

# A CRUDE AWAKENING

## *U.S. Sanctions on the Russian Oil Sector*

BY

**OLGA TORRES**  
Managing Member  
Torres Law Customs & Global Trade

**ANDREA FRASER-REID**  
Senior Counsel  
Torres Law Customs & Global Trade

**DERRICK KYLE**  
Associate  
Torres Law Customs & Global Trade

### Introduction

This article will discuss U.S. economic sanctions on Russia as enforced by the Office of Foreign Assets Control ("OFAC"), a government agency within the U.S. Department of the Treasury. Specifically, we will provide an overview of Directive 4 to Executive Order 13662 ("Directive 4"), which prohibits certain transactions related to the Russian oil sector.<sup>1</sup> While Directive 4 does not prohibit all oil sector transactions with companies in Russia, it does create many potential obstacles for U.S. businesses. We will also briefly discuss Russian oil sector prohibitions administered by the Department of Commerce Bureau of Industry and Security ("BIS").<sup>2</sup> Russia and Texas are two of the largest producers of oil and gas in the world, and, because many companies involved in the petroleum industry in Texas have dealings with Russian entities or individuals, they are likely to be faced with sanctions issues. Below we describe some of the issues that need to be addressed prior to the commencement of transactions involving Russian parties in the context of certain oil exploration and production activities.

### Background

U.S. economic sanctions are a tool of foreign policy that target countries as well as activities related to national security and other foreign policy-based concerns, such as terrorism, narcotics trafficking, human rights, and cybersecurity. In 2014, the Obama Administration implemented various economic sanctions against Russia in response to Russia's occupation of the Crimea region of Ukraine. These sanctions



programs included: 1) a trade embargo against Crimea; 2) blocking sanctions against persons listed on the Specially Designated Nationals and Blocked Persons ("SDN") List; and 3) sectoral sanctions prohibiting certain transactions with persons identified on the Sectoral Sanctions Identification ("SSI") List.<sup>3</sup> President Obama's sanctions were implemented primarily through a series of Executive Orders.

In August 2017, President Trump signed the Countering America's Adversaries Through Sanctions Act ("CAATSA"). This comprehensive, bipartisan sanctions regime targeted Russia, North Korea, and Iran. The part of CAATSA that focuses on Russia, the Countering Russian Influence in Europe and Eurasia Act of 2017 ("CRIIEEA"), codified many of the Executive Orders implemented during the Obama Administration.<sup>4</sup> Additionally, CRIIEEA

expanded the existing scope of sanctions on Russia as well as implemented new secondary sanctions (sanctions that apply to activities by non-U.S. individuals and entities).<sup>5</sup> The sanctions on Russia were passed in response to Russia's cyber meddling in the 2016 elections as well as their continued occupation of the Crimea region of Ukraine.

Specifically, the relevant Russian sectoral sanctions are implemented through four directives. Directives 1 through 3 prohibit and impose restrictions on various kinds of financial transactions between U.S. persons and individuals or entities identified on the SSI List. Directive 4 is slightly different from the other Directives in that it provides more tangible restrictions on exports of goods and non-financial services related to the Russian oil industry.

## Directive 4

### *Directive 4 prohibits:*

The provision, exportation, or reexportation, directly or indirectly, of goods, services (except for financial services), or technology in support of exploration or production for deepwater, Arctic offshore, or shale projects that:

(1) have the potential to produce oil in the Russian Federation, or in a maritime area claimed by the Russian Federation and extending from its territory, and that involve any person determined to be subject to this Directive [...]; or

(2) are initiated on or after January 29, 2018, that have the potential to produce oil in any location, and in which any person determined to be subject to this Directive... has (a) a 33% or greater ownership interest, or (b) ownership of a majority of the voting interests.<sup>6</sup>

There is a lot to unpack in Directive 4. To start, “persons subject to this Directive” means persons that are listed on the SSI List and specifically identified as subject to Directive 4. The list of parties subject to Directive 4 includes several prominent Russian energy companies, such as Gazprom, Lukoil, and Rosneft. Notably, OFAC’s 50% rule applies for purposes of the SSI List. The 50% rule states that an entity that is owned 50% or more by an individual or entity on the SSI List will also be treated as being on the SSI List. So, if Company A is listed on the SSI List and owns 80% of Company B, then Company B will also be considered to be on the SSI List. OFAC also applies the 50% Rule in conjunction with aggregation rules when determining which transactions are prohibited. For example, Company A and Company B are both listed on the SSI List. Company A owns 30% of Company C, while Company B owns 25% of Company C. Company C would be considered to be on the SSI List, because it is owned 55% by entities on the SSI List.<sup>7</sup>

Further, Directive 4 was amended by CAATSA in October 2017 to add the second section of the directive related

to oil produced in any location. This updated prohibition is interesting for a couple of reasons. First, the prohibition potentially now applies to oil projects anywhere in the world. Second, this part of the prohibition focuses on ownership of or voting interests in the project by a Directive 4-subject person, rather than just the involvement of a Directive 4-subject person. Importantly, this portion of the Directive 4 prohibition applies to listed persons having only a 33% ownership interest in the specified projects. Therefore, a project with a Russian company as a minority owner in a country other than Russia could be subject to the prohibitions of Directive 4.

Another important aspect of Directive 4 is the meaning of the terms used in the directive. As with many other sanctions regimes, the terms used do not necessarily carry their ordinary meanings. OFAC provided the definitions of some important terms in the Frequently Asked Questions (“FAQs”) section of its website:

- **Initiated.** Part of Directive 4 applies only to projects initiated on or after January 29, 2018. According to OFAC, a project is initiated when, “a government or any of its political subdivisions, agencies, or instrumentalities (including any entity owned or controlled directly or indirectly by any of the foregoing) formally grants exploration, development, or production rights to any party.”<sup>8</sup>
- **Services.** OFAC defines services to include, for example, drilling services, geophysical services, geological services, logistical services, management services, modeling capabilities, and mapping technologies. Importantly, for purposes of Directive 4, services does not include the provision of financial services, clearing transactions or providing insurance related to such activities.<sup>9</sup>
- **Deepwater.** OFAC defines deepwater as underwater activities at depths of 500 feet or more.<sup>10</sup>

- **Shale projects.** The term “shale projects” applies to projects that have the potential to produce oil from resources located in shale formations.<sup>11</sup>
- **Arctic offshore projects.** This phrase applies to projects that have the potential to produce oil in areas that (1) involve operations originating offshore, and (2) are located above the Arctic Circle.<sup>12</sup>

While the above focuses on primary sanctions, CAATSA also implements secondary sanctions. Under Section 225 of CAATSA, the President is required to impose sanctions on non-U.S. persons that knowingly make a significant investment in a “special Russian crude oil project,” which is a deepwater, Arctic offshore, or shale oil project in Russia.<sup>13</sup> The Department of State (“State”) is tasked with administering Section 225 and has stated it will determine what is “significant” on a case-by-case basis. In published guidance,<sup>14</sup> State has explained that it will not consider an investment significant if a U.S. person would not require specific licenses from OFAC to participate in the same conduct.<sup>15</sup> Section 226 of CAATSA, administered by OFAC, also now requires the imposition of secondary sanctions on Russian or other foreign financial institutions that knowingly engage in or facilitate significant transactions involving Russian deepwater, Arctic offshore, or shale oil projects.<sup>16</sup>

The penalties for violations of Directive 4 can be steep. Civil penalties can be up to \$295,141 per violation, or up to twice the value of the transaction that was the basis for the violation. Criminal, willful or knowing violations, can lead to penalties of up to \$1 million per violation and imprisonment up to 20 years for individuals.

### Screening of Parties

Because the Directive 4 prohibitions hinge on the involvement of a party on the SSI List, it is important that companies engage in the screening of all parties involved in potential transactions. Various government agencies maintain lists of

entities and individuals with whom U.S. (and sometimes non-U.S.) persons are restricted or prohibited from transacting. These lists include, but are not limited to, OFAC's SSI and SDN Lists, and the BIS Entity List. Entering into a transaction with a party on a denied party list can have grave consequences, such as sanctions, fines, or the denial of export privileges.

As such, companies should ensure that all parties to a transaction are screened. The U.S. Government provides a free screening search function that consolidates multiple government screening lists, aptly named the Consolidated Screening List ("CSL").<sup>17</sup> By searching for the name and address of an individual or company on the CSL, parties are able to screen against multiple government lists at once.

### Example

Because the minutia of the above can be complex, the following example aims to highlight the issues encountered during a Directive 4 analysis. Suppose Company A (a Texas company) plans to enter into an agreement to sell fracking fluid to Company B (a Russian company). Based on the sales agreement, Company A knows the fracking fluid will be used in a hydraulic fracturing project in Russia, and hydraulic fracturing is most often associated with shale projects. Company B is a subsidiary of Company C, which is on the SSI List and owns an unknown percentage of Company B. Finally, assume it is not clear from the sales agreement who the owner of the specific fracking project is. Company A should resolve several questions before exporting any fracking fluid to Company B in Russia. These questions include:

- Is Company B subject to Directive 4 based on Company C's listing on the SSI List?
- When was this project initiated?
- Who are the owners of the specific project, and how is this ownership structured? Is a 33% or greater owner listed on the SSI List?
- Is this project a shale project?

Even if not, how can Company A be sure the fracking fluid will not be used in a shale project?

End-use statements and other assurances from Company B stating that the project is not a shale project or subject to any U.S. sanctions would be helpful to show due diligence on the part of Company A. But OFAC sanctions violations are viewed under a strict liability standard, so if OFAC determines the fracking fluid has been used in activities prohibited by Directive 4, Company A could face an enforcement action. Additionally, it is notoriously difficult to determine the ownership structure of some Russian companies and oil projects, so Company A may not be able to obtain a verifiable answer regarding the applicability of Directive 4 to Company B or the proposed transaction. Ultimately, companies working in this space must conduct a cost-benefit analysis with regards to each proposed transaction and determine the level of risk with which they are comfortable. A legal opinion from international trade counsel can be helpful in deciding whether or not a transaction is permissible.

### BIS Rule

As if the above was not complicated enough, the Department of Commerce's export control agency, BIS, has its own prohibitions on exports to the Russian oil industry. Section 746.5 of the Export Administration Regulations ("EAR") imposes specific licensing requirements for certain parts identified in Supplement No. 2 to part 746 of the EAR as well as specific parts identified in the regulation.<sup>18</sup> These parts cannot be exported, reexported, or transferred without a license if the party knows the item will be used directly or indirectly in the exploration for, or production of, oil or gas in Russian deepwater or Arctic offshore locations or shale formations in Russia.<sup>19</sup>

Additionally, if the party is unable to determine whether the item will be used in such projects, then a BIS license is

required for export. Parties should also be aware that BIS may inform persons individually or through amendment to the EAR that a license is required for a specific end-use or end-user because there is a high risk of use in the activities specified above. Any request for such a license will likely be denied as BIS maintains a general policy of denial for such license requests.

### Latest Developments

In the latest string of Russian sanctions related developments, the State Department announced on August 8, 2018 that it would be imposing new sanctions on Russia pursuant to the Chemical and Biological Weapons Control and Warfare Elimination Act (CBWA), as a result of Russia's attempted assassination of former Russian intelligence officer Sergei Skripal and his daughter. A *Federal Register* notice was published on August 27, 2018 and more significant sanctions must be imposed in the next three months if the U.S. government finds that Russia does not meet certain conditions, absent a waiver by the President of the United States.<sup>20</sup> These potential additional sanctions should be closely monitored because there is an option for a very punitive track of sanctions depending on how the Russian government responds.

### Conclusion

Overall, Directive 4, CAATSA sanctions, and other U.S. Government regulations impose a complex network of restrictions on U.S. parties seeking to do business with the Russian oil industry. Even when OFAC and other relevant agencies provide guidance, few bright line rules exist. Whether a transaction is covered by the specific authority is determined by the facts of the specific case.

As such, it is important that parties who want to engage in transactions with the Russian oil industry conduct their due diligence. All parties to the transaction should be screened against the SSI and SDN Lists, as well as any other

denied party lists maintained by U.S. government agencies. The ownership of these parties and the interests held in oil projects must also be investigated to determine the potential involvement of sanctioned parties. Additionally, although this article focuses on Russian sanctions, other oil-producing nations, including Iran and Venezuela, among others, are subject to OFAC-administered sanctions. This means that any company engaged in oil and gas transactions with foreign companies or countries should make sure that there are no prohibitions on the transaction and conduct a review of any applicable sanctions programs.

## Endnotes

- 1 Exec. Order No. 13,662, 79 Fed. Reg. 16,169 (Mar. 20, 2014). *Countering America's Adversaries Through Sanctions Act* (CAATSA), Pub. L. No. 115-44, 131 Stat. 886 (2017).
- 2 See 15 C.F.R. § 746.5 (2018).
- 3 Briefly, the SDN List identifies individuals and entities that are targeted pursuant to U.S. sanctions programs, and the assets of SDNs in the United States are blocked (frozen) by the Department of the Treasury. While U.S. Persons generally are prohibited from engaging in any transactions with SDNs, only certain types of transactions with SSI-Listed entities are prohibited. "U.S. Person" means any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction within the United States (including foreign branches), or any person in the United States. 31 C.F.R. § 560.314 (2018).
- 4 See CAATSA § 201.
- 5 See CAATSA §§ 201-259.
- 6 U.S. Dep't of the Treasury, Resource Center, Ukraine-/Russia-related Directives, Office of Foreign Assets Control, *Directive 4 (as Amended on October 31, 2017) Under Executive Order 13662*, [https://www.treasury.gov/resource-center/sanctions/Programs/Documents/eo13662\\_directive4\\_20171031.pdf](https://www.treasury.gov/resource-center/sanctions/Programs/Documents/eo13662_directive4_20171031.pdf) (last visited Aug. 31, 2018).
- 7 See FAQ 399, U.S. Dep't of the Treasury, Resource Center, *OFAC FAQs: General Questions*, [https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq\\_general.aspx](https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_general.aspx) (last visited Aug. 31, 2018); U.S. Dep't of the Treasury, *Revised Guidance on Entities Owned by Persons Whose Property and Interests in Property are Blocked* (2014), [https://www.treasury.gov/resource-center/sanctions/Documents/licensing\\_guidance.pdf](https://www.treasury.gov/resource-center/sanctions/Documents/licensing_guidance.pdf) (last visited Aug. 31, 2018).
- 8 See FAQ 536, U.S. Dep't of the Treasury, Resource Center, *OFAC FAQs: Other Sanctions Programs*, [https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq\\_other.aspx](https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_other.aspx) (last visited Aug. 31, 2018).
- 9 *Id.* at FAQ 412.
- 10 *Id.* at FAQ 413.
- 11 *Id.* at FAQ 418.
- 12 *Id.* at FAQ 421.
- 13 See CAATSA § 225; *Ukraine Freedom Support Act of 2014*, Pub. L. No. 113-272, § 4(b), 128 Stat. 2954 (2014).
- 14 U.S. Dep't of State, Energy Sanctions, Section 225 Public Guidance, *CAATSA/CRIEEA Section 225 Public Guidance* (2017), <https://www.state.gov/enr/275194.htm> (last visited Aug. 31, 2018).
- 15 In general, licenses are required from OFAC to engage in a transaction that would otherwise be prohibited. There are two types of licenses: general licenses and specific licenses. A specific license is issued by OFAC to a particular person or entity to authorize that person or entity to engage in a particular transaction. Specific licenses are issued in response to written license applications. On the other hand, a general license authorizes a particular type of transaction for a class of persons without the need to apply for a license. So, conduct that does not require a specific license would be conduct authorized by a general license or not prohibited by OFAC.
- 16 See CAATSA § 226.
- 17 The CSL is found at <https://www.export.gov/csl-search>.
- 18 U.S. Dep't of Commerce Bureau of Industry and Security, Regulations, Export Administration Regulations, *Pt. 746 Embargoes and Other Special Controls*, § 746.5 Russian Industry Sector Sanctions; Supplement No. 2 to Part 746—Russian Industry Sector Sanction List (2017), <https://www.bis.doc.gov/index.php/documents/regulation-docs/420-part-746-embargoes-and-other-special-controls/file> (last visited Aug. 31, 2018).
- 19 *Id.*
- 20 *Determinations Regarding Use of Chemical Weapons by Russia Under the Chemical and Biological Weapons Control and Warfare Elimination Act of 1991*, 83 Fed. Reg. 43723 (proposed Aug. 27, 2018) (to be codified in 22 U.S.C. § 5604).