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State Department Allows Certain Civilian Trade to Continue with Russia's Defense Sector

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On October 27, 2017, pursuant to Section 231 of the Countering America's Adversaries Through Sanctions Act (CAATSA), the US Department of State published the list of entities that are part of, or operate for or on behalf of, the Russian defense or intelligence sectors, along with Guidance that sets out indicators of how the Trump Administration intends to implement Section 231. President Trump reluctantly signed the CAATSA on August 2, 2017, and Section 231 of CAATSA requires the imposition of sanctions on any person (US or otherwise) that, on or after that date, "knowingly…engages in a significant transaction with a person that is part of, or operates for or on behalf of, the [Russian] defense or intelligence sectors." See our previous advisory on CAATSA here. When Section 231 sanctions are triggered, the State Department (to which the authority to implement Section 231 was delegated) must impose five or more measures from a menu of sanctions. The measures range in severity from a restriction on financing by the US Export-Import Bank for exports to the sanctioned person, to more severe measures such as prohibiting US persons from conducting any transactions or dealings with the person that engages in sanctionable conduct. These measures are to be applied, beginning on January 29, 2018, to any person that engages in a significant transaction with a listed entity on or after August 2, 2017.

This provision appears to be an attempt to cut off the Russian defense sector from the global market, a remarkably bold ambition given that Russia is the world's number two arms exporter. (The largest markets for Russian defense items, in descending order, are India (which is by far the largest), Vietnam, China, Algeria, Venezuela, Azerbaijan, and Iraq.) Senior officials from the State Department, in an October 27 telephone briefing on Section 231, confirmed that its targets "could include the sale of advanced Russian weaponry around the world." However, this provision is not limited to trade in arms *per se*. The legislation refers to any "significant transaction" with the Russian defense or intelligence sectors. A "transaction" could involve goods or services; military or civilian parts and components used in the production or delivery of defense or intelligence goods or services; or even purely civilian items traded as such.

All but ten of the entities on the Section 231 List published by the State Department are currently designated on the Specially Designated Nationals (SDN) List or the Sectoral Sanctions Identifications (SSI) List, both of which are maintained by the US Department of the Treasury's Office of Foreign Assets Control (OFAC). Of course, these three sanctions programs all have different ramifications. US persons are prohibited from dealing with persons on the SDN List and are restricted from engaging in a more limited set of activities with persons on the SSI List. Under CAATSA, a so-called "secondary sanctions" authority that is not limited in application to US persons, the US government must apply sanctions to anyone, regardless of nationality, who engages in significant transactions with an entity on the Section 231 List. In this sense, Section 231 is a potential game-changer.

It is noteworthy that the Section 231 List includes names of additional entities in the Russian defense and intelligence sectors. Because the SDN and SSI restrictions also apply to non-listed entities owned 50% or more by persons on the SDN and SSI Lists, it would be prudent for any business partners of these newly-named Section 231 entities to conduct additional due diligence to determine whether they are 50% or more owned by any SDN or SSI entities.

The State Department's Guidance is silent on a number of key questions. For example, it is not clear if Section 231 applies only to entities that are specifically named on that list, or if it also applies to entities that are not named on the Section 231 list, but that are owned 50% or more by, or otherwise affiliated with, listed entities. Many of the identified Section 231 List companies have subsidiaries, some of which are in the defense or intelligence sectors (and others of which may operate in other sectors). Companies may conclude that unnamed subsidiaries and other affiliates are also the target of these sanctions, at least in cases in which the nature of that affiliation is public. The State Department Guidance, however, does not address this issue.

Section 231 only applies to transactions conducted "knowingly" with entities in the Russian defense or intelligence sectors, but the statutory definition of "knowingly" includes situations in which the person "should have known" of the relevant facts. This presumably means that there is a due diligence expectation – for example, to look into the affiliations of one's counterparties, the provenance of goods or services, etc., and determine whether sanctions may apply. The bottom line is that simply screening the names of your direct business partners against the Section 231 List may not be enough if the transaction could be considered "significant."

The Guidance also fails to address whether any existing transactions will be grandfathered. Section 231 requires the imposition of secondary sanctions on persons that engage in significant transactions with identified Russian defense and intelligence sector entities on or after August 2, 2017. But the State Department did not publish the list of entities that trigger Section 231 sanctions until October 27. How will it treat transactions that occurred in the interim period? And what about arrangements concluded before August 2, 2017 that may have options, milestones, or longer-term supply commitments, or are the subject of negotiated modifications? All of these questions call for further clarification from the State Department.

What is a "significant" transaction that could trigger sanctions under Section 231? Not surprisingly, the State Department Guidance makes clear that this is a case-by-case inquiry that looks at all of the facts and circumstances of a particular case, including diplomatic and other broader considerations. It is not simply a technical, quantitative analysis, and there are no monetary thresholds or other objective criteria that could provide any sort of "safe haven." Any

transaction with these sectors gives rise to some level of risk. The Guidance provides some insight on this issue, noting that if "a transaction for goods or services has purely civilian end-uses and/or civilian end-users, and 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." That raises some interesting questions: for example, if a civilian firearms supplier buys Kalashnikovs from an entity on the Section 231 List to sell to sporting goods stores, would that trigger sanctions? It would seem to fall squarely within the cited language from the Guidance, but any significant business with one of these entities could draw scrutiny. What about supplying listed Russian defense or intelligence sector entities with commercial items that might be used to support defense activities, such as commercial electronics used in building defense items? Or purchasing civilian goods that are produced by a defense company or its affiliate? The Guidance states: "In this initial implementation stage, our focus is expected to be on significant transactions of a defense or intelligence nature with persons named in the Guidance." Supplying beer or plywood to the Russian military may not be a transaction "of a defense or intelligence nature" in most people's view, but the Guidance does not rule out the possibility of sanctions for these types of transactions. The Russian military is a sprawling organization, much like the US military, that buys a wide range of goods from suppliers around the world, so it will be important for the State Department to make clear whether it intends to impose restrictions on purely commercial suppliers, or, for that matter, commercial customers of defense sector business units.

Addressing a situation that companies face if they import encryption-enabled items into Russia, the Guidance states that, if "a transaction is necessary to comply with rules and regulations administered by the [FSB]," or FSB investigations or enforcement actions, including rules and regulations "for the importation, distribution, or use of" IT products into Russia and any associated fees for licenses, permits, certifications, or notifications, this will again "weigh heavily against a determination that that such transaction is significant for purposes of this section." This is helpful guidance for IT importers that have to work with the FSB as a technology regulator. (There is also a related OFAC General License authorizing certain transactions with the FSB, which is on the SDN List.)

The Guidance also addresses situations of companies conducting business with the Russian defense or intelligence sectors in ways that are encouraged (or at least not discouraged) by their own governments. In a question and answer (Q&A) format, the Guidance states "Q: Are you required to sanction allied or partner states that purchase Russian-origin military equipment, spare parts, and related supplies? A: In implementing Section 231, the Department of State is mindful of the importance of unity and coordination with our allies and partners on these issues…Where possible, the United States intends to work with our allies and partners to help them identify and avoid engaging in potentially sanctionable activity while strengthening military capabilities used for cooperative defense efforts." This underscores that diplomatic engagement will be an important piece of the Section 231 program, but industry should not rely on the protective umbrella of their home governments.

State Department officials said in the October 27 telephone briefing that "certainly we're not looking at this particular sanctions legislation as some sort of competitive tool [i.e., to seek to block Russian suppliers from the global market in favor of US suppliers]. That's not the intent of Congress and certainly not the administration's intent in enforcing it." But, at the same time, the officials stated that Section 231 is "supportive and reflective of" the "longstanding policy not only in the United States, but among our NATO allies," to "reduc[e] reliance on old Soviet and Russian military equipment." Practically speaking, it could be inevitable that industrial competition considerations creep into the administration of these sanctions, and will likely be an unintended side effect, at the very least.

The Guidance states: "Where possible, the United States intends to work with persons considering transactions with persons named in this Guidance to help them identify and avoid engaging in potentially sanctionable activity." And, State Department officials said in the telephone briefing: "Our next steps, I think we are going to take a close look around the world at transactions and dealings that we think may fall within the scope of this sanctions provision, and we're going to look at really robust engagement with our partners, allies around the world based on our analysis. So we're right now in the beginning stages of that, but it's going to look – once we have a good analysis, we're going to start that robust engagement and talk to partners and allies about where we find transactions that may be problematic." This again suggests that there will be time for engagement with relevant government agencies, but should not be read as any sort of guarantee that there will be warnings or other leeway offered in the initial phases of implementing Section 231.

In considering what steps to take now, industry should not underestimate how challenging it can be to comply with wind-down orders from the US government. It would be prudent to prepare for this possibility as soon as possible. Unlike most secondary sanctions authorities, Section 231 allows the president to "delay" the implementation of sanctions in a particular case, with continuing certifications to Congress every 180 days that the party at risk of being sanctioned is "substantially reducing the number of significant transactions" in which it engages that would be sanctionable. That delay authority points to the possibility of the US government creating a "grey list" – whether public or not – of entities that are on deck for sanctions unless they wind down the business that is in the crosshairs. Using this authority could make it easier for the US Government to take action, without necessarily imposing sanctions, but in a way that could still have a significant impact for the companies involved, from pressure to wind down the activity, to "naming and shaming" through a public grey list, congressional hearings, or other fora.

It is likely that Congress will closely monitor the implementation of Section 231. As one illustration, Senators John McCain (R-AZ), Chairman of the Senate Armed Services Committee, and Ben Cardin (D-MD), Ranking Member of the Senate Foreign Relations Committee, have already issued a press release pressuring the Trump Administration to ensure that the Section 231 List is "comprehensive," and to "dedicate robust staffing and resources to the implementation effort," warning that they "will conduct focused oversight" of how the administration implements this program.

There has been some inaccurate reporting suggesting that the US government will no longer have the resources to implement Section 231, in light of recent reports that the State Department has dissolved its sanctions Coordinator's office. Several other offices at the State Department remain in place that will be responsible for implementing Section 231, including the Office of Sanctions Policy and Implementation in the Bureau of Economic and Business Affairs' Office of Counter Threat Finance and Sanctions. According to the president's delegation of authority memorandum, the State Department is to implement Section 231 in coordination with the Treasury Department, meaning that OFAC will also play a role. The State Department has published a specific email address for those with questions about this new sanctions

program (RussiaSection231Sanctions@state.gov), but one should not expect robust engagement through a public email address, and caution is always warranted in contacting the government.

Section 231 adds to a web of increasingly complex, and overlapping, sanctions provisions that implicate the Russian defense and intelligence sectors. As noted above, several Russian defense industry entities are on OFAC's SSI List under "Directive 3," which restricts US person dealings in their "new debt" of greater than 30 days' maturity. Other Russian defense industry entities are designated on OFAC's SDN List, which prohibits US persons from conducting any transactions or dealings with them and imposes an asset freeze. (And, several Russian intelligence sector entities are listed as SDNs under a separate authority related to cyberattacks.) Beyond these "primary sanctions," an array of secondary sanctions – not limited to Section 231 – target activity involving the Russian defense and intelligence sectors that is outside US jurisdiction. For example, Section 224 of CAATSA provides for secondary sanctions on persons that "knowingly" engage in "significant activities" on behalf of the Russian government "undermining cybersecurity." There are also CAATSA provisions targeting foreign persons involved in (including providing goods or services in support of) serious human rights abuses "in any territory forcibly occupied or otherwise controlled" by Russia, and those that transfer to Syria "significant financial, material, or technological support that contributes materially to the ability of the Government of Syria to" acquire or develop destabilizing weapons. In addition, there are several very broad secondary sanctions provisions in CAATSA, described in some detail in our previous advisory, which could implicate the Russian defense and intelligence sectors.

Given the bipartisan interest among members of Congress in this issue, and the Trump Administration's need to work closely with Congress to accomplish its priorities in tax reform, healthcare, and other areas, we may anticipate significant efforts by the administration to implement Section 231, primarily (but perhaps not exclusively) through diplomatic efforts to persuade governments and companies to retrench involvement with the Russian defense and intelligence sectors.

We will continue to keep you informed about sanctions developments. If you have any questions, please contact Peter Jeydel at +1 202 429 6291, Brian Egan at +1 202 429 8009, or Edward Krauland at +1 202 429 8083, in our Washington office. Further commentary is available on the Steptoe International Compliance Blog. You can also follow us on Twitter (@SteptoeIntlReg).

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