COVINGTON

Recent Developments in Russia and Iran Sanctions

Implementation of the Countering America's Adversaries Through Sanctions Act

November 8, 2017

International Trade Controls

During the past two weeks, the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") and the U.S. Department of State have taken a number of steps toward implementing aspects of the Countering America's Adversaries Through Sanctions Act ("CAATSA"), a major piece of sanctions legislation passed by the U.S. Congress in July and signed by President Trump in early August. These steps are in addition to those described in our client alert last month.

Specifically, as called for by CAATSA, OFAC on October 31 issued a revised Russia sectoral sanctions Directive 4 that expands the restrictions on U.S. person support for certain unconventional oil projects to reach new such projects being undertaken anywhere in the world where a sectorally sanctioned Russian energy company has a majority voting or 33 percent or greater ownership interest in the project. OFAC also issued related guidance on this expanded sanction. In addition, OFAC issued guidance on the application of secondary sanctions to foreign financial institutions and on the implementation of other measures in CAATSA.

Also with respect to CAATSA, the U.S. Department of State has issued guidance on the imposition of secondary sanctions relating to Russia's energy export pipelines, investments in special Russian crude oil projects, and a CAATSA provision that requires the President to sanction persons who knowingly engage in significant transactions with parties affiliated with Russia's defense and intelligence sectors.

With respect to Iran, OFAC issued amended regulations on October 31 implementing CAATSA's requirement to impose terrorism-related sanctions with respect to officials, agents, or affiliates of Iran's Islamic Revolutionary Guard Corps ("IRGC").

Primary Sectoral Sanctions Targeting Russia's Energy Sector

Since September 12, 2014, OFAC Directive 4 has prohibited U.S. persons from providing goods, services (except for financial services), or technology in support of exploration or production from deepwater, Arctic offshore, or shale projects that have the potential to produce oil in Russia or its territorial waters and that involve a sectorally sanctioned Russian energy company or an entity owned 50 percent or more, directly or indirectly, individually or in the aggregate, by one or more such companies. "U.S. persons" are legal entities organized under U.S. law and their non-U.S. branches; individual U.S. citizens and lawful permanent residents

("green-card" holders), wherever located or employed; and any persons when physically present in the United States.

Pursuant to Section 223(d) of CAATSA, OFAC has now amended Directive 4 to also cover U.S. person support for certain new deepwater, Arctic offshore, or shale projects anywhere in the world. The amended portion of the directive applies when each of the following three conditions is met:

- The project is new, meaning that it was "initiated" on or after January 29, 2018. OFAC clarified in a response to a frequently asked question that a project is "initiated" when a government formally grants exploration, development, or production rights to any party.

- The project has a potential to produce oil in any location, irrespective of whether the project also may produce gas. If the project has a potential to produce gas only, the prohibition would not apply.

- One or more parties that are subject to Directive 4, individually or in the aggregate, either (a) have a 33 percent or greater ownership interest, or (b) own a majority of the voting interest in such project. Parties subject to Directive 4 include those listed on OFAC's Sectoral Sanctions Identifications List ("SSI List") as being subject to Directive 4 and entities that are owned 50 percent or more, individually or in the aggregate, by one or more Directive 4 parties.

In determining whether one or more parties subject to Directive 4 hold a 33 percent or greater ownership interest in a project or own a majority of the voting interest, one must aggregate the interests of all parties subject to Directive 4 that have ownership or voting interests in the project.

Importantly, the amended Directive 4 does not modify the original prohibition on U.S. persons' provision of goods, services (except for financial services), or technology in support of deepwater, Arctic offshore, or shale oil projects in Russia if a party subject to Directive 4 is involved, regardless of the voting or ownership interest of such party in the Russian project.

"Deepwater" for purposes of both the original and amended Directive 4 includes projects that involve underwater activities at depths of more than 500 feet. "Shale projects" are those that have the potential to produce oil from resources located in shale formations. "Arctic offshore" projects are those that have the potential to produce oil in areas that involve drilling operations originating offshore and that are located above the Arctic Circle.

The services prohibited by Directive 4 include, but are not limited to, drilling services, geophysical services, logistical services, management services, modeling capabilities, and mapping technology. The exclusion from the prohibitions for financial services means that U.S. persons are not prohibited from, for example, clearing payments or providing insurance related to such projects.

Secondary Sanctions Targeting Russia's Energy, Defense, and Intelligence Sectors and Foreign Financial Institutions, and Other CAATSA Guidance

Special Russian Crude Oil Projects

CAATSA Section 225 requires the President to impose sanctions against a foreign person who is determined to knowingly have made a significant investment in a special Russian crude oil project on or after September 1, 2017. Engaging in such activities between December 18, 2014 and August 2, 2017 also exposed persons making such investments to secondary sanctions, but the imposition of such sanctions was discretionary, not mandatory. (President Obama had previously indicated that he did not intend to exercise such discretion to impose sanctions). According to the Ukraine Freedom Support Act of 2014, as amended by CAATSA, a "special crude oil project" is a project intended to extract crude oil from (1) the exclusive economic zone of Russia in waters more than 500 feet deep; (2) Russian Arctic offshore locations; or (3) shale formations located in Russia. Determinations under this provision will be made by the Secretary of State, in consultation with the Secretary of the Treasury.

According to recently issued State Department guidance, a determination of whether an investment is "significant" will consider the totality of the facts and circumstances and weigh factors on a case-by-case basis. The factors that will be considered include (a) the significance of the transaction to U.S. national security and foreign policy interests (particularly if the transaction has a significant adverse impact on these interests); (b) the nature and magnitude of the investment, including the size of the investment relative to the project's overall capitalization; and (c) the relation and significance of the investment to Russia's energy sector. An "investment" would not be considered "significant" for purposes of this secondary sanction if U.S. persons would not require a license from OFAC to make or participate in the investment.

According to the State Department guidance, an "investment" could 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.

Russia's Energy Export Pipelines

Section 232 of CAATSA authorizes (but does not require) the President to impose sanctions on persons who make certain investments in or provide goods, services, technology, information, or support for the construction of Russian energy export pipelines. Recent State Department guidance emphasizes that sanctions would be imposed in coordination with allies of the United States and would seek to avoid harming their energy security or endangering public health and safety.

According to the State Department guidance, any sanctions that are imposed would focus on energy export pipelines that (1) originate in the Russian Federation; and (2) transport hydrocarbons across an international land or maritime border for delivery to another country. Pipelines that originate outside Russia and transit through Russia will not be the focus of implementation, according to the State Department.

The State Department guidance indicates that the "focus of implementation of Section 232 sanctions" would be on persons (including non-U.S. persons) that the Secretary of State, in

consultation with the Secretary of the Treasury, determines knowingly on or after August 2, 2017 (the date CAATSA was enacted):

> (1) Make an investment that directly and significantly enhances the ability of the Russian Federation to construct energy export pipeline projects initiated on or after August 2, 2017; or
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> (2) Sell, lease, or provide goods, services, technology, information, or support that directly and significantly facilitate the expansion, construction, or modernization of such energy export pipelines by Russia.

In each case, the activity must meet the statutory fair market value thresholds of $1,000,000 or more, or $5,000,000 or more in aggregate during a 12-month period.

For the purposes of this section, a project is considered "initiated" when a contract for the project is signed.

Importantly, the State Department notes that investments and loans made prior to August 2, 2017 would not be subject to sanctions. Further, investments or other activities related to the standard repair and maintenance of energy export pipelines already in existence, and capable of transporting commercial quantities of hydrocarbons, as of August 2, 2017 would not be sanctioned.

Russia's Defense and Intelligence Sectors

Section 231 of CAATSA requires the imposition of secondary sanctions on or after January 29, 2018 against any person (including a non-U.S. person) that knowingly engages in a "significant transaction" on or after August 2, 2017 with a person that is part of, or operates for or on behalf of, the defense or intelligence sectors of Russia's government. The State Department has issued a list of 39 persons that the U.S. government considers to be part of, or operating for or on behalf of, Russia's defense and intelligence sectors for purposes of Section 231 ("the Section 231 List"). The list may be revised or expanded in the future.

Importantly, inclusion on the Section 231 List does not itself mean that a person's property and interests in property are blocked or that U.S. persons are prohibited from dealing with such persons, nor does it render the listed persons subject to sectoral sanctions. Many of the parties included on the Section 231 List, however, are blocked or sectorally sanctioned as a function of their separate, previous inclusion on the SSI List or OFAC's List of Specially Designated Nationals and Blocked Persons ("SDN List").

The State Department has issued guidance that in considering whether a transaction is "significant" for purposes of Section 231, it will consider the totality of the facts and circumstances of the transaction and weigh those factors on a case-by-case basis. Relevant factors may include, without limitation: (1) the significance of the transaction to U.S. national security and foreign policy interests, and particularly whether the transaction has a significant adverse impact on such interests; (2) the nature and magnitude of the transaction; and (3) the relation and significance of the transaction to the defense or intelligence sectors of the Russian government.

The State Department guidance notes that if a transaction is for goods or services that have purely civilian end-uses and/or civilian end-users, and the transaction does not involve entities in the intelligence sector, these factors will generally weigh heavily against a determination that such a transaction is significant for purposes of Section 231. It notes further that if a transaction is necessary to comply with rules and regulations administered by Russia's Federal Security Service, including rules and regulations governing the importation, distribution, or use of information technology products in the Russian Federation and the payment of any fees to the Federal Security Service for licenses, permits, certifications, or notifications, then these factors also will weigh heavily against a determination that that such transaction is significant for purposes of this section.

In response to a frequently asked question as to whether Section 231 requires the imposition of sanctions against an ally that purchases Russian-origin military equipment, spare parts, or related services, the State Department notes that it is mindful of the importance of unity and coordination with our allies and, where possible, the United States intends to help our allies identify and avoid engaging in potentially sanctionable activity.

Despite that guidance, there already has been one case in which one of the Congressional sponsors of the CAATSA legislation has pressed the Trump Administration to evaluate whether sanctions under Section 231 should be applied to a major U.S. ally, Turkey. This appears to indicate that there will be close Congressional attention to the enforcement of this section, and potentially strong political pressure brought to bear on the Administration to apply sanctions under the section on transactions that come to Congress' attention. It is important to note in this connection that the imposition of sanctions under Section 231 is mandatory, and the ability of the President to waive sanctions under this section is severely constrained. In most cases, therefore, whether sanctions will be imposed on a consummated transaction with entities on the Section 231 List is likely to turn on the Administration's decision whether to characterize the transaction as "significant."

Neither CAATSA nor the State Department guidance provides for grandfathering of significant transactions initiated prior to August 2, 2017 that continue beyond that date.

Sanctions with Respect to Foreign Financial Institutions

Section 226 of CAATSA requires the imposition of secondary sanctions against foreign financial institutions ("FFIs") if the Treasury Secretary determines that they knowingly, on or after August 2, 2017:

> (1) Engage in significant transactions involving certain Russian defense- and energy-related activities, subject to the Ukraine Freedom Support Act of 2014 discussed in our earlier alert, or
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> (2) Facilitate significant financial transactions on behalf of any person placed on the SDN List pursuant to existing Ukraine-related sanctions authorities.

Engaging in such activities between December 18, 2014 and August 2, 2017 also exposed FFIs to secondary sanctions, but the imposition of such sanctions was discretionary, not mandatory. As is the case with other U.S. secondary sanctions measures, these now mandatory sanctions reach activities of FFIs in any jurisdiction, including Russia.

For the purposes of Section 226, OFAC generally will interpret the term "financial transaction" broadly to encompass "any transfer of value" involving a financial institution. This will include, but is not limited to, the receipt or origination of wire transfers; the acceptance or clearance of commercial paper (including checks); the receipt or origination of ACH or ATM transactions; the holding of nostro, vostro or loro accounts; the provision of trade finance or letter of credit services; the provision of guarantees or similar instruments; the provision of investment products; or other transactions for or on behalf of a person serving as a correspondent, respondent, or beneficiary.

To determine whether transactions are significant, OFAC will consider the following seven factors: (1) the size, number, and frequency of the transaction(s); (2) the nature of the transaction(s); (3) the level of awareness of management and whether the transaction(s) are part of a pattern of conduct; (4) the nexus between the transaction(s) and a blocked person; (5) the impact of the transaction(s) on statutory objectives; (6) whether the transaction(s) involve deceptive practices; and (7) such other factors that the Secretary of the Treasury deems relevant on a case-by-case basis. OFAC also intends to construe the term "facilitation" broadly.

OFAC notes that sanctions will be imposed against FFIs engaging in the targeted sanctionable conduct unless the Secretary of State makes a determination that it is not in the national interest of the United States to do so. OFAC also has clarified that FFIs will not be exposed to secondary sanctions solely on the basis of knowingly facilitating transactions on behalf of persons on the SSI List.

OFAC Guidance on Implementation of Other Provisions of CAATSA

OFAC also has published guidance on several other secondary sanctions provisions of CAATSA, which will be important to those concerned about the potential reach of these sanctions.

OFAC published guidance on the interpretation of Section 228 of CAATSA, which requires the President to impose sanctions against any foreign person who knowingly, on or after August 2, 2017:

> (1) Materially violates, attempts to violate, conspires to violate, or causes a violation of any of the U.S. sanctions against Russia; or
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> (2) Facilitates a significant transaction, including deceptive or structured transactions, for or on behalf of a person (or a close relatives of such a person) subject to sanctions imposed by the United States with respect to the Russian Federation (including entities owned 50 percent or more, individually or in the aggregate, by one or more such sanctioned parties).

The OFAC guidance states that "materially violates" will refer to an "egregious" violation based on OFAC's Enforcement Guidelines found in Appendix A to 31 C.F.R. Part 501, and "facilitates" will be interpreted to mean providing assistance for a transaction from which a sanctioned person derives a particular, as opposed to a generalized, benefit.

As with the guidance relating to sanctions against FFIs, OFAC will consider the same seven factors outlined above in determining whether a transaction is significant. Importantly, however, a transaction is not significant if a U.S. person would not require a license from OFAC to participate in it. A transaction in which a person subject to U.S. sanctions is only identified on

the SSI List will not be considered significant unless it also involves a deceptive practice, such as an attempt to obscure or conceal the actual parties or the nature of the transaction. Moreover, a transaction involving an SSI List party will not automatically be considered significant even if a U.S. person would require a specific license from OFAC to participate in it and the transaction involves a deceptive practice.

OFAC also issued guidance with respect to CAATSA Section 233, which requires the imposition of sanctions against persons who knowingly make an investment above certain dollar thresholds if the investment directly and significantly contributes to the ability of the Russian Federation to privatize state-owned assets in a manner that unjustly enriches Russian government officials or their close associates or family members.

The OFAC guidance states that OFAC will interpret the term "investment" broadly as a transaction that constitutes a commitment or contribution of funds or other assets or a loan or other extension of credit, including a broad range of debt instruments. OFAC also will broadly interpret the term "facilitates" to mean the provision of assistance to certain efforts, activities, or transactions, including the provision of personnel, software, technology, or goods of any kind. The term "unjustly benefits" will be interpreted broadly as well, and will include such activities as public corruption resulting in any direct or indirect advantage, value, or gain, whether the benefit is tangible or intangible, by Russian government officials or their close associates or family members. A "close associate" would be a person who is widely and publicly known, or is actually known by the person engaging in the conduct, to have a close relationship with a Russian government official, and a "family member" would mean any extended family member.

Finally, while CAATSA Section 223(a) added state-owned entities operating in the railway or metals and mining sectors of the Russian Federation as entities that could be targeted for sectoral sanctions, OFAC's recently issued guidance notes that Section 223(a) does not require the imposition of sanctions against such entities. The guidance goes on to state that the U.S. government may impose sanctions against potential targets in any sector of the Russian economy, but that maintaining unity with our allies with respect to sanctions against Russia is important to the U.S. government.

Terrorism-Related Sanctions Against Iran

On October 30, OFAC amended the Global Terrorism Sanctions Regulations at 31 C.F.R. Part 594, which block the property and interests in property that are or come into the United States or the possession or control of a U.S. person of persons designated as terrorists or supporters of terrorism. The amended regulation, which is effective as of October 31, 2017, expands the property-blocking sanctions to foreign persons that are identified as officials, agents, or affiliates of the IRGC and placed on the SDN List.

The Administration had previously designated the IRGC for its support of terrorism-related activities, as discussed in our alert on October 16.

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Covington has deep experience advising clients on the legal, policy, and practical dimensions of international sanctions, including with respect to Russia and Iran. We will continue to monitor developments in this area, and are well-positioned to assist clients in understanding how these recent announcements may affect their business operations.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our International Trade practice:

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