Possible International Trade Consequences of Further Escalation of Conflict in Ukraine

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Key Takeaways:

- **The U.S., EU, and UK are coordinating a significant sanctions and export controls package to be implemented if Russia takes further action in Ukraine**
- **Restrictions are likely to target key Russian industries including finance, energy, and defense and would be far more severe and far-reaching than past sanctions.**
- **New export controls could include restrictions on foreign-produced items made using U.S.-origin technology or software, and a possible ban on a significant range of exports to Russia from the U.S. and its allies.**
- **Individuals or companies with business interests or investments in Russia should begin or continue contingency planning to mitigate risk.**

For months, the Biden administration and the governments of U.S. allies around the world have raised concerns about Russian actions in the region. In the same breath, those governments have warned of massive, coordinated sanctions against Russia as the certain response to an escalation of the conflict. Despite months of diplomacy, tensions have soared and there are now too many tea leaves to dismiss as merely hypothetical the threats of a renewed armed conflict breaking out in the region and the resulting crippling sanctions.

The Biden administration has now assessed that Russia has massed sufficient forces around Ukraine to launch an invasion. The U.S. and allied countries (as well as Russia) have ordered diplomatic staff and private citizens to leave Ukraine immediately, and there was a vote in the Russian parliament to request that Putin recognize two breakaway regions in eastern Ukraine. A superyacht alleged to be owned by Putin recently abruptly sailed from Germany, where it was undergoing renovations, to the nearby Russian enclave of Kaliningrad prior to the completion of the work on the vessel, in an apparent attempt to avoid its seizure in the event Putin himself is personally sanctioned.

While a new escalation of the armed conflict may seem imminent, the situation is rapidly developing, and may quickly swing from escalation to de-escalation to something in between. We do not know when or if military action will occur; however, the Biden administration has made it clear that sanctions and exports controls will be part of the response of the U.S. and its allies. Any individuals or companies with business interests or investments in Russia should escalate contingency planning if they have not already done so. In order to assist with these efforts, we have outlined sanctions, export, and investment controls that may be imposed against Russia, and what steps individuals or companies can take now to mitigate the economic impact of such actions.

Russia

Sanctions:

One of the hallmarks of U.S. sanctions policy in the first year of the Biden administration has been a preference for sanctions coordinated with allies including Canada, the EU, and the UK. It is certain that any new sanctions on Russia will follow this model. As outlined below, the U.S. and its allies have a variety of sanctions options from which to choose.

a. List-Based Sanctions

The U.S., EU, and UK all maintain lists of specific individuals and entities subject to comprehensive sanctions that typically involve the freezing of the person's assets, as well as a prohibition on further business dealings with listed entities. The U.S. Department of the Treasury's Office of Foreign Assets Control's ("OFAC") Specially Designated Nationals and Blocked Persons List ("SDN List") is perhaps the most well-known.

Among the most likely targets of list-based sanctions include:

i. **Banks**: Sberbank, VTB, Gazprombank, VEB.RF, The Russian Direct Investment Fund, Credit Bank of Moscow, Alfa Bank, Rosselkhozbank, FC Bank Otkritie, Promsvyazbank, Sovcombank, and Transkapitalbank have been specifically mentioned in the press and in pending sanctions legislation in the U.S. Senate.

ii. **Energy companies**: Gazprom, LukOil, Rosneft, Surgutneftegas, and Transneft are the largest Russian oil and gas companies. Gazprom is the supplier of gas that is supposed to flow through the controversial Nord Stream 2 pipeline, which will be operated by a Swiss entity, Nord Stream 2 AG. One way to stop the pipeline, which has been publicly threatened by President Biden, would be to sanction the Swiss entity. Germany, one of the main beneficiaries of the pipeline, has recently signaled that a renewed escalation of the conflict could mean the end of the project.

iii. **Defense/Aerospace sector**: United Aircraft Corporation, Tactical Missiles Corporation, Uralvagonzavod, and United Shipbuilding Corporation are all major Russian defense companies that would make logical targets in response to Russian military action.

b. SDN List Designation of Putin and Government Officials

In addition to targeting certain sectors of the Russian economy, specific sanctions are expected to target Russian President Vladimir Putin, along with key Russian government officials. These individuals could be operating in any sector of the Russian economy and would be designated by OFAC. White House Press Secretary Jen Psaki has described these individuals as "in or near the inner circle of the Kremlin," and noted that they are especially vulnerable to sanctions due to their financial ties to the U.S. and Western Europe, as many hold investments outside of Russia. While the U.S.

government has not released a list of potential targets, it is likely that many would appear on the Report on Senior Foreign Political Figures and Oligarchs in the Russian Federation, which includes Russian individuals with an estimated net worth of $1 billion or more, as well as individuals who are senior members of the Russian Presidential Administration, members of the Russian Cabinet, ministers, heads of other major executive agencies, and other senior political leaders and senior executives at state-owned enterprises. This report was provided to Congress by the Department of the Treasury in 2018 pursuant to the Countering America's Adversaries Through Sanctions Act of 2017 ("CAATSA").

If added to the SDN List, all U.S. assets held by such individuals would be frozen, and U.S. persons would be prohibited from engaging in most transactions with the designated persons. These sanctions are also likely to apply to close family members of those designated, such as spouses and children. As a result, the children of designated individuals could be banned from attending U.S. universities, which is common for the children of Russian elites. The EU and UK have also announced that they would implement similar sanctions on "inner circle" individuals in parallel with the U.S. In addition, both the U.S. and EU apply sanctions to entities owned or controlled by designated individuals (known as the "50% rule"). This will create significant compliance challenges for individuals and companies trying to assess whether sanctioned individuals own or control business partners as the assets of the Russian political and economic elite are notoriously difficult to scrutinize. Putin, for example, is estimated to have $200 billion in assets, but appears nowhere on the Forbes list of richest persons in the world, though such a net worth would place him at the top of the list.

c. Sectoral Sanctions

If economic or political realities result in the U.S. and its allies deciding not to use list-based sanctions on specific entities, they could rely on so-called sectoral sanctions, which impose restrictions on certain transactions with companies in a targeted sector. The U.S., for example, currently imposes sectoral sanctions on Russia's financial, energy, and defense sectors. Sectoral sanctions could be expanded to cover additional transactions within these three sectors or they could target other industries, such as commodities (beyond oil and gas) or manufacturing. These sanctions could also be deployed in tandem with list-based sanctions.

d. Sovereign Debt Restrictions

U.S. financial institutions are currently prohibited from participating in the primary market for ruble or non-ruble denominated bonds issued after June 14, 2021, by the Russian Central Bank, the National Wealth Fund of the Russian Federation, or the Russian Ministry of Finance. U.S. financial institutions also cannot lend funds to these three entities. There is a significant loophole to these restrictions in that U.S. financial institutions are still permitted to participate in the secondary market for Russian sovereign debt. An escalation of the conflict could result in the expansion of restrictions to the secondary market, which is a step the U.S. recently took with Belarusian sovereign debt. The move would largely freeze Russia out of the global bond markets, seriously impeding its access to debt financing. Russia currently runs budget surpluses and has large foreign currency reserves, but that could quickly change under the bite of international sanctions making the debt restrictions a potent tool.

e. SWIFT

Disconnecting Russian banks from the Society for Worldwide Interbank Financial Telecommunication ("SWIFT") messaging system is another potential sanction. SWIFT is a Belgian messaging service that connects over 11,000 financial institutions globally. The service is not used to actually transmit funds, but instead allows members to alert one another of upcoming transactions. Removing Russian financial institutions from the SWIFT system would dramatically hinder, if not stop, a significant number of transactions involving Russian banks. The result could be global financial turmoil. Russia has also developed its own messaging system, but it is limited in scope. Recent press reports have indicated that U.S. and EU officials are focusing on sanctioning Russian banks rather than leveraging SWIFT, likely in order to limit unintended consequences to the global financial system.

f. Investment Controls

While disconnecting Russia from SWIFT has received significant press attention, potential investment restrictions have not. During the Trump administration, and continuing (and expanding) under the Biden administration, the U.S. published a list of Chinese companies deemed to be part of the Chinese Military-Industrial Complex ("CMIC"). U.S. individuals and entities are prohibited from conducting any transaction in publicly traded securities of these companies, including derivatives or other investments designed to provide exposure to securities. It is conceivable that the U.S. could prepare a list of Russian companies that pose a national security threat to the U.S. and impose similar investment controls to those imposed on CMIC entities. It is unclear how much time investors would be given to unwind positions in impacted Russian entities.

U.S. Export Controls

a. Country Group E Designation

The most serious export control restriction that could be applied is for the Department of Commerce’s Bureau of Industry and Security ("BIS") to downgrade Russia to Country Group E under the Export Administration Regulations ("EAR"). Russia is effectively in Country Group D:5 at the moment, along with China, a categorization that nevertheless permits exports of many products without an export license. Country Group E is reserved for comprehensively embargoed countries, specifically Cuba, Iran, North Korea, and Syria. This would mean that many additional items exported from the U.S. or that are of U.S. origin would require an export license to send to Russia, including software with standard encryption, many aircraft parts, and a host of other, off-the-shelf, commercial items. Not only would this increase the burden on exporters who would now need to apply for, and manage, export licenses, but license applications would presumably be subject to a policy of denial by BIS. It is also likely that processing and reviewing such applications would take BIS a considerable amount of time, further delaying any transactions that were allowed to move forward.

b. Foreign Direct Product Rule

U.S. export controls include the Foreign Direct Product Rule, whereby foreign-produced items located outside the United States are subject to the EAR when they are a “direct product” of specified “technology” or “software,” or are produced by a plant or “major component” of a plant that itself is a "direct product" of specified "technology" or "software." The Trump administration used an expanded version of this rule to restrict the export of items to Huawei that otherwise would not have been subject to U.S. export controls. The Biden administration could similarly lower the threshold for when the Foreign Direct Product Rule would apply to exports to Russia. Indeed, on January 25, 2022, two senior Biden administration officials threatened "novel" export controls, should Russia take action in Ukraine, that could well allude to a more expansive version of the Foreign Direct Product Rule.

c. Application of the *de minimis* Rule

Currently, foreign-origin items that incorporate more than 25 percent of certain U.S.-origin content require a license if exported to Russia from outside the U.S. This is known as the *de minimis* rule and is applicable to other countries beyond Russia. However, if Russia were to be downgraded to Country Group E, as discussed above, the types of U.S.-origin hardware, software, and technology encompassed by the rule would expand significantly, and the threshold content would drop from 25 percent to a mere 10 percent. The result would be that many non-U.S. exporters would face the often daunting task of calculating the percentage of U.S.-origin content in each of their products (particularly difficult when the content is software or technology) and potentially having to apply for U.S. export licenses to export such products to Russia.

d. EU/NATO Country Export Controls and Sanctions

In addition to U.S. sanctions and export controls and their potential extraterritorial application, companies and individuals with business interests in Russia cannot afford to ignore what we must assume will be materially similar sanctions and export controls from the EU, UK, and other NATO countries, including Canada. The likely result, which is certainly the intent of these Western allies, is to leave few places in the world to hide from the impact of sanctions against Russia.

Belarus

In response to what the U.S. deemed a fraudulent presidential election in Belarus on August 9, 2020, and the violent political repression that followed, the U.S. has launched five rounds of sanctions against the country in coordination with Canada, the EU, and the UK. Sanctions have targeted government officials and businesspeople as well as major construction, petrochemical, potash (fertilizer), and tobacco product companies. Of particular note was the imposition of restrictions on dealings in new issuances of Belarusian sovereign debt in both the primary and secondary markets, which, as noted above, may serve as a model for future sanctions against Russia. Although major industries in Belarus have already been heavily sanctioned, the risk of further sanctions against the country remains very high, especially if Belarus assists Russia in the conflict. Belarus is currently hosting tens of thousands of Russian forces and participating in a menacing military exercise with Russia near the border with Ukraine. It is conceivable that the Department of Commerce could add Belarus to Country Group E along with Russia given its close ties (the two countries form a so-called Union State, which aims to integrate the countries economically and militarily) and be subject to a comprehensive sanctions program by the U.S. and its allies.

Ukraine

The Biden administration has said little about what U.S. policy would be towards an occupied Ukraine. Its treatment of Crimea could be illustrative. There, the U.S. imposed sanctions on individuals and entities operating in Crimea and has prohibited the import or export of goods, services, or technology to or from the Crimea region. In addition, U.S. persons are barred from making new investments in the Crimea region. As a result, most U.S. companies, and many non-U.S. companies with connections to the U.S., treat Crimea as off-limits, akin to Cuba, Iran, North Korea, and Syria. The U.S. and EU will need to balance support of the Ukrainian people with not wanting to assist in economically supporting the government of an occupied Ukraine.

China

In a move certainly designed, in part, to blunt the impact of U.S. and EU sanctions, Russia agreed to supply an additional 10 billion cubic meters per year of natural gas to China. Russia's Gazprom signed the deal with China National Petroleum Corporation ("CNPC") on February 4, 2022. Gazprom is currently subject to limited U.S. sanctions that prohibit U.S. persons from entering into transactions, directly or indirectly, in relation to oil exploration or production involving deepwater, Arctic offshore, or shale projects that either: (a) have the potential to produce oil in Russian Federation territory, including maritime territory claimed by the Russian Federation; or (b) if the project was initiated on or after January 29, 2018, has the potential to produce oil in any location and Gazprom has (a) 33% or greater ownership interest, or (b) ownership of a majority of the voting interests. Gazprom is not currently subject to EU sanctions, which is perhaps why the deal with CNPC is structured to settle in euros. This is nevertheless an odd choice because Gazprom would almost certainly be targeted by the EU, U.S., and UK for significant sanctions, including placement on OFAC's SDN List. CNPC is not currently subject to U.S. sanctions and, in the past, has suspended its involvement in transactions in Venezuela and Iran that risked running afoul of U.S. sanctions.

This raises the question of whether the deal is worth the paper it is printed on, as it would seem unlikely, based on past conduct, that CNPC or other Chinese entities would risk secondary sanctions or other penalties from violating U.S. sanctions. Nevertheless, a newly-assertive China, armed with anti-sanctions blocking laws, could be signaling that its willingness to abide by Western sanctions is at an end. This, in turn, raises the specter that Chinese firms could themselves be targeted for actions that appear to support and enable Russia's actions.

Far-Reaching Impacts of U.S. Sanctions and Export Controls

a. Secondary Sanctions

Even individuals and companies located in countries that do not impose sanctions on Russia may nevertheless be impacted. Under certain sanctions programs, including those related to Iran, persons without a connection to the U.S. can be subject to U.S. extraterritorial sanctions known as "secondary" sanctions. Through secondary sanctions OFAC claims authority to impose sanctions on persons who fail to abide by U.S. sanctions. It is possible that secondary sanctions could form part of the U.S.'s response to an escalation of the conflict in the region.

b. Facilitation & Causing

OFAC regulations prohibit U.S. persons from facilitating transactions by non-U.S. persons with sanctioned parties. Thus, companies hoping to avoid complying with U.S. sanctions by using entities located outside of the U.S. to deal with sanctioned persons must be careful not to involve U.S. persons in the transaction. Further, OFAC has pursued non-U.S. entities under a "causing" theory, wherein the non-U.S. entity causes a U.S. person to violate sanctions.

c. Extra-Territorial Export Controls

As noted above, U.S. export controls include the Foreign Direct Product Rule, which could be expanded to assert U.S. jurisdiction over a wide range of items made using American technology or tools. In addition, items made outside of the U.S. that incorporate more than a *de minimis* amount of certain U.S. content (hardware, software, or technology) are also subject to U.S. exports controls, whether or not they were produced using U.S.-origin technology or software. Companies located outside of the U.S. need to carefully monitor whether the Foreign Direct Product Rule or *de minimis* rule are expanded in the context of exports to Russia.

What to Do?

Individuals and companies with customers, suppliers, or operations in Russia, Ukraine, or Belarus should strongly consider taking the following steps to mitigate international trade risks should the conflict escalate in the region:

- Closely monitor press reports and government communications related to the situation in Ukraine;
- Continue to make preparations to evacuate employees and staff in Ukraine and secure, to the extent possible, facilities located in the country;
- Develop and update contingency plans for operations in Ukraine including shifting work to other facilities outside of the country;
- Compile a list of all Russian, Ukrainian, and Belarusian customers, suppliers/vendors, and other business partners or counterparties (including Russian financial institutions involved in any transactions and non-Russian counterparties ultimately owned by a Russian entity);
- Review outstanding contracts, invoices, and purchase orders with those entities to understand contractual rights in the event that sanctions, investment, or export controls prevent either party from performing its obligations;
- Strengthen due diligence procedures to ascertain whether any customers, suppliers/vendors, and other business partners or counterparties are owned or controlled by Russian individuals or entities that may become sanctioned in the future;
- Identify investments in Russian companies, either direct or indirect, that may require immediate divestment;
- Prepare to quantify accounting losses from uncollected debts, lost contracts, or the closing of operations in Ukraine; and
- If exporting to Russia, Ukraine or Belarus, evaluate which exports may be subject to an expanded Foreign Direct Product or *de minimis* rule.

Companies with questions about these actions or how to ensure compliance with U.S. sanctions and export control regulations should contact a member of Foley Hoag's Trade Sanctions & Export Controls practice.