THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 57 No. 15 September 11, 2024

Author Copy

NAVIGATING SECURITIES PROHIBITIONS IN U.S. SANCTIONS

In this article, the authors explore the complexities of navigating the U.S. sanctions and securities paradigm. They specifically examine three distinct U.S. sanctions programs: the Russian Harmful Foreign Activities Sanctions Regulations, Venezuela Sanctions Regulations, and Chinese-Military Industrial Complex Sanctions Regulations, and the varying securities-related prohibitions associated with each. The authors highlight best practices for market participants to consider incorporating into their corporate compliance programs to ensure adherence to these sanctions regulations.

By Laura Deegan, Annie Cho, and Igor Dos Santos *

American market participants are accustomed to navigating complicated regulatory frameworks as they must adhere to substantial disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934. Most are familiar with laws on insider trading, transaction exemptions, and pay compensation — including safe harbors. However, other regulations may be less familiar to hedge fund managers and private equity analysts — such as those related to U.S. sanctions — despite being just as complex. In recent years, U.S. sanctions regulations have increasingly affected global trading and securities transactions, as such sanctions have often included prohibitions on the trading of certain sovereign debt, currency-use restrictions, bans on trading of stock in specific companies, and in the case of some securities, bans on secondary trading.

This article describes securities-related measures enacted in three distinct U.S. sanctions programs: the Russian Harmful Foreign Activities Sanctions Regulations ("RuHSR");[1] the Venezuela Sanctions Regulations ("VSR");[2] and the Chinese-Military Industrial Complex Sanctions Regulations ("CMIC").[3] These regulations are issued by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"), which is the agency in the United States that administers and enforces sanctions. As each set of regulations varies in scope, in terms of securities-related prohibitions, it is necessary for an institution's compliance program to consider varying limitations with right-sized controls and personnel who are well versed in OFAC guidance. Such guidance is not always tailored for the securities industry, as OFAC's expertise is more commonly centered on foreign policy and national security measures rather than on swaps, derivatives, and other complex financial products. However, with the rise of sanctions prohibitions affecting global and

[1] 31 C.F.R. pt. 587.

[2] 31 C.F.R. pt. 591.

[3] 31 C.F.R. pt. 586.

* *LAURA DEEGAN is counsel, ANNIE CHO is an associate, and IGOR DOS SANTOS is a summer associate at Miller and Chevalier Chartered's Washington, DC office. Their e-mail addresses are ldeegan@milchev.com, acho@milchev.com, and idossantos@milchev.com.*

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

domestic securities changing, securities firms must be proactive in understanding U.S. sanctions prohibitions and creating compliance programs that take into account controls to combat potential violations.

Below, we discuss the discrete differences in securities-related prohibitions among the RuHSR, VSR, and CMIC regulations, penalties for failure to comply with OFAC regulations, and compliance best practices for the securities industry for both U.S. and non-U.S. securities firms.

SANCTIONS OVERVIEW

The Federal Government uses economic sanctions in part to administer the national security and foreign policy directives of the president.[4] Under the International Emergency Economic Powers Act ("IEEPA"),[5] the president has the power to declare a national emergency in response to a foreign threat and then direct the Secretary of the Treasury to block, freeze, or restrict the trade of assets. Since its enactment in 1977, the use of IEEPA has "increased in frequency and length."[6] As noted above, OFAC is the federal agency responsible for administering and enforcing sanctions, by way of IEEPA.

The RuHSR and the URSR

The Russian Federation has been subject to U.S. economic sanctions since it annexed the Crimea region of Ukraine in 2014.[7] Under the Ukraine-/Russia-related Sanctions Regulations ("URSR"),[8] U.S. persons were restricted from engaging in certain investments in certain targeted Russian entities. For example, Directive 1, as amended, to Executive Order ("E.O.") 13662[9] restricts U.S. persons from transacting in certain "new" debt or "new equity" issued after certain maturity dates, or other "dealings in new debt" or "new equity" of persons subject to the directive.[10] This directive included several large Russian financial institutions. Other directives prohibited similar transactions with targeted entities operating in the defense and energy sector of Russia.

Following Russia's full scale invasion of Ukraine in early 2022, the U.S. President issued new Russia-related E.O.s in response, enacting what some call the most stringent non-embargo sanctions program in effect to date.[11] This program, operating under the RuHSR, imposes additional restraints on the Russian economy in part by limiting its access to the international financial market.[12] Allies from across the globe have joined in these efforts and enacted separate measures that target the Russian Federation economy.[13]

---

[4] Tom C.W. Lin, *Financial Weapons of War*, 100 Minn. L. Rev. 1377, 1399–1400 (2016) (describing the evolution of the use of economic sanctions in the United States from the early nineteenth century to the War on Terror.).

[5] 50 U.S.C. §§ 1701–1707.

[6] Congressional Research Service, *The International Emergency Economic Powers Act: Origins, Evolution, and Use* at 17 (Mar. 20, 2019), https://crsreports.congress.gov/product/pdf/R/R45618/2#:~:text=IEEPA%20grants%20sweeping%20powers%20to,IEEPA%20authorities%20to%20impose%20sanctions.

[7] Michael Kofman et al., *Lessons from Russia's Operations in Crimea and Eastern Ukraine*, RAND Corp. (May 9, 2017), https://www.rand.org/pubs/research_reports/RR1498.html; Congressional Research Service, U.S. Sanctions on Russia: Legal Authorities and Related Actions 8 (April 26, 2024), *available at* https://crsreports.congress.gov/product/pdf/R/R48052/4.

[8] 31 C.F.R. pt. 589.

[9] E.O. 13662, 79 Fed. Reg. 16,169 (Mar. 20, 2014).

[10] OFAC, *Directive 1 (as Amended on September 29, 2017), Under Executive Order 13662* (Sept. 29, 2017), https://ofac.treasury.gov/media/8696/download?inline.

[11] Lev E. Breydo, *Political Default. The Implications of Weaponizing Global Financial Infrastructure*, 56 U.C. Davis L. Rev. Online 53, 55–56 (2023).

[12] OFAC, Frequently Asked Question (FAQ) 886 (updated Feb. 23, 2024), https://ofac.treasury.gov/faqs/886.

[13] Statements & Releases, The White House, *FACT SHEET: Biden Administration Expands U.S. Sanctions Authorities to Target Financial Facilitators of Russia's War Machine*

footnote continued from previous column…

The RuHSR contains restrictions, for example, that prohibit U.S. persons from purchasing Russian securities, including sovereign debt, as well as those that prohibit U.S. persons from providing capital to persons in Russia. One such prohibition is Directive 1A to E.O. 14024, issued (as an amendment) in February 2022, which prohibits U.S. financial institutions from participating in the primary or secondary market for ruble or non-ruble bonds issued by the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, or the Ministry of Finance of the Russian Federation.[14] Further, such institutions are prohibited from lending ruble or non-ruble funds to these sovereign entities. These restrictions "had the practical effect of 'freezing' about $325 billion of Russia's foreign reserves held in U.S., European, and Japanese financial institutions."[15]

Additionally, Directive 4 (as amended) to E.O. 14024 prohibits U.S. persons from transacting *with* the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, or the Ministry of Finance of the Russian Federation,[16] effectively immobilizing U.S. nexus transactions with such sovereign entities at its inception. Lastly, and perhaps most importantly, E.O. 14071, issued in April 2022, prohibits "new investment" in the Russian Federation by a U.S. person.[17] Through its guidance, OFAC has defined "investment" as the "commitment of capital or other assets for the purpose of generating returns or appreciation."[18] It interprets "new" investment as a commitment made on or after the effective date of the E.O 14071.[19] It further includes any purchasing or selling of any debt or equity issued by an "entity in the Russian Federation," even in the secondary market.[20] However, "new investment" does not include a U.S. fund containing Russian equity or debt, provided that such securities do not represent 50 percent or more of the value of the fund.[21] Moreover, "new investment" does not include the "selling or divesting" of debt or equity securities to a non-U.S. person, which include those transactions necessary to effectuate the divestment.[22]

Since the inception of these prohibitions, OFAC has also issued several general licenses available to the public, authorizing certain securities-related activity. For example, when placing certain entities on its List of Specially Designated Nationals and Blocked Persons ("SDN List") OFAC has often — though not always — issued time-limited general licenses allowing for the divestment of certain debt or equity transactions involving such blocked entities. Further, in July 2022, OFAC issued a general license authorizing transactions related to a credit derivatives auction to allow credit derivatives linked to the sovereign Russian Federation to settle, after the Russian government had been determined to default on its debt.[23]

footnote continued from previous page…

(Dec. 22, 2023), https://www.whitehouse.gov/briefing-room/statements-releases/2023/12/22/fact-sheet-biden-administration-expands-u-s-sanctions-authorities-to-target-financial-facilitators-of-russias-war-machine/; *see also* Press Release, OFAC, *Targeting Key Sectors, Evasion Efforts, and Military Supplies, Treasury Expands and Intensifies Sanctions Against Russia* (Feb. 24, 2023), https://home.treasury.gov/news/press-releases/jy1296.

[14] OFAC, *Directive 1A Under Executive Order 14024* (Feb. 22, 2022), https://ofac.treasury.gov/media/918731/download?inline.

[15] S*upra* note 11.

[16] OFAC, *Directive 4 (as Amended) Under Executive Order 14024* (May 19, 2023), https://ofac.treasury.gov/media/918806/download?inline ("[T]he following activities by a United States person are prohibited [:] . . . any *transaction* involving the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, or the Ministry of Finance of the Russian Federation, including any transfer of assets to such entities or any foreign exchange transaction for or on behalf of such entities.").

[17] E.O. 14071, 87 Fed. Reg. 20,999 § 1(a)(i) (Apr. 6, 2022) ("The following are prohibited: . . . new investment in the Russian Federation by a United States person, wherever located . . . ."); OFAC, FAQ 1005 (updated May 19, 2023), https://ofac.treasury.gov/faqs/1005 ("[T]he 'new investment' prohibitions of E.O.14066, E.O. 14068, and E.O. 14071 prohibit U.S. persons from purchasing debt and equity securities issued by an entity in the Russian Federation.").

[18] OFAC, FAQ 1049 (June 6, 2021), https://ofac.treasury.gov/faqs/1049.

[19] *Id.*

[20] OFAC, FAQ 1054 (updated Jan. 17, 2023), https://ofac.treasury.gov/faqs/1054.

[21] OFAC, FAQ 1055 (updated Jan. 17, 2023), https://ofac.treasury.gov/faqs/1055.

[22] *Supra* note 20.

[23] OFAC, *General License No. 46: Authorizing Transactions in Support of an Auction Process to Settle Certain Credit Derivative Transactions Prohibited by Executive Order 14071*

The VSR

The VSR was established in response to alleged human rights abuses occurring in Venezuela under the Maduro regime. Beginning in 2017, the U.S. Government began ramping up sanctions on Venezuela, with additional sanctions imposed on the Government of Venezuela, particularly pertaining to securities.

E.O. 13808, issued in August 2017, prohibits U.S. persons from transacting in "new equity" of the Government of Venezuela,[24] prohibits transacting in "new debt" of the Government of Venezuela which has a maturity of greater than 30 days,[25] and prohibits transacting in "new debt" with a maturity of greater than 90 days of state-owned Petróleos de Venezuela, S.A ("PDVSA").[26] The E.O. also prohibits transacting in *any* bonds issued by the Government of Venezuela issued prior to August 24, 2017,[27] or receipt of dividend payments or other distributions of profits from the Government of Venezuela.[28]

The VSR however, like the RuHSR, contains a number of general licenses (which are self-executing) allowing U.S. persons to engage in certain securities related activity with respect to otherwise blocked assets of the Government of Venezuela or PDVSA. Such licenses previously allowed U.S. persons only to divest certain prohibited debt to non-U.S. persons, even on the secondary market. However, in October 2023, OFAC issued licenses that allowed for secondary market trading, including between U.S. persons of specified Government of Venezuela or PDVSA debt.[29]

CMIC

The CMIC regulations were issued in 2022, but the underlying E.O. from which their authority stems was issued by the U.S. Government in November 2020. E.O. 13959,[30] as amended by E.O. 14032,[31] was enacted in response to an alleged growing threat posed by the Chinese military sector. The prohibitions of the E.O. center around targeted publicly traded securities, including its derivatives of specified Chinese entities.[32] Specifically, under the CMIC regulations it is prohibited for U.S. persons to transact in such publicly traded securities 60 days after the underlying issuer is listed by OFAC. Under E.O. 14032, the term "publicly traded securities" includes any "security" as defined in section (a)(10) of the Securities Exchange Act of 1934.[33] The CMIC sanctions do allow divestment to non-U.S. persons up until 365 days of the listing date of the entity issuer. This is very different from the RuHSR's "new investment" prohibition, which allows for divestment and selling to non-U.S. persons without such time limitation.

OFAC guidance indicates that "publicly traded securities" also include "over-the-counter" securities, but omit others, such as private placements.[34] Financial instruments that qualify as "any publicly traded securities that are derivative of such securities," include, but are not limited to, "derivatives (e.g., futures, options, swaps), warrants, American depositary receipts ("ADRs"), global depositary receipts ("GDRs"), exchange-traded funds ("ETFs"), index funds, and mutual funds . . . ."[35] To assess whether a security falls under the program, market participants "may rely uponthe information available to them in the ordinary course of business."[36]

ENFORCEMENT TRENDS AFFECTING THE SECURITIES INDUSTRY

Over the years, relatively few OFAC enforcement actions have focused on the shortcomings of securities firms. While many global banks with trading divisions and broker-dealers have found themselves at the center of OFAC enforcement investigations, there have been

footnote continued from previous page…

(July 22, 2022), https://ofac.treasury.gov/media/924546/download?inline.

[24] E.O. 13808, 82 Fed. Reg. 41,155 (Aug. 24, 2017).

[25] *Id.* § 1(a)(ii).

[26] *Id.* § 1(a)(i).

[27] *Id.* § 1(a)(iii).

[28] *Id.* § 1(a)(iv).

[29] OFAC, *General License No. 9H: Authorizing Transactions Related to Dealings in Certain Sanctions* (Oct. 18, 2023), https://ofac.treasury.gov/media/932221/download?inline.

[30] E.O. 13959, 85 Fed. Reg. 73,185 (Nov. 12, 2020).

[31] E.O. 14032, 86 Fed. Reg. 30,145 (June 7, 2021).

[32] *Id.* § 1(a).

[33] *Id.* § 3(c).

[34] OFAC, FAQ 859 (June 3, 2021), https://ofac.treasury.gov/faqs/859.

[35] OFAC, FAQ 860 (June 3, 2021), https://ofac.treasury.gov/faqs/860.

[36] OFAC, FAQ 901 (June 3, 2021), https://ofac.treasury.gov/faqs/901.

few enforcement cases focusing on potential violations in relation to securities transactions. The cases that have caught the attention of enforcement authorities have focused somewhat on the opaque nature of securities custodianship, as we describe below.

One of the first securities cases involved Clearstream Banking, S.A., a non-U.S. entity, which settled with OFAC in 2014 for $152 million USD.[37] Clearstream held interests in corporate and sovereign bonds, in its omnibus account at a U.S financial institution, in which the Central Bank of Iran, a blocked entity, had a beneficial ownership interest.[38] The Clearstream matter was instructive, as OFAC stated in a related press release that "the activity in question highlights the need for vigilance in the securities industry, where vehicles such as omnibus accounts — as well as the intermediated nature of the securities custody industry itself — can serve to obscure the interests of sanctioned parties."[39]

Clearstream has been followed nearly 10 years later with OFAC's settlement with EFG International. EFG is a private Swiss bank that provides a range of financial services to a global clientele.[40] In 2023, OFAC designated a client of EFG's Swiss subsidiary as an SDN under E.O. 14024.[41] EFG restricted the client's account internally and notified U.S. custodians about the securities positions they held for the newly designated client. However, EFG's notification failed to include three securities positions that the client had pledged to EFG Switzerland before the designation, which were under EFG's name. This oversight led to at least five dividend transactions being processed in the United States in favor of the SDN. To settle its liability, EFG agreed to pay OFAC $3,740,442 USD.[42] OFAC stated that "[t]his case illustrates certain sanctions risks that financial institutions with global clientele, including foreign securities firms who hold omnibus accounts at U.S. firms, may face."[43] It went on to recommend that those firms "ensure risk-based controls are in place to prevent U.S. firms from inadvertently providing services to sanctioned parties or jurisdictions."[44]

In the EFG settlement overview, OFAC pointed to guidance in a 2014 Frequently Asked Question ("FAQ") where it listed five compliance best practices for securities intermediaries in identifying beneficial owners of assets (to ensure such owners are not designated persons).[45] Specifically, firms should (1) advise customers of sanctions compliance obligations and have them agree not to use their accounts in ways that could violate OFAC sanctions; (2) use questionnaires to identify customers involved with countries or persons subject to U.S. sanctions; (3) impose restrictions on products or services for high-risk customers, particularly those utilizing omnibus accounts which can obscure transactions; (4) gather information about third parties whose assets may be held in non-proprietary accounts to identify potential red flags; and (5) regularly check accounts for unusual or suspicious activities, like significant unexplained changes in asset value orvolume, which might indicate unvetted third-party transactions with possible sanctions implications.[46]

SANCTIONS COMPLIANCE BEST PRACTICES FOR THE SECURITIES INDUSTRY

While the guidance in the aforementioned OFAC FAQ is helpful, it is limited in scope and was issued nearly 10 years ago. Since then, OFAC guidance for the security industry has been sparse. Market participants, in particular brokerage houses and smaller underwriting firms, face unique and new sanctions-related risks with the rise of sanctions programs — such as the RuHSR, VSR, and CMIC — imposing ever more complex and

[37] OFAC, Settlement Agreement (Jan. 15, 2014), https://ofac.treasury.gov/media/13466/download?inline (OFAC Settlement Agreement with Clearstream Banking, S.A. for $151,902,000 USD Related to Apparent Violations of IEEPA and the Iranian Transactions and Sanctions Regulations).

[38] *Id.*

[39] Press Release, OFAC, *Treasury Department Reaches Landmark $152 Million Settlement with Clearstream Banking, S.A.* (Jan. 23, 2014), https://home.treasury.gov/news/press-releases/jl2264.

[40] Mengqi Sun, *Swiss Private Bank EFG to Settle U.S. Sanctions Violations*, The Wall Street J. (Mar. 14, 2024), https://www.wsj.com/articles/swiss-private-bank-efg-to-settle-u-s-sanctions-violations-c8a86006.

[41] OFAC, *Enforcement Release: EFG International AG Settles with OFAC for $3,740,442 for Apparent Violations of Multiple Sanctions Programs* (Mar. 14, 2024), https://ofac.treasury.gov/media/932766/download?inline.

[42] *Id.* (EFG was also accused of violating the Cuba embargo and of processing transactions on behalf of Chinese nationals blacklisted for foreign narcotics trafficking.).

[43] *Id.* at 4.

[44] *Id.*

[45] OFAC, FAQ 335 (Jan. 23, 2014), https://ofac.treasury.gov/faqs/335.

[46] *Id.*

changing prohibitions specifically targeting securities transactions.

In May 2019, OFAC published its "A Framework for Compliance Commitments" (the "Framework"), which sets forth "hallmarks" of an effective sanctions compliance program.[47] Through the Framework, OFAC encourages organizations in various industries, including securities, to implement a risk-based approach to sanctions compliance. There is no mandate that a sanctions compliance program be in place, and each program will vary depending on a company's size, products and services, customers and counterparties, and geographic locations. However, considering the various sanctions risks and challenges tethered to the securities market, securities firms should ensure they undertake a risk-based approach in developing a sanctions compliance program that incorporates the following elements: (1) management commitment; (2) risk assessment; (3) internal controls; (4) testing and auditing; and (5) training.

As indicated above, depending on the market participant's risk profile, services, and products, the controls within a sanctions compliance program may differ in size and scope. Nonetheless, securities firms should ensure their compliance programs take into account the following recommended controls, from the Framework:

- advanced screening procedures to monitor transactions, clients, and counterparties against OFAC's SDN list;
- automated compliance and monitoring systems to ensure real-time tracking of sanctions changes and enforcement of compliance policies;
- ongoing training for employees on sanctions regulations, updates, and compliance protocols to ensure all staff are aware of their responsibilities, and in particular, personnel in key gatekeeping functions;
- conducting of thorough due diligence on new and existing clients, including beneficial ownership verification as required by the Financial Crimes Enforcement Network ("FinCEN"), to determine whether an issuer of securities, for example, is owned 50 percent or more by a blocked person;
- development and maintenance of detailed internal policies and procedures tailored to sanctions compliance, including clear escalation processes for potential breaches;
- performance of periodic audits of a firm's sanctions compliance program to ensure effectiveness and address any deficiencies;
- keeping abreast of changes in applicable sanctions laws and regulations, and modification of compliance programs accordingly; and
- maintenance of comprehensive and organized records of all transactions, screening activities, and compliance measures.

While the above list is not meant to be exclusive, market participants should consider incorporating such controls to remain vigilant against sanctions risk with respect to securities transactions. In situations where market participants are subject to an OFAC enforcement action related to violations of securities-related prohibitions, existence of a sanctions compliance program may mean reduced fines or even declination to prosecute. As demonstrated in the case of EFG, approximately 25 percent of the total fine was "suspended," pending satisfactory completion of certain compliance commitments. A robust sanctions compliance program that is aligned with OFAC's Framework will allow market participants to identify any vulnerabilities to certain securities transactions and mitigate potential violations of securities-related prohibitions delineated across U.S. sanctions programs. ■

[47] OFAC, *A Framework for OFAC Compliance Commitments* (May 2, 2019), https://ofac.treasury.gov/media/16331/download?inline.

The Review of Securities & Commodities Regulation