Money Laundering bulletin

Russian dealings – a safe passage

Sanctions against Russia over its involvement in the Ukraine conflict are complex but navigable: ***Brian Zimbler*** *and* ***Vasilisa Strizh*** *of the Moscow office of Morgan Lewis take the helm.*

Well over a year has passed since the US, European Union and a number of other countries (notably including Australia, Canada and Switzerland) began imposing sanctions against Russia in connection with the Ukraine conflict. The sanctions programs remain well in place, and the lists of sanctioned persons have continued to grow. The underlying conflict in Ukraine continues to fester, despite the "Minsk II" agreement and other diplomatic efforts. In March 2015, US President Obama extended the US sanctions for another year, and EU leaders pushed for the renewal of their own sanctions until year-end. Accordingly, it appears possible that both the Ukraine crisis and the corresponding sanctions will continue as long-term issues for the region, as well as for international banks and companies who operate there.

Blacklists

By now, bank and corporate compliance officers will be well-versed in the Russian sanctions, and should have systems in place to track and implement them. The "blacklists" of persons with whom all trading is banned, and whose assets must be frozen (deemed "SDNs" or Specially Designated Nationals in US terminology) are relatively straightforward. The US list connected with the Ukraine crisis currently includes over 130 entries, and the corresponding EU list contains over 200 entries. However, the bans and freezes may also extend to companies 50% or more owned by such persons, directly or indirectly, and in some cases to companies controlled but not owned. Analyzing ownership structures and obtaining the necessary KYC documentation can be a challenge.

Sectoral Sanctions

Taking a different tack, the US and EU have also imposed "sectoral" sanctions focused on selected types of transactions involving designated Russian entities in the financial, energy and military sectors. For example, both the US and EU ban the provision of certain goods or services for designated energy projects, specifically targeting certain deepwater, Arctic offshore, or shale projects. Other sanctions focus on business with Crimea, and are not discussed here. Although there is some overlap, the US and EU sanctions work differently, and include separate carve-outs and exceptions. Careful analysis is required to navigate the different rules, and complex issues of interpretation may arise. When needed, clarifications may be sought from the responsible authorities. In the US, these include the Office of Foreign Assets Control ("OFAC") of the US Treasury Department and the Bureau of Industry and Security ("BIS") of the US Department of Commerce. In the EU, various national authorities are charged with implementation, such as HM Treasury in the UK, while periodic guidance is provided by the European Commission and other bodies.

Practical Consequences

The sanctions have severely disrupted business relationships with clients, suppliers and other counterparties in Russia, which has been a strategically important market for many international banks and companies. To continue trading with Russian partners, international players have found it necessary to refresh their existing KYC and due diligence files. Generally, the goal is to ensure that:

- Each business partner and its direct and indirect owners (generally with 50% or more ownership) and controlling persons have not been blacklisted; and

- Each business partner and its direct and indirect owners are not subject to any "sectoral" sanctions, or if they are, the proposed transaction does not violate the sanctions.

For example, under the sectoral sanctions, all trading with the designated Russian banks and energy companies is not banned; however, specifically targeted forms of financing, or provision of certain goods or services for certain energy projects are prohibited. (Of course, this brief summary is not comprehensive and does not reflect the full complexities of the sanctions.) Despite the practical difficulties of complying with these rules, the stakes are high, as substantial civil and criminal penalties may be imposed for violations.

Evaluating Compliance Risks

Under these circumstances, the risks have clearly escalated for companies and banks engaged in international business. However, in analyzing these risks, several points should be kept in mind. First, the vast majority of Russian companies are not subject to *any* sanctions, and can clearly demonstrate this status by provision of the necessary documentation. So generally, trading with Russia may continue.

Second, the practical risks that a "surprise" compliance violation may arise from the Russian sanctions may not be as high as feared by some observers, because their current impact is relatively narrow. The blacklisted individuals are primarily political or military figures, or other public officials connected with the situation in Ukraine/Crimea. Relatively few appear to be prominent business figures or wealthy "oligarchs" with substantial overseas assets. Meanwhile, the sectoral sanctions focus on large banks and companies and certain types of projects that should be

relatively easy to identify. These factors may should make it somewhat easier for compliance officers to perform their duties.

Third, despite vocal political opposition to the Western sanctions in Russia, as a practical matter many Russian banks and companies are fully ready to cooperate with compliance efforts, and understand the legal and reputational risks faced by their international partners. Therefore, it can be expected that adequate KYC and due diligence materials will be provided in most cases. Similarly, it is often possible to negotiate sanctions-specific clauses for contracts, so that trading may be terminated if new sanctions arise in the future.

Risks Posed by Restructuring or Asset Sales

Further issues may arise if a Russian-affiliated counterparty has recently restructured, purchased or sold substantial assets, or otherwise undergone a material change. In certain recent cases, it has been reported that blacklisted persons have transferred control of their businesses to new "clean" owners. Ostensibly, this should allow international partners to continue their business relationships with the counterparties, since they are not owned by sanctioned persons.

Nonetheless, it is advisable to treat such situations with care. Recent changes in ownership or group structure may be a "red flag", prompting further due diligence and analysis. It may not be safe to proceed if the new owners are linked to former owners – by family ties, common business dealings or otherwise. In such cases, the risks for international companies would appear to be significantly higher. According to the U.S. guidance on this subject, "sufficient due diligence should be conducted to determine that any purported divestment in fact occurred and that the transfer of ownership interests was not merely a sham transaction."

Due Diligence Process with Russian Counterparties

As a practical matter, it may be quite difficult to establish the ownership of a private company, both in Russia and elsewhere. For compliance purposes, the following approaches are suggested:

- Ask the counterparty. Sophisticated Russian companies will be able to provide full documentation to confirm their ownership, including ultimate beneficial owners, and information about any recent changes. In the past, requests for such information were very sensitive and sometimes met with resistance, in part for cultural reasons. Given the current environment, that has changed.

- Obtain references from trusted third parties. Many Russian companies have existing relationships with Western banks, law firms or advisers who will be able to serve as references generally, as well as to supply detailed KYC information (of course, with the prior consent of their Russian client).

- Search public databases. Substantial information about Russian companies may be obtained on-line, using official sources such as the Unified State Register of Legal Entities. A number of public databases are also helpful (in the Russian language). For example, the identities of company officers, and in some cases shareholders, may be confirmed. Corporate websites often post key documents such as the corporate charter and licenses. Russian-language publications and news sites may also be useful, to provide

background and context for the information gleaned from official sources.

- Investigations. In some cases, private investigators may be engaged to go deeper into the facts, especially if complex, multi-country structures arise. However, other issues must be considered first, including compliance with privacy laws in the relevant countries. There may also be adverse consequences if the investigation becomes known to the target.

Contractual Protections

Beyond due diligence, it is important to consider the legal consequences if after trading begins, it becomes apparent that the counterparty is subject to sanctions, or new sanctions are imposed. Such a situation may create a serious conflict: on the one hand, the international company or bank may be required to cease trading immediately. On the other hand, the sanctioned party may bring a claim for breach of contract.

In some cases the existing provisions of the contract – such as a "force majeure" clause – will already address the situation, providing proper grounds for terminating the contract, or acting as a shield against potential claims. Under certain circumstances, the sanctions may also prohibit the counterparty from pursuing such claims. Nonetheless, the current best practice is to include specific, sanctions-focused clauses in contracts, where there is a potential risk. Ideally, such a clause would:

- Set forth specific warranties from the counterparty regarding its ownership, and that international sanctions do not apply to it;

- Allow termination of the contract to avoid any breach of sanctions; and

- State that each party bears no liability for termination under such circumstances.

Drafting the appropriate language will require careful consideration of legal, commercial and political factors. Negotiations may be difficult, but the extra effort is likely to be worthwhile.

Ultimately, the future of Russian sanctions will depend on diplomatic and political developments that are difficult to predict. In the meantime, international companies and banks will face a heightened compliance burden, and should take into account the issues discussed in this note.

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