Clients&FriendsMemo

Unwelcome Intrusion: Reckoning with the Impact of Economic Sanctions on Derivatives Transactions

March 1, 2021

I. A Growing Risk

The United States, along with the United Kingdom and European Union, has increasingly wielded economic sanctions against major commercial actors and financial transactions, sometimes roiling global markets in the process. It is now common for sanctions to target not only rogue regimes, terrorists, and drug traffickers, but also major corporations that are deeply integrated into international financial markets – including derivatives markets. For evidence of this trend, one need look no further than the November 12, 2020 Executive Order ("E.O.") "on Addressing the Threat from Securities Investments that Finance Communist Chinese Military Companies." The Order prohibits transactions by U.S. persons in the securities of identified Communist Chinese military companies ("CCMCs"), including "any securities that are derivative of, or are designed to provide investment exposure to such securities."[1]

Market participants have taken note. In 2019, the International Swaps and Derivatives Association ("ISDA") released a Whitepaper on the potential effects of sanctions on derivatives.[2] In general, the imposition of sanctions can impact derivatives where, among other things: (i) a party to a derivative is targeted by sanctions, (ii) the issuer of the underlying asset of a derivative is the target of sanctions, or (iii) an index on which a derivative is based includes an asset issued by an entity targeted by sanctions (*e.g.*, a reference issuer in an index).

In December 2020, ISDA followed up with publication of a Guidance Note for Addressing Sanctions Issues in ISDA Documentation (the "Guidance Note").[3] The Guidance Note focuses on the circumstance when a ***party*** to a derivative is the target of sanctions, and it provides useful

1 See E.O. 13959 (Nov. 12, 2020).

2 ISDA, Whitepaper – Economic Sanctions Programs & Derivatives (Dec. 18, 2019).

3 ISDA, Guidance Note for Addressing Sanctions Issues in ISDA Documentation (Dec. 15, 2020). ISDA makes clear that the Guidance Note is not a recommendation that specific contractual language be included as standard in all ISDA documentation. Rather, the utility of specific sanctions-related provisions will depend on the facts and circumstances of each transaction. Parties to contracts remain free to negotiate the scope and precise terms of any contractual provisions.

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background and considerations for market participants seeking to address this issue. Part II of this memo discusses the Guidance Note's example definitions, representations, and other contractual terms, which – based on the circumstances of a transaction – should be considered for inclusion in ISDA documentation. Many of the provisions discussed in the Guidance Note closely mirror language that for years has been used in certain commercial lending, trade, investment, and similar agreements, while other provisions reflect the unique characteristics of derivatives transactions.

However, the impact of sanctions on derivatives transactions goes beyond this particular scenario, as highlighted in ISDA's 2019 Whitepaper. Part III of this memo discusses the challenges that arise when sanctions are directed at an asset referenced in a derivative or an index on which a derivative is based. In many ways, sanctions of this type present thornier issues, as they have the potential to prohibit some or all dealings in affected derivatives across a range of products for all market participants who are subject to the restrictions. And even where certain transactions are explicitly permitted for buyers and sellers, the extension of relevant authorizations to market intermediaries may be unclear. The potential for uncertainty in these circumstances has been on display during the implementation of the recent U.S. sanctions targeting certain Chinese securities. As discussed below, parties may find some protection in existing contractual terms, but clear guidance from regulators, as well as reasonable exemptions, authorizations and wind-down periods, are critical to stable, well-functioning derivatives markets.

II. Strategies for Managing Counterparty Sanctions Risk in Derivatives Transactions

A. Identifying Counterparty Sanctions Risk

Derivatives trading relationships may be affected by sanctions in a number of ways. First and foremost, a counterparty may become the target of sanctions, either because it has been specifically designated by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") or another sanctions authority, or because it is incorporated, domiciled, or maintains business operations in a jurisdiction targeted by comprehensive sanctions.[4] A counterparty also generally will be deemed a sanctions target if it is owned at least 50 percent by one or more sanctioned parties. Sanctions also may impact a trading relationship when they target a financial institution or other entity that supports one or more parties' obligations (*e.g.*, as a credit support provider) under a derivatives agreement. In addition, sanctions concerns arise where a counterparty uses proceeds from transactions under a derivatives agreement in a way that violates sanctions, or where a derivatives transaction otherwise facilitates activities that are prohibited by sanctions.

4 OFAC has primary responsibility for the administration and civil enforcement of economic sanctions laws in the United States. Major non-U.S. sanctions authorities include the UK Office of Financial Sanctions Implementation ("OFSI"), a part of Her Majesty's Treasury, the Council of the European Union, and the United Nations Security Council.

The propensity for new sanctions to be imposed quickly and without warning makes it impossible to identify all sanctions risks in advance. Nonetheless, certain factors may indicate an elevated risk level, and thus warrant consideration of the contractual terms discussed below. For example, sanctions risk is greater where a counterparty does business in a jurisdiction targeted by sanctions, *e.g.*, Iran or Cuba, or with sanctioned parties, *e.g.*, Venezuela's state-owned oil company Petróleos de Venezuela, S.A. ("PdVSA"). Such parties would be at higher risk of being named to OFAC's Specially Designated Nationals and Blocked Persons List ("SDN List") or otherwise impacted by sanctions. They could also create exposure to sanctions liability for their counterparties by using the proceeds of a derivatives agreement to further business with a sanctions target.

B. Example Sanctions Provisions for ISDA Documentation

When a party to a derivatives agreement is targeted by sanctions, the result may be that all transactions under that agreement are immediately prohibited, making it extremely difficult – if not impossible – for counterparties permissibly to wind down the relationship. And where one party uses a derivatives trading relationship to finance or otherwise facilitate sanctioned activity, the counterparty may be left without any contractual basis for terminating the relationship. To guard against these risks, the Guidance Note discusses example definitions, representations, and other contractual terms that should be considered for inclusion, on a case-by-case basis, in certain ISDA documentation (namely, the 1992 and 2002 ISDA Master Agreements, the 1994 and 1995 ISDA Credit Support Annexes, and the 1995 ISDA Credit Support Deed).

1. Sanctions-Related Definitions and Representations

The Guidance Note's sample definitions will be familiar to practitioners experienced with sanctions provisions that are routinely included in many loan, investment and other types of documentation. For example, the Guidance Note suggests that "Sanctions Authority" be defined to include agencies responsible for the imposition of sanctions in major jurisdictions, including the United States, the United Kingdom, and the European Union, as well as the United Nations and other jurisdictions relevant to a particular transaction. "Sanctions" is defined broadly to include "any economic or financial sanctions, trade embargoes or other similar prohibitions or restrictions." Consistent with sanctions laws in the United States and the European Union, the example definition of "Sanctions Target" is broad enough to cover entities owned 50 percent or more by one or more sanctioned parties.

When sanctions risks are present, parties should consider utilizing representations regarding the "sanctions status of a counterparty," which asks the counterparty to represent that they are not a "Sanctions Target." Where applicable, this representation should be given on a repeating basis as of each date on which a transaction is entered into. Other useful terms include a representation regarding the non-sanctioned "use of transactions or proceeds," in which a party represents that they will not use proceeds of the transaction in a manner that would violate sanctions. The Guidance Note also suggests consideration of a representation that transactions are not connected

to the issuance of "any debt or equity obligation which is subject to any restrictions on dealings by any Sanctions Authority." This language reflects the increased incidence of U.S. and other sanctions targeting debt and equity securities, discussed further below.

2. Sanctions-Related Termination Events

Beyond definitions and basic representations, the Guidance Note suggests consideration of additional provisions concerning sanctions-related termination events, payment and delivery obligations, termination payments, and the transfer or novation of transactions following a sanctions-related termination event. Each of these provisions seeks to manage the challenges, uncertainties, and potential economic harm for non-sanctioned parties involved in derivatives transactions.

While the 1992 and 2002 ISDA Master Agreements include an "Illegality" termination event that would cover certain scenarios related to the application of sanctions, other considerations may warrant inclusion of an Additional Termination Event specifically addressing sanctions issues (a "Sanctions ATE"). For example, in some cases performance of an obligation may not be illegal, but could nonetheless expose a party to so-called "secondary sanctions" that target non-U.S. banks and other firms that engage in specified dealings with a "primary" sanctions target, *e.g.*, certain Iranian financial institutions and Russian investments. These sanctions could include measures ranging from visa restrictions on managers at the offending firm, to denial of export or import licenses, restrictions on the maintenance of U.S. correspondent and payable-through accounts, and even full "blocking" (*i.e.*, designation to the SDN List). Secondary sanctions are an increasingly common component of U.S. sanctions programs,[5] underscoring the potential utility of an ATE tailored to sanctions risk.

Similarly, a Sanctions ATE could permit termination where a sanctions-related representation has been breached, even if that breach does not make transactions under the agreement illegal (*e.g.*, where breach by one party exposes a counterparty to material reputational risk arising from its dealings with a sanctions target). A Sanctions ATE also could prove beneficial where a sanctions program provides for a "wind-down" period during which contractual relationships can be unwound – but where the applicable agreement does not otherwise provide a party with the right to terminate the relationship before the end of the wind-down period.

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5 For example, section 5(b) of the Hong Kong Autonomy Act of 2020, Pub. L. 116-149, directs the Department of the Treasury to impose sanctions on foreign financial institutions that conduct one or more "significant transactions" with persons identified as having materially contributed to the erosion of the autonomy of the Hong Kong Special Administrative Region. Similarly, section 231 of the Countering America's Adversaries Through Sanctions Act of 2017 ("CAATSA"), Pub. L. 115-44, mandates sanctions against persons who knowingly engage in a significant transaction with identified entities operating in the Russian defense or intelligence sectors. Under this provision of CAATSA, sanctions were imposed on a Chinese entity and individual in September 2018, and on a Turkish entity and four individuals in December 2020.

Accordingly, the example ATEs discussed in the Guidance Note would provide for termination where (i) a party becomes a sanctions target, or acts directly or indirectly on behalf of a sanctions target; or (ii) any cash, securities or other deliveries under the agreement are used to finance or facilitate activity in violation of sanctions. In lieu of a specific ATE covering these events, parties may rely instead on an event of default caused by breach of the sanctions-related representations discussed above, assuming such representations are included in the documentation governing the relationship.

Additional ATEs discussed in the Guidance Note provide for termination where performance of an obligation is impossible, impracticable, or unlawful for reasons not covered in items (i) and (ii), above, or where a relevant sanctions authority announces its intent to implement sanctions that would give rise to one of the aforementioned ATEs, but where the sanctions have not yet been implemented. A final Sanctions ATE would apply where any sanctions-related representation proves to have been incorrect or misleading when made or repeated.

3. Deferral of Payment and Deliveries

The Guidance Note highlights that even where a Sanctions Termination Event has occurred, the non-sanctioned party may be left with payment or delivery obligations that are impermissible under applicable sanctions. A potential means of mitigating this risk is the inclusion of an additional "Specified Condition" in the Schedule to the Master Agreement (to the extent ATEs are not already captured as a Specified Condition), stating that each obligation of the non-sanctioned party "is subject to the further condition precedent that no Sanctions Termination Event has occurred and is continuing." This provision could – depending on the definition of "Sanctions Termination Event" – prevent a non-sanctioned party from being required to make payments where doing so would be prohibited under applicable sanctions, and protect the non-sanctioned party from triggering an event of default for failure to pay.

4. Determination and Payment of Termination Payments

The imposition of sanctions could trigger significant changes in the size and direction of future obligations under a derivatives agreement. This potential shift in exposure is one of the most vexing implications of sanctions on derivatives. Moreover, the Guidance Note explains that a provision on "Deferral of Payment and Deliveries" (discussed above) would defer – but not eliminate – a non-sanctioned party's obligations. Additionally, applicable sanctions may prohibit the non-sanctioned party from closing out the transaction.

To address this concern, parties may wish to include additional protections against a post-sanctions swing in exposure. In this regard, the Guidance Note suggests consideration of an entirely novel clause to provide the non-sanctioned party with the ability to "crystallize" (*i.e.*, "fix") the value of any termination payment – even if that payment could not legally be made at the time due to sanctions restrictions. Under the Guidance Note's example language, the "Crystallization

Date" may be determined by the non-sanctioned party following occurrence of a Sanctions Termination Event (or determined automatically upon occurrence of a Sanctions Termination Event, if applicable sanctions would not permit the non-sanctioned party to make such determination). The example provisions also would allow for covered payments to be made into a blocked account, where required by applicable sanctions.

5. Transfers Following a Sanctions Event

Lastly, the Guidance Note suggests consideration of a provision to permit the non-sanctioned party to transfer an agreement, or all or part of its rights and obligations, "following the occurrence of a Sanctions Termination Event." Such a provision could allow for the orderly divestment of an agreement in cases where the applicable sanctions permit a "wind-down" period.

C. The EU and UK Blocking Regulations

The Guidance Note also highlights the difficulties that may be faced by derivative counterparties where conflicts of laws issues might arise when dealing with sanctions issues. In particular, Article 5 of the EU Blocking Regulation[6] prohibits EU persons from complying (directly or indirectly) with any requirement or prohibition based on or resulting (directly or indirectly) from certain U.S. sanctions targeting Iran and Cuba. We note that the United Kingdom has also introduced an "onshored" version of the EU Blocking Regulation and supporting implementing measures following its departure from the European Union, by virtue of the European Union (Withdrawal) Act 2018 and the Protecting against the Effects of the Extraterritorial Application of Third Country Legislation (Amendment) (EU Exit) Regulations 2020. In the context of a derivatives transaction, these blocking regimes would apply to legal persons incorporated in the European Union or the United Kingdom (as applicable), but not branches of non-EU/UK financial institutions located in either territory.

The Guidance Note suggests that where a party is subject to these restrictions, it may wish to consider limiting the scope of sanctions provisions solely to the extent that those provisions would be permissible under relevant blocking laws. However, the Guidance Note provides no clear solution to the issue of competing regulatory obligations and risks for such parties, and it is clearly key for parties to obtain advice from legal counsel on these issues before agreeing to modifications to the scope of the sanctions provisions in derivative arrangements.

III. Beyond Counterparties: "Underlying" Sanctions Risk

As mentioned above, the Guidance Note does not cover ***all*** potential sanctions risks that may present themselves in connection with derivatives transactions. In particular, it does not address the

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6 Council Regulation (EC) No. 2271/96.

impact of sanctions on dealings in "reference transactions," *i.e.*, credit or equity derivatives linked to the debt obligations or shares of a sanctioned entity.

A. Understanding the Impact of Sanctions on Derivatives Underliers

The potential effects of sanctions on derivatives underliers are neither insignificant nor theoretical. In fact, economic sanctions, especially those imposed by the United States, increasingly are designed to target financial products of various types, including derivatives. This was seen in connection with 2014 sanctions against Russia, as well as Venezuela-related sanctions in 2017 and, more recently, the November 12, 2020 E.O. targeting the securities of Chinese companies alleged to have close ties to that country's defense and intelligence agencies.

1. Which Products Are Targeted?

When sanctions take aim at securities and other financial products, a threshold question is whether prohibitions on investment, trading, and other activities also apply to related derivatives transactions. In some cases, such as the recent sanctions targeting certain Chinese securities, the answer is clear: the E.O. explicitly applies to "any securities that are derivative of" the publicly traded securities of identified Communist Chinese military companies.[7] Much less clear is the ***scope*** of derivatives (and securities) covered by the Order: the definition of "securities" includes – but may not be limited to – the broad definition of "security" found at section 3(a)(10) of the Securities Exchange Act of 1934.

As of the date of this writing, OFAC has provided limited guidance as to the boundaries of the term "securities" under E.O. 13959. In FAQ 860, the agency offered the somewhat tautological explanation that covered instruments "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" – but only to the extent such products meet the definition of "security" under the E.O. [8]

Other sanctions programs also have implications for derivatives. In 2014, Russia-related sanctions placed restrictions on dealings in certain debt and equities of named companies, although those sanctions did not explicitly include or exclude derivatives.[9] To resolve this ambiguity, OFAC issued a General License specifically authorizing transactions "involving derivative products whose value is linked to an underlying asset" covered by the sanctions.[10]

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7 See E.O. 13959 (Nov. 12, 2020).

8 See OFAC FAQ 860 (Dec. 28, 2020).

9 See Directives 1, 2, and 3, which were issued pursuant to E.O. 13662 and prohibit dealings in certain debt and equity of named companies in the Russian financial, energy, and defense sectors.

10 See Ukraine General License No. 1B.

Similarly, in the case of Venezuela sanctions, E.O. 13808 prohibited transactions related to certain debt and equity issued by the Government of Venezuela, including PdVSA, the state-owned oil company. [11] OFAC issued guidance clarifying that Venezuela General License No. 3 authorizes derivatives transactions related to certain bonds impacted by sanctions. As OFAC further explained, "[o]ne corollary to this authorization is that U.S. persons are not authorized to buy, sell, or otherwise deal in derivatives that reference bonds" not covered by the General License.[12]

Further complicating matters, market participants cannot assume that derivatives-related guidance provided in the context of one sanctions program can be extended or extrapolated to other sanctions programs. For example, in the context of Venezuela sanctions, OFAC issued FAQ 653 on January 31, 2019, addressing the application of those sanctions to synthetic ETFs. OFAC explained that, in general, U.S. persons may trade in shares of synthetic ETFs that track baskets of debt, equity, or other holdings, even where the underlying basket includes entities named on OFAC's SDN List – as long as the fund in question includes only synthetic risk, and the SDN component of the basket is "less than a predominant share by value."[13] Compare that guidance to FAQ 861, related to the recent China sanctions, in which OFAC advised that investments in ETFs and index funds are prohibited if they include covered securities, or any securities that are derivative of (or are designed to provide investment exposure to) such securities, "regardless of such securities' share of the underlying index fund, ETF, or derivative thereof."[14]

2. Which Parties and Activities Are Targeted?

In addition to addressing the threshold question of whether (and which) derivatives are impacted by sanctions, market participants also must understand what activities are prohibited, and to whom prohibitions apply. For example, in the case of E.O. 13959 (as amended by E.O. 13974) U.S. persons are prohibited from engaging in "transactions" in covered Chinese securities, defined as a "purchase for value, or sale."[15] The E.O. also explicitly permits U.S. persons to divest their holdings during a one-year wind-down period,[16] but it is silent as to whether U.S. intermediaries can take part in effecting these divestment transactions.

OFAC responded to this uncertainty in FAQ 863, confirming that U.S. intermediaries may engage in "clearing, execution, settlement, custody, transfer agency, back-end services, as well as other such support services," but only "to the extent that such support services are not provided to U.S.

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11 See E.O. 13808 (Aug. 24, 2017).

12 See OFAC FAQ 524 (Jul. 19, 2019).

13 See OFAC FAQ 653 (last updated Jan. 31, 2019).

14 See OFAC FAQ 861 (Dec. 28, 2020).

15 E.O. 13959 § 4(e), as amended by E.O. 13974 § 3.

16 E.O. 13959 § 1(b).

persons in connection with prohibited transactions."[17] Similarly, in FAQ 856, OFAC stated that: "Market intermediaries and other participants may engage in ancillary or intermediary activities that are necessary to effect divestiture during the relevant wind-down periods or that are otherwise not prohibited under the E.O."[18]

As illustrated by the recent sanctions on Chinese securities, timely and precise regulatory guidance is critical to minimizing market disruption and unnecessary harm to non-sanctioned parties. Indeed, central to ISDA's December 2019 Whitepaper was a call to regulators for more predictability regarding the application of sanctions to derivatives products. Regulators can also promote market stability by crafting reasonable exemptions, authorizations, and wind-down periods.

B. Addressing Sanctions On Derivatives Underliers

When sanctions impact a derivative's underlier, the development of a market-wide solution may be more effective than the negotiation of contract terms on a case-by-case basis – assuming that regulators permit the activities involved in effecting the market's preferred solution. The Guidance Note cites the 2017 ISDA Venezuela Additional Provisions Protocol as an example of a successful market-wide approach. In that case, ISDA published new terms for transactions related to certain sanctioned Venezuela-related debt obligations, which parties could choose to adopt, and thereby exclude sanctioned obligations from the scope of "Obligations" and "Deliverable Obligations." In doing so, parties were able to ensure that these sanctioned obligations would not trigger a "Credit Event" or be delivered in a credit default swap auction.

For many types of derivatives documented under ISDA standard terms, additional provisions to address sanctions on underliers may not always be necessary. For example, market participants that document equity derivatives under the ISDA 2002 ISDA Equity Derivatives Definitions often include "Additional Disruption Events" that permit a counterparty to the transaction to terminate under specified circumstances.[19] A transaction that incorporates the "Change in Law" provision in 12.9(a)(ii) of the Equity Definitions may permit a person to terminate a transaction where it has become "illegal to hold, acquire or dispose of [hedge shares]." This could arise, for example, where a dealer engages in a derivative with a counterparty that references an equity security, in which the counterparty seeks long exposure to that equity security. If the equity security was targeted by sanctions, the dealer – who has likely acquired the security as a hedge to its obligations under the derivative – could potentially rely on "Change in Law" to terminate the transaction.[20] The Equity

17 See OFAC FAQ 863 (Jan. 6, 2021).

18 See OFAC FAQ 865 (Jan. 6, 2021).

19 ISDA also published a 2011 version of the Equity Derivatives Definitions. We make reference to the 2002 version, given that those remain more commonly used by market participants.

20 Market participants often expand the scope of the definition of "Change in Law" in practice, and should consider whether existing phrasing appropriately captures sanctions-related risks.

Definitions contain other terms that could also be relevant to sanctions. For example, "Hedging Disruption" (generally applies where a hedging party is unable to maintain its hedge) and "Loss of Stock Borrow" (generally applies where a hedging party is unable to maintain a stock borrow – for example, where the counterparty is short via derivative and the dealer engages in short sale to hedge its position); each of these terms could be triggered by sanctions that affect the underlier.

However, notwithstanding the potential application of these terms, firms that engage in derivatives should closely review standard terms to consider whether appropriate protections are included. The Equity Definitions were not drafted with the subtleties of sanctions issues in mind and updates to standardized terms (the Additional Disruption Events in the Equity Definitions are already commonly modified by market participants) could increase certainty that appropriate protections are in place.

IV. Conclusions

The Guidance Note provides a helpful framework for analyzing important counterparty sanctions risks, and for negotiating contractual protections where appropriate. Of course, the variety of sanctions risks – like the variety of derivatives transactions – is nearly endless, and the Guidance Note should be the start of a party's analysis, not the endpoint. In some cases, for example, contractual protections should be augmented by thorough diligence on a derivative agreement's parties and underliers. Experienced legal counsel should be consulted as agreements are negotiated in order to best prevent sanctions risks from upending transactions.

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