic of using third-party intermediaries to circumvent sanctions, according to Asonye.

“The first of these tri-seal compliance notes, was published in March [2023], and focused on various ways in which Russia and other bad actors have used third party intermediaries to evade sanctions,” Asonye said.

That March 2023 note identified common red flags including the use of corporate vehicles to obscure ownership, funding sources or the countries involved. Of particular interest are IP addresses that do not correspond to a customer’s reported location data, and complex or international businesses that use residential addresses or share addresses with other closely held corporate entities. Transactions involving entities with little or no web presence are also of interest, according to the agencies.

Effective compliance programs need to adopt controls to minimize the risk of evasion and misuse by third-party intermediaries, according to the guidance.

“The note identified red flags that could indicate a third-party intermediary is attempting to evade sanctions or export controls,” Asonye said. The agencies are concerned about corporate efforts to “mask the identity of Russian end-users,” he explained.

Collaboration With FinCEN

The Financial Crimes Enforcement Network (FinCEN), a bureau of the Department of the Treasury, has also been cooperating with BIS, Schisa noted.

Summing up some recent significant anti-money laundering developments, he said the agencies have highlighted red flags such as the specific types of customers being served.

“Red flags include recently incorporated customers, and whether the customer’s line of business is consistent with the kinds of items it is ordering,” he explained.

FinCEN and BIS requested that financial institutions conduct due diligence of new customers, focusing on the customer’s date of incorporation, lines of business in relation to ordered items and other trade-related red flags.

In March, BIS jointly released an alert with FinCEN listing red flags of export control evasion and reminding institutions of compliance obligations.

FinCEN also specifically warned financial institutions of vulnerabilities in the commercial real estate sector related to sanctions evasion. Sanctions evasion can be achieved through means including

pooled investment vehicles for facilitating transactions, shell companies and trusts to purchase real estate, and inconspicuous investments that seemingly provide stable returns.

See “Ransomware and Sanctions in the Time of War” (Jun. 22, 2022).

Oil Prices Capped

The imposition of oil and energy price caps against Russia has been an important development, Schisa noted.

“While the economic consequences are still unclear, Treasury reported in May that Russian oil revenue fell following implementation of the price cap, even though the volume of oil that Russia exported increased,” he said.

The price cap on both crude oil and petroleum products coming out of Russia was imposed in hopes of limiting revenues earned by Russia from those sales. The U.S. imposed the measure as part of an international coalition that includes the G7, the E.U. and Australia.

In November 2022, OFAC prohibited U.S. persons from providing services related to the maritime transport of Russian oil, but authorized providing these services in connection with Russian oil that is purchased at or below the price cap.

Individuals Pursued Over Russian Ties

Counsel Margarita Clarens highlighted some cases of federal agencies enforcing rules against individual intermediaries of sanctioned persons and entities.

Charges were brought against intermediaries who were found to be using complex schemes to facilitate transactions that evaded sanctions. For example, the DOJ brought an indictment against U.K. individual Graham Bonham-Carter for allegedly facilitating dollar transactions for a sanctioned oligarch, Oleg Deripaska; after that oligarch was sanctioned in 2018, the U.K. individual allegedly set up a new company in his own name to make payments on the oligarch’s U.S. properties.

In another case concerning the American attorney Robert Wise, the DOJ said that the sanctioned oligarch Viktor Vekselberg’s associate retained that attorney to manage the finances of Vekselberg’s U.S. properties. Wise pled guilty to receiving money from the oligarch through shell companies to make dollar payments.

A third case Clarens mentioned involved Vladislav Osipov of Russia and Richard Masters of the U.K., and concerned the alleged facilitation of money laundering and sanctions evasion. According to the allegations, the individuals masked the ownership of the sanctioned oligarch’s yacht, using a complex ownership structure.

See “Fifth Circuit’s Rafoi Bleuler Decision Underscores Extraterritorial Reach of FCPA and Money Laundering Law” (Apr. 26, 2023).