FINANCIAL INTEGRITY NETWORK

Financial Integrity Network Policy Alert
United States Ramps Up Financial Pressure on Venezuela

Summary:

On August 25, 2017, President Donald Trump issued an Executive Order significantly ramping up U.S. sanctions on Venezuela. The Executive Order, along with four general licenses and a number of Frequently Asked Questions relating to the new sanctions, targets the debt and equity of the Government of Venezuela, the debt of Petroleos de Venezuela, S.A. (PdVSA), and a number of other transactions related to payments to the Government of Venezuela and activities of entities it owns or controls. These new actions build on previous rounds of sanctions designations undertaken by the Trump Administration, which to this point have only blocked property of individuals closely associated with the regime of Venezuelan President Nicolas Maduro.

These new measures, which closely resemble some elements of the sectoral sanctions identifications (SSI) program in response to malign Russian activity, are designed to put economic pressure on the Government of Venezuela by making it more difficult to secure international financing and receive payments. The continuing use of such nuanced financial sanctions that prohibit some activities but fall short of full blocking indicates that these sophisticated tools are likely here to stay, and that the Office of Foreign Assets Control (OFAC) at the United States Department of the Treasury will continue to employ them both in this context and against other countries and persons.

This Policy Alert details the five primary prohibitions contained in the Executive Order, "Imposing Additional Sanctions With Respect to the Situation in Venezuela," discusses the four general licenses, and provides an assessment of the implications of these new sanctions for financial institutions.

New Prohibitions:

The new Executive Order contains five primary prohibitions on conducting certain transactions with the Government of Venezuela and entities closely associated with the Government. The Executive Order defines the Government of Venezuela broadly to include any political subdivision, agency, or instrumentality of the Government, as well as the Central Bank of Venezuela and PdVSA, and any person owned or controlled by, or acting for or on behalf of, the Government of

Venezuela. Given this expansive definition, clients should be sure to conduct appropriate due diligence on relevant customers and counterparties to ensure they do not fall under this definition. These prohibitions must be read in conjunction with the general licenses and the Frequently Asked Questions; the Executive Order makes clear what activity is broadly prohibited, but the general licenses carve out exceptions for activities that would otherwise be impermissible. Likewise, the Frequently Asked Questions provide additional detail to help companies better understand the scope of these prohibitions and exceptions.

It is important to note that these restrictions apply only to U.S. persons or for transactions that take place in the United States or otherwise have a U.S. jurisdictional nexus. The prohibitions therefore apply to transactions settled through U.S. institutions, including those that rely on U.S. dollar clearing through U.S. correspondent accounts or involve securities held in custody in the United States or by U.S. persons. Although non-U.S. entities can continue to engage in such activity, they must be exceedingly cautious that no U.S. parties are involved or no other U.S. nexus exists. In addition, it is possible that other countries may impose similar restrictions on transacting in Venezuelan debt and equity.

Finally, as in the case of the sectoral sanctions program targeting designated entities in key sectors of the Russian economy, these prohibitions are not blocking actions. Rather, they are restrictions on certain types of transactions with specified entities.

Prohibition #1: All transactions related to, provision of financing for, and other dealings by a United States person or within the United States in new debt with a maturity of greater than 90 days of PdVSA.

Implications: This prohibition closely resembles SSI-style restrictions imposed on Russian companies in the early days of the Russia sanctions program in 2014. Based on the clear language of this prohibition, U.S. persons are not permitted to engage in any transaction in new debt with maturity over 90 days of PdVSA. The purpose of this sanction is to squeeze PdVSA's ability to secure debt on open markets and put additional economic pressure on the state-owned energy company. It is important to note that OFAC broadly interprets the definition of "new" and "debt", and while certain definitions are included in the FAQs, financial institutions should take a conservative approach when determining whether a product is "new" or "debt" for the purposes of these regulations. The language of this prohibition also appears sufficiently broad to cover secondary markets, meaning U.S. persons will likely be prohibited from transacting in new debt issued by PdvSA on secondary markets.

Prohibition #2: All transactions related to, provision of financing for, and other dealings by a United States person or within the United States in new debt with a maturity of greater than 30 days, or new equity, of the Government of Venezuela, other than debt of PdVSA covered by Prohibition #1.

Implications: This prohibition directly targets Venezuelan sovereign debt and bars U.S. persons from participating in most debt offerings by the Government of Venezuela. The purpose of this prohibition is to squeeze the Government of Venezuela's ability to secure financing on international markets and exacerbate the cash crunch it is experiencing. Note that this is the first time the United States has imposed restrictions in a regime-based program on transacting in a country's sovereign debt. The language of this prohibition appears sufficiently broad to cover secondary markets, meaning U.S. persons will likely be prohibited from transacting in new debt issued by the Government of Venezuela on secondary markets. It also directly limits U.S. persons' ability to transact in new equity of the Government of Venezuela.

Prohibition #3: All transactions related to, provision of financing for, and other dealings by a United States person or within the United States in bonds issued by the Government of Venezuela prior to August 25, 2017.

Implications: This restriction broadly prohibits transacting in bonds issued by the Government of Venezuela *prior to* the imposition of this new Executive Order. While at first glance a broad prohibition that would cover the so-called "hunger bonds" purchased by some U.S. firms in 2017, as well as any other bond issued by the Government of Venezuela since the country began issuing bonds, in practice the restriction is much less expansive. Read in conjunction with General License 3, detailed below, this restriction appears to apply to only a very limited number of Government of Venezuela bonds. At the present time, the only bond that appears to be specifically targeted is the so-called "Ven 36" bond. Note however that, as discussed below, the scope of this prohibition could be expanded to target a greater number of Government of Venezuela bonds if the Treasury Department wanted to put additional pressure on the Maduro regime. The broad scope of this prohibition means that the Treasury Department will not need a new or amended Executive Order to target other bonds. Rather, it will only need to withdraw names listed on the General License 3 annex.

Prohibition #4: All transactions related to, provision of financing for, and other dealings by a United States person or within the United States in dividend payments or other distributions of profits to the Government of Venezuela from any entity owned or controlled, directly or indirectly, by the Government of Venezuela.

Implications: This restriction directly targets the Government of Venezuela's access to revenue by prohibiting U.S. persons from transacting in or providing dividend payments or profits to the Government from any entity it owns or controls. It is important to note here that PdVSA is defined as being an entity owned or controlled by the Government of Venezuela, and thus Citgo Holdings, Inc. and its subsidiaries (Citgo), which is wholly owned by PdVSA, cannot provide dividend payments or profits to its parent company.

Prohibition #5: The purchase, directly or indirectly, by a United States person or within the United States, of securities from the Government of Venezuela, other than securities qualifying as new debt with a maturity of less than or equal to 90 or 30 days as covered by Prohibitions #1 and #2 is prohibited.

Implications: This restriction deprives the Venezuelan government of U.S. capital if it decides to securitize loans longer than 90 days in the case of PdVSA or 30 days in the case of the government itself. This restriction deprives the Venezuelan government of U.S. capital if it decides to issue securities backed by other assets. This is a new restriction, which raises significant compliance challenges related to implementation and interpretation. The restriction indicates that U.S. persons cannot buy such securities and that U.S. persons likely cannot sell such securities within the United States (as such securities may have to be purchased in the U.S., violating the prohibition). OFAC's interpretation of this restriction will be important when determining what activity is ultimately prohibited.

General Licenses:

General License 1: Wind Down Period

These sanctions are effective as of August 25, 2017. However, General License 1 provides that any transaction ordinarily incident to winding down a contract entered into prior to August 25, 2017, that is prohibited by any of the trading restrictions on debt or securities is permissible, so long as the wind down transactions are completed by September 24, 2017. Such wind-down transactions are subject to a reporting requirement to OFAC. Note however that this wind down exception does not apply to distributions of dividends or profits to the Government of Venezuela. All such payments must stop on August 25, 2017.

General License 2: Citgo

General License 2 directly impacts Citgo Holdings, Inc. and its subsidiaries. Citgo Holdings, Inc. is a wholly-owned subsidiary of PdVSA and there is subject to the same restrictions imposed on PdVSA pursuant to the OFAC 50 Percent Rule. To protect Citgo, which has extensive operations in the United States, and to limit the direct impact on the American economy, General License 2 exempts Citgo from the restrictions on debt and the purchase of new securities established in the Executive Order. Importantly and as discussed above, the General License does not authorize dividends or other distributions or profits to the Government of Venezuela or PdVSA, meaning Citgo cannot send any such profits to either entity. Further, any U.S. financial institution engaged in such a transfer would also likely be liable for a sanctions violation in such a scenario.

General License 3: Transacting in Certain Venezuelan Bonds

General License 3 provides a significant carve out for transactions in Government of Venezuela bonds. While the prohibitions in the Executive Order specify that any transactions related to Government of Venezuela bonds issued prior to the date of the Executive Order are prohibited, General License 3 permits all transactions related to bonds specified in an annex to the General License. The annex contains 76 Government of Venezuela bonds and constitutes almost all Government of Venezuela bonds previously issued. General License 3 also authorizes transactions otherwise prohibited involving bonds that were issued prior to August 25, 2017, by U.S. entities that are directly or indirectly owned by the Government of Venezuela.

Financial institutions, when considering transacting in Government of Venezuela bonds issued prior to August 25, 2017, should verify that those bonds are listed on the annex. Note also that OFAC has the discretion to remove those bonds listed in the annex at any time, meaning transactions with those de-listed bonds would become prohibited. While such a scenario is unlikely, financial institutions should consider the possibility when deciding whether to conduct transactions where the financial institution or its clients will be holding such bonds.

General License 4: Authorizing New Debt Transactions Related to the Exportation or Reexportation of Agricultural Commodities, Medicine, Medical Devices, or Replacement Parts and Components

General License 4 specifies that most transactions related to the exportation or reexportation, from the United States or by a U.S. person, of agricultural commodities, medicine, medical devices, and components for medical devices to Venezuela, are authorized. This type of humanitarian license is standard and OFAC regularly issues such licenses to ensure that sanctions do not impede the flow of necessary humanitarian goods to targeted countries.

General Implications:

These new financial sanctions represent a significant escalation in U.S. economic pressure on the Maduro regime. They are sophisticated and present complex challenges to financial institutions doing business in Venezuela, in Venezuelan assets, and in debt and equity markets across the world. In addition to the prohibitions and their implications discussed above, three additional points merit consideration:

1) **Additional U.S. economic pressure is possible.** While these new sanctions are qualitatively different from—and significantly stronger than—previous sanctions imposed on Venezuelan individuals, the United States Government may continue increasing economic pressure on the Maduro regime through a variety of measures. Such potential mechanisms may include prohibiting certain Venezuelan entities from enjoying broad access to U.S. financial markets, prohibitions on importing Venezuelan energy products to the United States, and prohibitions on exporting U.S. energy products to Venezuela. Whether and how the United States decides to ramp up pressure will depend on facts on the ground in the country, the impact on the Maduro regime's capabilities, and how well these new sanctions are judged to be working in changing the regime's behavior. Given the timeframe of these current sanctions—which target Venezuelan debt in the 30-to-90 day time period—the Trump Administration may want to wait and see the impact of these targeted measures on the regime's activities and capabilities before escalating further. However, developments in the country could change this calculus.

2) **Possible unintended consequences.** A number of downstream risks exist here for U.S. policy. PdVSA's ownership of Citgo is a case in point. In 2016, PdVSA took a loan from Rosneft, the Russian energy giant which is subject to restrictions as an SSI. As collateral on that loan, PdVSA pledged 49 percent of Citgo. If PdVSA defaults, Rosneft will consequently own 49 percent of Citgo, which is a major U.S. oil refiner. This presents

significant national security concerns for the United States and is reportedly being examined by the Committee on Foreign Investment in the United States (CFIUS). Further, if Rosneft were to acquire an additional 1 percent of Citgo from PdVSA (*e.g.*, as collateral on an additional loan) and PdVSA were to default, Citgo would be subject to the same sanctions as Rosneft. Under the SSI program, if an entity is owned 50 percent or greater by a designated SSI, it is legally designated as well. In this situation, Citgo would be subject to the same restrictions on new debt as Rosneft. Of course, OFAC could specifically exempt or license ongoing activities of Citgo, potentially conditioned on prohibiting a roll-up of profits or revenue to its owner, Rosneft. This particular situation illustrates the unforeseen and unintended consequences that could arise from this new sanctions program. Financial institutions should remain vigilant and, as appropriate, inform relevant authorities when unintended and undesired consequences emerge.

3) **Complex financial sanctions are here to stay.** This Executive Order indicates that complex financial sanctions, originally developed as part of the Russia/Ukraine sanctions program, are here to stay. These restrictions, which are transaction-specific, provide the United States with precise tool of economic pressure, especially in comparison to comprehensive sanctions programs or blocking designations. In many ways, these tools are also more burdensome on financial institutions. Instead of simply asking whether one can do business with a designated entity, now one must ask whether the type of proposed business could be permissible. This development will likely raise compliance challenges and underscores the importance of integrating traditional sanctions and AML compliance functions to effectively assess and manage the compliance risks associated with such new and sophisticated tools. Our clients should expect to see more of these types of sanctions used in the future, and FIN remains ready to assist in facing the challenges posed by these sophisticated tools of economic statecraft.