

Q&A

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The Bottom Line of Russian Sanctions' Impact on AML for Private Funds

Earlier this spring, following the Russian invasion of Ukraine, the Biden administration issued a series of executive orders imposing strong sanctions against Russia. Over the last few months, those sanctions have continued to expand, with OFAC, as well as sanctions authorities in the UK and EU, issuing dozens of new sanction regulations that impact countless segments of the global economy. Those sanctions have had a ripple effect across the investment industry, reshaping AML standards and practices for fund managers and their LPs. Below, we have presented a collection of questions and answers addressing some of the more meaningful aspects that impact fund managers today.

*This document is intended as a complement to The Bottom Line's webinar, **How Global Sanctions against Russia Impact the AML Landscape for Private Fund Sponsors and their LPs**. If you missed this installment, please see the links at the end of this document to request an invitation for access to the recordings and the electronic versions of the materials.*

General U.S./UK/EU Framework

Q: What is the basic statutory and regulatory framework pursuant to which the U.S. is imposing sanctions against Russia?

A: *The President of the United States often issues an executive order that imposes sanctions. The Executive Order typically outlines what the sanctions are, in broad terms, and sometimes comments on why the sanctions are being imposed and why they are consistent with U.S. foreign policy.*

After an Executive Order is issued, the Office of Foreign Assets Control – OFAC – issues regulations that actually tell you what you can and can't do. OFAC is part of the Treasury Department and is the agency that administers and enforces the sanctions.

After the sanctions get issued, gray areas often emerge. OFAC can never anticipate what the true effect is on the market. So people start to ask questions – those questions sometimes become FAQs that OFAC publishes and answers. Although the FAQs do not have the force of law, they provide guidance on how OFAC will interpret the sanctions regulations.

Q: What are the main government agencies involved and how do they enforce sanctions?

A: *OFAC is the main agency that enforces sanctions. Sanctions apply with strict liability – which means it does not matter if you intended to violate the sanctions or if you made a mistake – a violation is still a violation.*

However, as a practical matter, intent does matter. OFAC considers whether you tried to comply with the sanctions when it decides what penalty to impose. OFAC applies a formula where violations are classified as either “egregious” or “non-egregious”, and OFAC considers mitigating and aggravating factors when imposing a penalty.

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Sanctions are different from the FCPA or AML laws which require written compliance programs. However, in 2019, OFAC issued a framework for sanctions compliance clarifying that having a sanctions compliance program will be considered a mitigating factor in the event of a sanctions violation. OFAC's framework is a good reference for assessing whether a sanctions compliance program is adequate.

Separate from OFAC, the Department of Justice also has the power to enforce sanctions through two criminal statutes, the International Emergency Economic Powers Act (IEEPA) and the Trading with the Enemy Act (TWEA). DOJ can bring a case under these statutes only where it believes there has been a "willful" violation of the sanctions. By comparison, OFAC can bring enforcement cases based on strict liability, even where the violation is completely inadvertent and not intentional.

Q: Who do the OFAC sanctions rules apply to (do they apply to private investment funds)? Do they apply to non-U.S. persons, and what about offshore / non-U.S. private funds?

A: OFAC sanctions apply to U.S. persons and OFAC's definition of "U.S. persons" is very broad. It includes any person residing in the U.S. as well as U.S. nationals living abroad. It also includes U.S. companies and, in some cases, foreign subsidiaries of U.S. companies. Sometimes, a foreign entity can be deemed a U.S. person if U.S. persons are operating or managing the company, or otherwise controlling the company through voting shares.

In the case of offshore funds, the nexus between the fund and the U.S. – such as whether the fund has a U.S. manager or a substantial number of U.S. investors – can be significant. Unlike U.S. AML laws, which currently do not apply to private investment funds, U.S. sanctions apply to all U.S. persons.

Q: Who is responsible for enforcing sanctions in the UK/EU?

A: The United Nations (UN) imposes financial sanctions and requires EU member states to implement them through Resolutions passed by the UN Security Council. The UK sanctions regime can apply to persons and entities where the UK government has imposed sanctions unilaterally or implemented sanctions imposed by the UN.

In the UK, financial sanctions are imposed through a combination of statutory instruments through UK regulations and primary legislation: For example, the Sanctions and Anti-Money Laundering Act 2018 (Sanctions Act) which provides the main legal basis for the UK to impose, update and lift sanctions, the Terrorist Asset-Freezing etc. Act 2010 and the Counter Terrorism Act 2008, among others.

The Office of Financial Sanctions Implementation (OFSI) is responsible for implementing the UK's financial sanctions on behalf of HM Treasury. The Financial Conduct Authority (FCA) can also impose restrictions and enforcement action on firms it regulates, by way of fines, warnings and in serious

cases, striking entities or individuals from the financial services register. The Serious Fraud Office and National Crimes Agency are also able to exercise certain powers of investigation.

In Europe, decisions on the adoption, renewal, or lifting of sanctions regimes are taken by the Council of the European Union. The European Commission, together with the High Representative, give effect to these decisions adopted by the Council.

The sanctions regime imposes serious and extensive restrictions on dealing with people who are listed on the respective sanctions list. Under the legislation, they're referred to as "designated persons". Breaches of financial sanctions are a serious criminal offence. The levels of penalties for breaches of financial sanctions have been expanded and, in serious cases, custodial sentences can be imposed.

Q: What is the territorial reach of UK/EU sanctions?

A: UK sanctions apply to British citizens and British overseas citizens; UK incorporated/constituted entities; and any conduct by any persons that takes place wholly or partly in the UK or in UK territorial seas.

EU sanctions apply to nationals of EU Member States; EU incorporated/constituted entities within the territory of the EU; onboard any aircraft or any vessel under the jurisdiction of an EU Member State; and to any person in respect of business conducted in whole or part within the EU.

Q: What should a private fund do if it finds out an investor is a sanctioned person?

A: In the fund management context, firms with exposure to sanctioned persons (e.g., a Russian investor or investment in Russia), should isolate these persons in accordance with the fund governing documents, which can result in implications such as:

- Ceasing funding to Russian investments and potential divestment;
- Cease capital calls and distributions in relation to Russian persons;
- Freezing a sanctioned investors' interest or
- Forcing the redemption of a sanctioned investor's interest, or forcing the sale of the sanctioned investor's interest.

As firms are prohibited from further dealing with a sanctioned party, asset managers cannot give the investors the proceeds from an asset sale or simply return their investment. In these instances, the assets may be put into a blocked account in the relevant jurisdiction. Firms will therefore need to refer to the fund governing documents alongside the relevant sanctions regime's requirements in each applicable jurisdiction, to consider what appropriate action should be taken on a case-by-case basis.

When dealing with a sanctioned investor there is an obligation to report to the OFSI in the UK at the earliest opportunity and, where applicable, to the FCA or relevant EU competent authority if, as a relevant firm, you know or suspect that a breach of financial sanctions has occurred, that a person is a designated person, or you hold frozen assets and that knowledge or suspicion came to you while conducting your business.

In the U.S., you have an obligation to file a report with OFAC, within 10 days, of any blocked or rejected transaction.

Q: What happens if an investor is sanctioned under UK/EU law but not U.S. law?

A: The U.S., UK, and EU sanctions regimes are distinct and need to be considered individually. But when an investor is sanctioned, even in one jurisdiction, it can impact the overall AML risk that the investor presents. It may also impact the ability of the fund to make distributions or receive money from the investor due to other sanctions regulations at play – for example, restrictions on the ability of financial institutions to process transactions with Russian parties.

Q: What are the types of transactions that are potentially subject to sanctions that private investment funds need to consider?

A: There are a number of contexts in which sanctions issues can arise in the private investment fund sector. Asset managers will need to consider the impact of direct exposure they may be subject to, where they are operating in jurisdictions which are, or may become, the target of sanctions and should also prepare for investor-related issues where existing or potential investors are or may become subject to sanctions. Portfolio-level issues are also relevant, for example, where restrictions may be imposed on entering into new transactions with respect to assets that are subject to sanctions and asset freezes, which could impact portfolio companies.

Q: Is it possible to ask for OFAC's opinion or approval of a transaction that is or might be in violation of the letter but not the spirit of the sanctions?

A: Yes, in these circumstances, you can apply to OFAC for a "specific license." In the submission, you must explain why you are asking for permission to do something that is otherwise prohibited, and why that permission would be consistent with the policy underlying the sanctions. While obtaining a specific license can be very helpful, there are downsides to the license process. OFAC can take a very long time to act on license applications, and, in the meantime, you clearly cannot proceed with an activity that you believe is prohibited.

OFAC also issues general licenses which you do not need to apply for. Rather, the general license is an exemption to how the sanctions would normally apply and general licenses are periodically issued by OFAC when the agency sees a widespread need for a license. For example, general licenses often set forth wind-down periods in which otherwise prohibited transactions are permitted, so that people have time to comply with new sanctions.



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